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AT&T

ORIGINAL FILE

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September 2, 1992

Ms. Donna Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

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SEP 2 1992

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: *Ex Parte* Presentation
CC Docket No. 92-101

Dear Ms. Searcy:

Today, Fred Jones, Jim Sabine, and I, representing AT&T, met with Chris Frentrup, Dan Grosh, and Michael Mandigo of the Common Carrier Bureau to discuss AT&T's position on the price cap exogenous cost treatment of OPEB (Other Post-Employment Benefit) expense. We reiterated our position as filed on July 1, 1992 in opposition to the Local Exchange Company direct cases on this issue. We also provided responses to issues raised by the Local Exchange Companies in their replies to our comments. The attached material was used in our discussion.

Two copies of this Notice are being submitted to the Secretary of the FCC today in accordance with Section 1.1206(a) (1) of the Commission's Rules.

Sincerely,

Charles H. King

Copies to: Chris Frentrup
Dan Grosh
Michael Mandigo

Attachments

0+1

Our presentation is outlined as follows:

I. **Some limitations should be placed on the LECs' SFAS 106 accrual calculation for exogenous price cap treatment purposes**

II. **The LECs have not shown that their SFAS 106 accruals have properly considered the "double count" associated with GNP-PI**

III. **Only Prefunded OPEB costs should be considered for exogenous treatment**

I. Some limitations should be placed on the LECs SFAS 106 accruals for Exogenous Price Cap Treatment Purposes

o A limitation is appropriate because

- OPEB costs are substantially within the LECs' control

- full exogenous treatment could give the LECs an unearned windfall.

- OPEB accrual amounts are somewhat speculative

The FCC should establish parameters to be used by the carriers in their OPEB calculations used for Price Cap purposes

- o AT&T believes some restraint on full exogenous treatment is required

- o Ratepayers must be protected from the possibility of overstated OPEB accruals

  - If overstated, there is no mechanism for making the ratepayer whole again. The Price Cap rules would treat any savings that are realized as an apparent productivity gain.

- o The parameters AT&T proposed to be utilized for Exogenous Treatment Purposes

  1) Caps - Companies should assume Medical Expense Plan, Medicare Part B premium reimbursements, and Dental Care costs per employee will be capped at the level projected as of January 1, 1993. No"substantive plan" increases should be included.

  2) Discount rate - 9% as Bell South has utilized.

  3) Rate of Return on Plan Assets - 9% as NYNEX has utilized.

  4) Health Care Trend Rate - 10% in 1991, decreasing by 0.4% annually to 4% in 2006 as Ameritech has utilized.

- The LECs have misunderstood the AT&T proposal
  - Parameters only affect calculation for Price Caps
  - LECs are free to offer any benefit level they choose.
  - AT&T recognizes that actual LEC costs estimated will vary due to differences in demographics.
- Setting parameters is an appropriate approach.
  - The suggested parameters are within a range of reasonableness and in accordance with GAAP. FASB Interpretation No. 14, para 3, in addressing the reasonable estimation of losses or liabilities, states, "when no amount within the range is a better estimate than any other amount,...the minimum amount in the range shall be accrued."
- Parameters set are logical and supportable
- AT&T selected "best in class" individual assumptions actually proposed by LECs themselves

- An alternative approach would be to select the total "best in class" assumptions of a single LEC.

- Ameritech's optimal health care trend rate assumption makes their total assumptions the most conservative.

- Using Ameritech's assumptions, AT&T projects a reduction in total SFAS 106 LEC accruals of approximately 20 - 25% before accounting for the double count issue.

Table 1

Estimated Reduction in exogenous cost if Ameritech's parameter assumptions are utilized for Discount Rate, Rate of Return on Plan Assets, and Health Care Trend Rate. *

LEC	Original Cost (Millions)	Percentage Reduced		Projected Cost (Millions)
Ameritech	$16.9	0.0%		$16.9
Bell Atlantic	19.9	18.5%		16.2
Bell South	0.8	6.2%		0.8
GTE	55.1	15.0%		46.9
NYNEX	38.2-85.7	44.1%		21.4-47.9
Pacific	28.1	13.1%		24.4
Rochester	2.7	37.8%		1.7
SNET	2.0	0.0%	**	2.0
SW Bell	37.4	25.1%		28.0
United Tel	7.8	16.0%		6.6
US West	38.0	15.3%		32.2
TOTAL	$247-$294	20.2%-24.4%		$197-$223

Thus, the total reduction in accrual costs is in the range of $50 million to $71 million.

