ORIGINAL FILE

AT&T

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

92-134

August 14, 1992

Donna R. Searcy, Secretary
Federal Communications Commission
Washington, D.C. 20554

Attention: Common Carrier Bureau

Re: Price Cap Performance Review For AT&T

On July 17, 1992, the Commission released a Notice of Inquiry ("NOI") which commenced the Price Cap Performance Review For AT&T.[1] Paragraph 43 of the NOI directed AT&T to submit the following financial data concerning AT&T's Basket 1 services: (i) revenue, expenses and taxes, net earnings, rate base, and rate of return data for Basket 1 services for each of the first three years of AT&T price cap regulation and overall; and (ii) the effects during this period of changes resulting from depreciation represcriptions, of changes in the accounting treatment for employee post-retirement benefits, and of employee early retirement plans. This submission provides the requested data.

Basket 1 Performance

The Commission instituted price cap regulation in part to eliminate the burdensome and costly regulatory requirements associated with rate of return regulation. Among the regulatory requirements that were eliminated was the obligation to maintain accounting records in compliance with the Interim Cost Allocation Manual ("ICAM").2 The

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1 In the Matter of Price Cap Performance Review For AT&T, Docket No. 92-134, FCC 92-257 (released July 17, 1992).

2 See Policy and Rules Concerning Rates For Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. 2873, paras. 175, 547, released April 17, 1989 ("AT&T Price Cap

(footnote continued on following page)

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List A B C D E

ICAM had identified the terms on which AT&T's costs and expenses were allocated to the Public Switched Network ("PSN") and Private Line ("PL") service categories on a fully-distributed cost basis. Although it eliminated ICAM requirements, the Commission continued to require AT&T to report its overall interstate rate of return on an annual basis under price cap regulation. AT&T has complied with that requirement.

The NOI request for financial data by price cap year that pertain solely to Basket 1 services is inconsistent with the way AT&T maintains its records under price cap regulation. First, AT&T maintains its records by calendar year, not by price cap year. Second, AT&T is not required to maintain and does not maintain financial data by price cap basket. Compliance with the request required AT&T after-the-fact to allocate its costs and expenses for the three years of price cap regulation between Basket 1 services and all other services. Such an allocation in effect requires a fully-distributed cost process comparable to the former ICAM methodologies.

AT&T has attempted to comply with the Commission's request despite the unavailability of cost allocation data which are not compiled or maintained under price cap regulation. Where possible, AT&T has allocated costs and expenses in a manner consistent with the methodologies specified by the former ICAM. In some instances, historical data necessary to perform such allocations were not available. For those costs and expenses, AT&T used available current data.

Based on the foregoing principles, AT&T developed the requested Basket 1 financial data, using the following allocation methodologies:

- Revenues for Basket 1 were based on AT&T's accounting records.
- Investments and reserves were allocated where possible based on ICAM-like procedures. AT&T allocated PSN investments and reserves to Basket 1 on the basis of relative usage.
- Expenses (including access expenses) and taxes were directly assigned where applicable or were allocated based on ICAM-like methodologies.

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Order"). The Commission concluded in the AT&T Price Cap Order (at para. 547) that the ICAM requirements were not applicable under price cap regulation and noted that the ICAM categories did not in any event match the price cap service categories.

Pursuant to these principles, AT&T developed the requested data, which are included in Exhibit A to this submission. At the Commission's direction, AT&T has included year-by-year Basket 1 results as well as the overall Basket 1 results for the three-year price cap period. A year-by-year approach, however, is inconsistent with the way the Commission formerly regulated AT&T's rate of return, which evaluated periods longer than a single year.

Impact on Basket 1 of Specified Accounting Events

The second category of financial data requested by the Commission concerned certain events that occurred during the first three years of price cap regulation. Specifically, the Commission inquired about the effects on Basket 1 during this period of changes resulting from depreciation represcriptions, of changes in the accounting treatment for employee post-retirement benefits, and of employee early retirement plans. NOI, para. 43.

The three accounting events for which the NOI seeks data were all made in the ordinary course of business in accordance with generally accepted accounting principles and were fully disclosed to the Commission. In addition, these events were consistent with accounting events that occurred prior to price cap regulation; i.e., prior to price cap regulation, the Commission represcribed AT&T's depreciation rates and the Commission approved entries for pension accruals and other employee-related expenses. Consequently, AT&T questions the relevance of these three particular categories of events to the Commission's analysis of AT&T's performance under price cap regulation. Nevertheless, this submission provides the information sought by the Commission.

To quantify the impact on Basket 1 of the changes at issue, AT&T first developed a process to compute the impact of these items by price cap year on AT&T's total interstate results. AT&T then allocated the interstate impact to Basket 1 based on the methodology described in the preceding section of this submission. As with the computation of Basket 1 financial results, AT&T's after-the-fact computation of the Basket 1 impact of the three accounting events is necessarily imprecise. Exhibit B to this submission sets forth the results of AT&T's analyses and further describes AT&T's methodology.