* **Milliman and Robertson model fully described in Appendix F of AT&T's Opposition to the LECs Direct Cases filed June 1, 1992, was utilized for this calculation.**

** **Not calculated, due to lack of complete trend information in SNET's direct case. We assumed zero reduction.**

II. Double Count.

- **Definition:**

  Double recovery of SFAS 106 costs through GNP-PI and Delta Z components of the PCI formula.

- **AT&T accepts the LEC arguments that removing GNP-PI from the Accrual calculation is inappropriate (p. 12-14, AT&T).**

- **Correct method to remove Double Count is based on the Modified NERA Method discussed in AT&T's Appendix C.**

Modified NERA Method

- o Modifications to NERA's Methodology
  - Firms in both Non Regulated and Regulated Sectors have not yet increased their prices to reflect their unfunded OPEB Liabilities.
  - Government SFAS 106 - like costs should also be included.
- o Agree with NERA
  - Prices will have a cumulative increase of 1.10% due to the SFAS 106 Accrual.
  - All of the unfunded OPEB expenses will eventually be passed through as higher prices.
- o Findings using Modified NERA Double Count Method

	Exogenous	Amount
LEC Filed Accrual	43%	$125M
Modified Accrual	34%	$78M
LEC Accrual with Gov. OPEB	39%	$111M
Modified Accrual with Gov. OPEB	29%	$67M

Firms in both Non Regulated and Regulated Sectors have not yet increased their prices to reflect their unfunded OPEB Liabilities.

- **AT&T agrees with the LECs that firms base their pricing decisions on Economic costs.**

- **FASB rules were designed for financial reporting purposes, not pricing purposes, and hence are not true Economic Costs.**

- **There is no empirical evidence that firms increased prices before Price Caps began to cover their SFAS 106 liabilities.**

- **Empirical evidence in Towers Perrin Survey found:**

  - **Few firms have prefunded their liability.**

  - **Significant numbers of firms have yet to measure their liabilities.**

  - **Average liability is 7% of payroll, about 6 times PAYG costs.**

MODIFIED NERA METHOD OF CALCULATING THE DOUBLE COUNT
LEC FILED ACCRUAL
Table 2

LEC (A)	Revenue Reqmt. Before Double Count Removal [Delta Z] (B)	Source (C)	1991 Interstate Price Cap Revenue (a) [R] (D)	% Proposed Revenue Increase [Delta Z/R] (E) [(B)/(D)]	US Average (b) (F)	Exogenous Diff. (G) [(E)−(F)]	% Exogenous (H) [(G)/(E)]	% Endogenous (I) [(F)/(E)]	Exogenous [Corrected Delta Z Amount] (J) [(B)*(H)]	Excluded Double Count (K) [(B)−(J)]
Ameritech	$19,921	[Exhibit 4, Line 15]	$2,281,155	0.87%	1.10%	0.00%	0%	100%	$0	$19,921
Bell Atlantic	$20,116	[Workpaper 6−43, Line 5]	$2,749,310	0.73%	1.10%	0.00%	0%	100%	$0	$20,116
Bell South	$887	[Appendix 3, Rev. Effect]	$2,770,278	0.03%	1.10%	0.00%	0%	100%	$0	$887
GTE	$65,000	[Page 7. Item 2]	$2,034,593	3.19%	1.10%	2.09%	66%	34%	$42,619	$22,381
Nevada Bell	$1,118	[Appendix 2, Line 7]	$46,349	2.41%	1.10%	1.31%	54%	46%	$608	$510
NYNEX (1)	$45,000	[Attach. B, Increment. RR]	$2,954,309	1.52%	1.10%	0.42%	28%	72%	$12,503	$32,497
NYNEX (2)	$101,000	[Attach. B, Increment. RR]	$2,954,309	3.42%	1.10%	2.32%	68%	32%	$68,503	$32,497
Pac Bell	$28,800	[Appendix 2, Line 4]	$1,467,884	1.96%	1.10%	0.86%	44%	56%	$12,653	$16,147
Rochester/Vista	$3,251	[Exhibit III. P. 2 Of 3, Line 5]	$87,730	3.71%	1.10%	2.61%	70%	30%	$2,286	$965
SNET	$2,300	[Exhibit 1, Interstate RR]	$319,860	0.72%	1.10%	0.00%	0%	100%	$0	$2,300
S. West Bell	$48,000	[P. 17, Line 7]	$1,708,638	2.81%	1.10%	1.71%	61%	39%	$29,205	$18,795
US West	$44,884	[Attach. B, Line 110* 2/.848	$2,005,097	2.24%	1.10%	1.14%	51%	49%	$22,828	$22,056
United	$9,165	[Attach. B, P. 3 Of 4, Line 12]	$596,683	1.54%	1.10%	0.44%	28%	72%	$2,601	$6,564
Total (1)	$288,442		$19,021,886	1.52%	1.10%		43%	57%	$125,304	$163,138
Total (2)	$344,442		$19,021,886	1.81%	1.10%		53%	47%	$181,304	$163,138

(a) Source: 1992 Annual Access Tariff Filing, Chart PCI−1, line 160

(b) From NERA, The Treatment of FAS 106 Accounting Changes Under Price Cap Regulation (April 15, 1992), p. 32.

EXO.WK3

MODIFIED NERA METHOD OF CALCULATING THE DOUBLE COUNT
MODIFIED ACCRUAL
Table 3

LEC (A)	Revenue Reqmt. Before Double Count Removal [Delta Z] (With Corrected Parameters) (a) (B)	Source (C)	1991 Interstate Price Cap Revenue (b) [R] (D)	% Proposed Revenue Increase [Delta Z/R] (E) [(B)/(D)]	US Average (c) (F)	Exogenous Diff. (G) [(E)−(F)]	% Exogenous (H) [(G)/(E)]	% Endogenous (I) [(F)/(E)]	Exogenous [Corrected Delta Z Amount] (J) [(B)*(H)]	Excluded Double Count (K) [(B)−(J)]
Ameritech	$19,921	[Exhibit 4, Line 15]	$2,281,155	0.87%	1.10%	0.00%	0%	100%	$0	$19,921
Bell Atlantic	$16,395	[Workpaper 6−43, Line 5]	$2,749,310	0.60%	1.10%	0.00%	0%	100%	$0	$16,395
Bell South	$832	[Appendix 3, Rev. Effect]	$2,770,278	0.03%	1.10%	0.00%	0%	100%	$0	$832
GTE	$55,250	[Page 7. Item 2]	$2,034,593	2.72%	1.10%	1.62%	59%	41%	$32,869	$22,381
Nevada Bell	$972	[Appendix 2, Line 7]	$46,349	2.10%	1.10%	1.00%	48%	52%	$462	$510
NYNEX (1)	$25,155	[Attach. B, Increment. RR]	$2,945,475	0.85%	1.10%	0.00%	0%	100%	$0	$25,155
NYNEX (2)	$56,459	[Attach. B, Increment. RR]	$2,945,475	1.92%	1.10%	0.82%	43%	57%	$24,059	$32,400
Pac Bell	$25,027	[Appendix 2, Line 4]	$1,467,884	1.70%	1.10%	0.60%	35%	65%	$8,880	$16,147
Rochester/Vista	$2,022	[Exhibit III. P. 2 Of 3, Line 5]	$87,730	2.30%	1.10%	1.20%	52%	48%	$1,057	$965
SNET	$2,300	[Exhibit 1, Interstate RR]	$319,860	0.72%	1.10%	0.00%	0%	100%	$0	$2,300
S. West Bell	$35,952	[P. 17, Line 7]	$1,708,638	2.10%	1.10%	1.00%	48%	52%	$17,157	$18,795
US West	$38,017	[Attach. B, Line 110* 2/.848	$2,005,097	1.90%	1.10%	0.80%	42%	58%	$15,961	$22,056
United	$7,699	[Attach. B, P. 3 Of 4, Line 12]	$596,683	1.29%	1.10%	0.19%	15%	85%	$1,135	$6,564
Total (1)	$229,541		$19,013,052	1.21%	1.10%		34%	66%	$77,521	$152,019
Total (2)	$260,845		$19,013,052	1.37%	1.10%		39%	61%	$101,580	$159,264

(a) Col. B, Table 2 multiplied by (1−percentage reduction from Table 1)

(b) Source: 1992 Annual Access Tariff Filing, Chart PCI−1, line 160

(c) From NERA, The Treatment of FAS 106 Accounting Changes Under Price Cap Regulation (April 15, 1992), p. 32.