Respectfully,

Joel E Lubin

Exhibit A

BASKET 1 RESULTS FOR EACH PRICE CAP YEAR

($ MILLIONS)

ITEM	YEAR 1	YEAR 2	YEAR 3	OVERALL*
TOTAL REVENUES	13,541	13,396	13,826	40,763
TOTAL EXPENSES AND TAXES	13,149	12,871	13,438	39,458
NET EARNINGS	392	525	388	1,305
AVG. NET INVESTMENT	5,631	5,224	5,246	5,367
RATE OF RETURN (NET.EARNINGS/AVG.NET INV.)	7.0	10.0	7.4	8.1

* The Multiplicative factor used for annualizing Rate of Return for the overall measurement period was 0.3333

BASKET IMPACT OF THREE SPECIFIED ACCOUNTING EVENTS
($ Millions)

Results

BASKET 1 IMPACT

Period: 07-01-89 to 06-30-90	Deprec.	Post-Retire. Benefits	Early Retirement
Depreciation Expense	385		
All Other Expenses	(10)	72	81
Income Adjustment for FIT	19		
ITC Amortization	27		
Average Net Investment	(191)	4	

BASKET 1 IMPACT

Period: 07-01-90 to 06-30-91	Deprec.	Post-Retire. Benefits	Early Retirement
Depreciation Expense	441		
All Other Expenses	(11)	145	
Income Adjustment for FIT	11		
ITC Amortization	40		
Average Net Investment	(489)	36	

BASKET 1 IMPACT

Period: 07-01-91 to 06-30-92	Deprec.	Post-Retire. Benefits	Early Retirement
Depreciation Expense	388		
All Other Expenses	(11)	145	
Income Adjustment for FIT	15		
ITC Amortization	8		
Average Net Investment	(833)	91	

Methodology

AT&T first developed a process to compute the impact of the three accounting items by price cap year on: interstate depreciation expense; all other expense (including state and local taxes); income adjustments for federal income tax ("FIT"); investment tax credit ("ITC") amortization; and average net investment. AT&T next took the results of the foregoing process and assigned the changes to Basket 1 based on the same fully-distributed cost methodology by which AT&T computed the Basket 1 financial results requested by the Commission and provided in Exhibit A of this submission.

1. Depreciation Represcription

The Commission authorized depreciation rate represcriptions effective January 1989 and January 1991.[3] To quantify the impact of these changes on total interstate depreciation expense, AT&T computed its average depreciable Telecommunications Plant in Service for each of the price cap years. AT&T then applied the 1988 Commission-prescribed depreciation rates to these averages to determine what AT&T's depreciation accrual level would have been using the 1988 rates. In addition, AT&T identified the Commission-prescribed amortization amounts by rate category and added those amounts to the computed depreciation accrual amounts to determine the total depreciation expense levels that would have resulted without the 1989 and 1991 represcriptions. The difference between the result of this computation and AT&T's actual booked depreciation expense represents the depreciation expense increase attributable to the Commission's represcriptions.

The depreciation expense generated by the 1989 and 1991 represcriptions resulted in a decrease in property tax in those states that determine property tax on the basis of income. AT&T computed the property tax impact by comparing actual levied taxes to what they would have been if the depreciation represcriptions had not occurred.

The change in depreciation rates resulting from the 1989 and 1991 represcriptions also resulted in an increase in the amortization of surplus deferred income tax and the amortization of investment tax credits. Based on the restatement of depreciation to reflect the 1988 rates, AT&T recalculated surplus deferred income tax and the amortized investment tax credits, with a decrease resulting in both categories.

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3 In the Matter of The Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, as amended, for American Telephone and Telegraph Company, 5 FCC Rcd. 660 (1990); In the Matter of The Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, as amended, for AT&T Communications, 7 FCC Rcd. 1050 (1992).

AT&T also computed the impact of the represcriptions on Average Net Investment. The represcriptions increased AT&T's Depreciation Reserve, which decreased Average Net Investment. In addition, the represcriptions decreased deferred tax reserves,[4] which in turn increased Average Net Investment.

2. Other Post-Retirement Benefits

AT&T's earnings were affected in each of the price cap periods by a change in the accounting treatment for employee post-retirement benefits pursuant to which AT&T recognized (accrued) expenses in current periods to fund future post-retirement benefits. This change in accounting treatment is now required by the Commission's adoption of Statement of Financial Accounting Standards, No. 106.[5] AT&T calculated the impact of this change on interstate expense by computing the difference between the accrual basis and the pay-as-you-go (cash accounting) method. The resulting increase in expense decreased net income in each of the price cap periods. It also lowered property taxes in those states that impose property taxes based on net income. AT&T computed the property tax impact by comparing actual levied taxes to what they would have been if the accounting change had not occurred.

The change in accounting for employee post-retirement benefits also affected deferred taxes because of the timing difference between book expense recognition and tax expense recognition. The change decreased deferred tax reserves which in turn increased Average Net Investment.

3. Early Retirement Plans

AT&T decreased the size of its staff by offering a one-time voluntary retirement plan to many of its employees in 1990. The early retirement expense decreased net income and lowered property taxes in those states that impose property taxes based on net income. AT&T computed the property tax impact by comparing actual levied taxes to what they would have been if the early retirement had not occurred.

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4 AT&T recalculated deferred tax reserves as if the represcriptions had not occurred. The difference between the result of that calculation and the amount actually booked yielded a decrease in deferred tax reserves. This occurred because the effect of higher depreciation is to close the gap between booked depreciation and accelerated depreciation for tax purposes, which lowers deferred tax reserves.

5 In the Matter of Southwestern Bell, GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, AAD 91-80 (released December 26, 1991).