EXO.WK3

MODIFIED NERA METHOD OF CALCULATING THE DOUBLE COUNT
LEC FILED ACCRUAL WITH GOV'T OPEB
Table 4

LEC (A)	Revenue Reqmt. Before Double Count Removal [Delta Z] (B)	Source (C)	1991 Interstate Price Cap Revenue (a) [R] (D)	% Proposed Revenue Increase [Delta Z/R] (E) [(B)/(D)]	US Average (b) (F)	Exogenous Diff. (G) [(E)−(F)]	% Exogenous (H) [(G)/(E)]	% Endogenous (I) [(F)/(E)]	Exogenous [Corrected Delta Z Amount] (J) [(B)*(H)]	Excluded Double Count (K) [(B)−(J)]
Ameritech	$19,921	[Exhibit 4, Line 15]	$2,281,155	0.87%	1.23%	0.00%	0%	100%	$0	$19,921
Bell Atlantic	$20,116	[Workpaper 6−43, Line 5]	$2,749,310	0.73%	1.23%	0.00%	0%	100%	$0	$20,116
Bell South	$887	[Appendix 3, Rev. Effect]	$2,770,278	0.03%	1.23%	0.00%	0%	100%	$0	$887
GTE	$65,000	[Page 7. Item 2]	$2,034,593	3.19%	1.23%	1.96%	61%	39%	$39,975	$25,025
Nevada Bell	$1,118	[Appendix 2, Line 7]	$46,349	2.41%	1.23%	1.18%	49%	51%	$548	$570
NYNEX (1)	$45,000	[Attach. B, Increment. RR]	$2,945,475	1.53%	1.23%	0.30%	19%	81%	$8,771	$36,229
NYNEX (2)	$101,000	[Attach. B, Increment. RR]	$2,945,475	3.43%	1.23%	2.20%	64%	36%	$64,771	$36,229
Pac Bell	$28,800	[Appendix 2, Line 4]	$1,467,884	1.96%	1.23%	0.73%	37%	63%	$10,745	$18,055
Rochester/Vista	$3,251	[Exhibit III. P. 2 Of 3, Line 5]	$87,730	3.71%	1.23%	2.48%	67%	33%	$2,172	$1,079
SNET	$2,300	[Exhibit 1, Interstate RR]	$319,860	0.72%	1.23%	0.00%	0%	100%	$0	$2,300
S. West Bell	$48,000	[P. 17, Line 7]	$1,708,638	2.81%	1.23%	1.58%	56%	44%	$26,984	$21,016
US West	$44,884	[Attach. B, Line 110* 2/.848	$2,005,097	2.24%	1.23%	1.01%	45%	55%	$20,221	$24,663
United	$9,165	[Attach. B, P. 3 Of 4, Line 12]	$596,683	1.54%	1.23%	0.31%	20%	80%	$1,826	$7,339
Total (1)	$288,442		$19,013,052	1.52%	1.23%		39%	61%	$111,241	$177,201
Total (2)	$344,442		$19,013,052	1.81%	1.23%		49%	51%	$167,241	$177,201

(a) Source: 1992 Annual Access Tariff Filing, Chart PCI−1, line 160

(b) From NERA, The Treatment of FAS 106 Accounting Changes Under Price Cap Regulation (April 15, 1992), p. 32 multiplied by (1/.894), Godwins' estimate of the size of the public sector.

EXO.WK3

MODIFIED NERA METHOD OF CALCULATING THE DOUBLE COUNT
MODIFIED ACCRUAL WITH GOV'T OPEB
Table 5

LEC (A)	Revenue Reqmt. Before Double Count Removal [Delta Z] (With Corrected Parameters) (B)	Source (C)	1991 Interstate Price Cap Revenue (a) [R] (D)	% Proposed Revenue Increase [Delta Z/R] (E) [(B)/(D)]	US Average (b) (F)	Exogenous Diff. (G) [(E)−(F)]	% Exogenous (H) [(G)/(E)]	% Endogenous (I) [(F)/(E)]	Exogenous [Corrected Delta Z Amount] (J) [(B)*(H)]	Excluded Double Count (K) [(B)−(J)]
Ameritech	$19,921	[Exhibit 4, Line 15]	$2,281,155	0.87%	1.23%	0.00%	0%	100%	$0	$19,921
Bell Atlantic	$16,395	[Workpaper 6−43, Line 5]	$2,749,310	0.60%	1.23%	0.00%	0%	100%	$0	$16,395
Bell South	$832	[Appendix 3, Rev. Effect]	$2,770,278	0.03%	1.23%	0.00%	0%	100%	$0	$832
GTE	$55,250	[Page 7. Item 2]	$2,034,593	2.72%	1.23%	1.49%	55%	45%	$30,225	$25,025
Nevada Bell	$972	[Appendix 2, Line 7]	$46,349	2.10%	1.23%	0.87%	41%	59%	$401	$570
NYNEX (1)	$25,155	[Attach. B, Increment. RR]	$2,945,475	0.85%	1.23%	0.00%	0%	100%	$0	$25,155
NYNEX (2)	$56,459	[Attach. B, Increment. RR]	$2,945,475	1.92%	1.23%	0.69%	36%	64%	$20,230	$36,229
Pac Bell	$25,027	[Appendix 2, Line 4]	$1,467,884	1.70%	1.23%	0.47%	28%	72%	$6,972	$18,055
Rochester/Vista	$2,022	[Exhibit III. P. 2 Of 3, Line 5]	$87,730	2.30%	1.23%	1.07%	47%	53%	$943	$1,079
SNET	$2,300	[Exhibit 1, Interstate RR]	$319,860	0.72%	1.23%	0.00%	0%	100%	$0	$2,300
S. West Bell	$35,952	[P. 17, Line 7]	$1,708,638	2.10%	1.23%	0.87%	42%	58%	$14,936	$21,016
US West	$38,017	[Attach. B, Line 110* 2/.848	$2,005,097	1.90%	1.23%	0.67%	35%	65%	$13,354	$24,663
United	$7,699	[Attach. B, P. 3 Of 4, Line 12]	$596,683	1.29%	1.23%	0.06%	5%	95%	$359	$7,339
Total (1)	$229,541		$19,013,052	1.21%	1.23%		29%	71%	$67,190	$162,350
Total (2)	$260,845		$19,013,052	1.37%	1.23%		34%	66%	$87,420	$173,425

(a) Source: 1992 Annual Access Tariff Filing, Chart PCI−1, line 160

(b) From recalculation of Godwins, Analysis of Impact of FAS 106 Costs on GNP−PI (February, 1992), p. 10.

EXO.WK3

III. Only prefunded OPEB costs should be considered for Exogenous Treatment

- Prefunding ensures amounts paid by ratepayers are used only for the intended purpose.

- Currently, there is no requirement that funds will ever be used to pay OPEB costs at all.

- VEBAs are available for both management and bargained for employees.

Some LECs claim that they can not fund on a tax effective basis. United claimed that "VEBAs would not be tax-effective and would be detrimental." GTE claimed that VEBAs are only available for bargained-for employees

- 501 (c)(9) of the Internal Revenue Code is the primary tax effective funding vehicle. (For tax exemption determination, distinction is made between bargained-for and non-bargained-for employees. Not all non-management employees are union-represented employees.)

- Contributions to both the bargained-for and non-bargained-for 501 (c)(9) VEBA trusts are tax deductible.

- For the bargained-for trust, earnings on the assets of the trust and benefit payouts are non-taxable.

- For the non-bargained-for trust, contributions are limited to the annual funding requirement calculated without including medical inflation, and investment earnings are generally subject to the Unrelated Business Income Tax (UBIT). However, tax-exempt investments can be employed such as Trust-owned Life Insurance (TOLI) or several available tax exempt bonds.

United says that under present tax law they would incur a tax liability on any OPEB revenues collected, while only a small portion of the funded amount would be deductible for tax purposes. They would have to borrow funds and incur costs to cover the portion of funding not deductible for tax purposes.

- **This is a baseless argument. If the LECs collect revenues for OPEB costs and do not fund, <u>all</u> of the revenues are fully taxable.**
- **VEBAs provide tax deductibility for most of the collected revenues. Certain trust investments provide additional tax avoidance.**
- **If a company does not fund, not only will the revenues collected for OPEB not be available when needed, but the interest anticipated over the period will not exist.**

SFAS 106 Double Count Correction

- **TS Basktet**

  $$PCI(t) = PCI(t-1)[1+w(GNP-PI-X) + Z/R]$$

  $$= PCI(t-1)[1+w(GNP-PI'-1.1\%-X) + Z/R]$$

  Where GNP-PI' equals the observed rate of inflation including the inflation caused by the SFAS 106 Accrual, 1.1%.

  $$= PCI(t-1)[1+w(GNP-PI'-X) + Z/R - 1.1\%w]$$

- **The term -1.1%w corrects the TS PCI formula for the SFAS 106 Double Count.**

- **The correction for the CL PCI formula is -1.1% w/(1+g/2)**

Problem: Derive an adjusted SFAS 106 Accrual with the Double Count removed.

- **Double Count can be removed by constructing an adjusted Delta Z, Z'.**

$$(1) \quad PCI(t) = PCI(t-1)[1+\frac{R+Z'}{R}(GNP\text{-}PI\text{-}x)+Z'/R]$$

- **Or, the Double Count can be removed by substracting the double counted price increase, d, from GNP-PI.**

$$(2) \quad PCI(t) = PCI(t-1)[1+\frac{R+Z}{R}(GNP\text{-}PI\text{-}d\text{-}x) + Z/R]$$

- **Setting equations (1) and (2) equal and solving for Z' yields the Exogenous Cost with the Double Count removed:**

$$(3) \quad Z' = Z\frac{[1+(GNP\text{-}PI\text{-}x\text{-}d) - dR]}{1+GNP\text{-}PI\text{-}x}$$

- **Note: If the Double Count is zero, Z' = Z.**

- **Note: If (GNP-PI-x) is zero, the expression becomes**

$$(4) \quad Z' = Z(1-d) - dR$$

- **NERA's methodology yields equation (4):**

$$(5) \quad Z' = Z - dR.$$

Towers Perrin

Monitor

April 1992 Issue 129

Complying With the ADA: A Checklist

Towers Perrin Monitor: tracking benefit and compensation issues you need to know about **now.**

By July 26, 1992, employers with 25 or more employees must bring their employment practices into compliance with the Americans With Disabilities Act (ADA). This new federal law prohibits discrimination against disabled individuals in all terms and conditions of employment and requires employers to make "reasonable accommodations" for disabled applicants and employees, unless the employer can demonstrate that doing so would create an "undue hardship" for the organization.

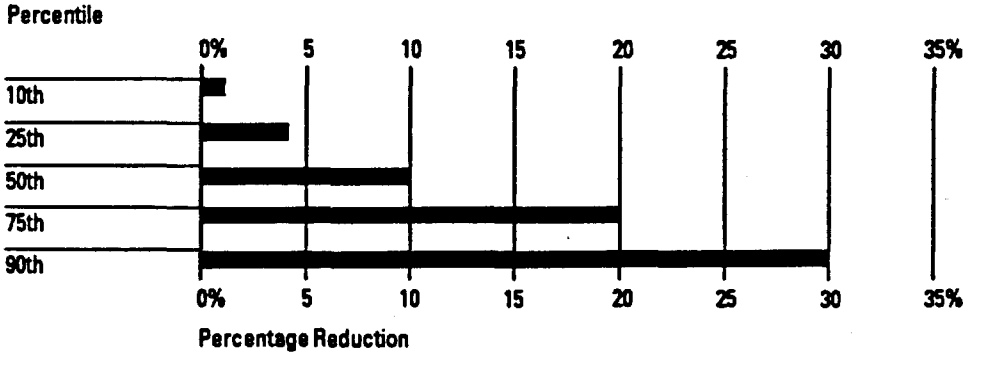
To be protected by the law, the disabled person must be otherwise qualified for the position — in other words, able to perform the "essential functions" of the job, with or without reasonable accommodation. The law also protects people who are merely perceived as having a disability, who have a history of disability or who are associated with disabled persons (for example, an employee with a disabled spouse).

(continued on page 2)

FAS 106: Preparing to Take the Hit

With the deadline for adopting accrual accounting for retiree welfare benefits less than a year away, companies nationwide are analyzing their benefit cost trends and assumptions, swallowing hard and preparing to take the FAS 106 "hit," if they haven't done so already. A new Towers Perrin survey of 150 *Fortune* 1000 companies suggests that many employers will begin booking their retiree welfare liabilities this year, instead of waiting another year as FAS 106 allows. And while FAS 106 costs represent a significant drag on future profits for many companies, most are already developing strategies to limit the balance-sheet impact, the survey found.

FAS 106 Impact on Pretax Earnings*



*Based on a survey of 150 companies. The average reported reduction is 17%.

On the whole, the companies surveyed provide a fairly generous (although typical) package of retiree welfare benefits. More than two-thirds (69%) offer lifetime medical benefits to all employees, and almost half (42%) pay 100% of the premiums. Thus, for most of the survey companies, FAS 106 liabilities are likely to take a big bite out of pretax earnings.

For the average company surveyed, annual FAS 106 expense represents 7% of payroll, al-

(continued on page 3)

ADA Checklist

(continued from page 1)

Health Plans and the ADA

Employers also need to take a close look at their employee benefit programs — comprehensive health plans especially — to make sure they comply with the ADA.

The Act's legislative history and EEOC interpretations make it clear that many general coverage limitations will be permissible under the ADA. Pre-existing-condition exclusions are one example. ADA liability could arise, however, where an exclusion or limit specifically targets a group of disabled individuals by reference to their protected status. Here are two frequently asked questions:

Q. An employer's comprehensive health plan covers treatment of mental health problems and chemical dependency. However, these benefits are subject to more restrictive limits and maximums than are other plan benefits. Must this plan be modified to comply with the ADA?

A. Most likely not. Guidance provided by the EEOC indicates that such limits would not conflict with the ADA because they apply equally to all plan participants, regardless of whether an individual has a protected disability.

Q. Can an employer's health plan exclude or limit coverage for AIDS?

A. The ADA specifically prohibits employers from discriminating against qualified disabled individuals. The EEOC has indicated that persons who have tested HIV-positive will be considered disabled. Thus, restrictions on AIDS coverage would likely present problems under the Act because the exclusion or limit would appear to target a group of individuals by specific reference to their ADA-protected disability.

In many cases, accommodating disabled employees involves no more than reassigning nonessential job duties, modifying work schedules and making low- or no-cost alterations in the workplace. In other cases, however, more costly modifications may be required. Thus, what constitutes "reasonable" accommodation and "undue" hardship will depend to a certain extent on the size and resources of the employer, and on the facts in each particular case. The Equal Employment Opportunity Commission will be active in investigating alleged violations, although ultimately, it will be up to the courts to clarify the scope of employers' compliance obligations.

However, the law does specify that written job descriptions prepared in advance of making employment decisions can be used to define essential job functions. As a result, maintaining written position descriptions identifying all essential job functions may be crucial to a company's ability to defend itself should ADA claims arise.

The stakes in such cases could be high. The ADA permits disabled individuals to file job bias suits in federal court, and the Civil Rights Act of 1991 permits ADA claimants to request jury trials and seek limited punitive damages from employers. That's why many companies are taking preventive measures before the law goes into effect. The following checklist provides a good starting point for employers in reviewing employment practices for compliance.

Hiring and job classification:

- Develop comprehensive, written job descriptions based on essential job duties. Be sure to include descriptions and examples of all essential functions (rather than an exhaustive list of all job duties), as well as qualitative and quantitative performance standards, attendance requirements and physical/mental requirements (for example, those necessitated by working conditions). These job descriptions should be used as the basis for all advertising, recruiting and promotional policies and materials.
- Retain the right in all job descriptions to modify duties at any time.
- Verify the accuracy of job descriptions with supervisors and current job incumbents.
- Check existing recruiting materials, advertising and the like for ADA compliance.

Selection criteria:

- Check job applications for prohibited questions (for example, disability status, workers compensation history).
- Review interview procedures and train interviewers. It's permissible, for example, to ask whether applicants can perform essential job functions.
- Review tests and other selection criteria to ensure that they're job-related and accurately gauge applicants' ability to perform essential job functions. It's also important to administer tests in a way that does not require the use of impaired abilities, unless measuring such abilities is the purpose of the test.

Medical questions:

- Eliminate all pre-job-offer medical exams and questionnaires.
- Make sure any post-offer or post-employment medical exams are clearly job-related and are required for all applicants and employees in a given job category. Test results should address only whether the individual is able to perform the job's essential functions. Results also should be kept confidential and apart from other personnel files.

Compensation policies:

- Audit pay programs to ensure that compensation for disabled employees mirrors that for similarly situated nondisabled employees.
- Document in writing nondiscriminatory reasons for any existing pay disparities (for example, performance ratings, experience).

(continued on page 3)

ADA Checklist

(continued from page 2)

Leaves of absence:

- Check to make sure medical leave policies are uniformly applied and enforced for nondisabled and disabled employees.
- Require all employees to present medical documentation when applying for medical leave and grant job reinstatement rights equally to those with and without protected disabilities.
- Review workers compensation programs. Also review return-to-work policies to make sure they're applied uniformly for occupational and nonoccupational disabilities.

Training activities:

- Ensure that all training facilities, work areas and work sites are fully accessible to disabled workers.
- Train supervisors, managers and employees on the ADA and its impact on the workplace.

General policies:

- Review employee handbooks and procedures to ensure that they reflect ADA requirements.
- Identify and remove any physical barriers blocking access for disabled workers (unless such actions would create an undue business hardship).
- Be prepared to discuss with disabled individuals the types of accommodations they might require to perform their jobs. Consider the individual's preferences and assess the effectiveness, cost and potential impact on the workplace. Document this process and the results.

Final suggestion. Consider appointing an individual such as the company's equal employment opportunity compliance officer to serve as the focal point and coordinator for the company's ADA compliance effort — for example, handling managers' questions and problems, overseeing implementation of compliance procedures, reviewing accommodation requests and conducting ongoing training.

The law will have an impact on many aspects of the company's operations. Having someone knowledgeable about ADA issues and alert to potential problems can go a long way toward ensuring that the company's compliance program is well thought out and consistently applied. □

FAS 106

(continued from page 1)

though a quarter of the respondents put the annual expense at 10% of payroll or higher. These expense levels translate into a 17% reduction in pretax earnings for the average company. Companies at the 50th percentile report a 10% earnings reduction — and a quarter of the companies report reductions of 20% or more. (See breakdown, page 1.)

On average, the current liability represents a 13% reduction in net worth. And a third of the respondents report reductions in net worth of more than 20%.

While pay-as-you-go accounting is still the norm, 12% of the companies surveyed have adopted accrual accounting for retiree welfare benefits in advance of the 1993 deadline. A slightly smaller percentage (just under 10%) has funded part of the liability. Interestingly, of those that have started prefunding, the assets average only 22% of the liability.

Many more companies are likely to adopt FAS 106 this year, the survey shows. What's more, almost two-thirds are considering taking the "hit" up front — that is, recognizing the transition obligation as a one-time charge, rather than spreading it out over many years.

Confronting the cost. Faced with liabilities of this magnitude, most companies have made or are considering retiree benefit plan design changes to reduce future costs. Asking retirees to contribute more of the cost of health benefits is the most common change. And nearly a quarter of the respondents have put in preferred provider arrangements or some form of managed care for current retirees.

The assumptions a company uses in valuing its retiree welfare benefit expense can also have a substantial impact on the bottom line. As a result, many companies are taking a more strategic view of their valuation assumptions as the FAS 106 deadline approaches.

(continued on page 4)

FAS 106 Assumptions: Ultimate Gross Medical Trend*

	Percent of Companies***		
Trend**	1988	1990	1991
5%	1%	5%	6%
6	3	7	31
7	11	24	42
8	40	39	15
9	37	21	6
10	8	3	0
11	0	0	0
12	0	1	0
>12	0	0	0

* Ultimate gross medical trend is an estimate of long-term medical cost inflation.

** Rounded to the nearest whole percent.

*** Based on an analysis of valuation data in *MEDBase*, a Towers Perrin database. The 1988 valuation sample included 100 companies, the 1990 sample included 185 companies and the 1991 sample included 147 companies.

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In Brief...

■ The EEOC is seeking public comments on the Older Workers Benefit Protection Act of 1990, which clarified how the federal Age Discrimination in Employment Act (ADEA) applies to certain employee benefit programs. The law also established standards that employers must meet when asking older workers to waive their ADEA rights (for example, as a condition of receiving early retirement window benefits). The EEOC invites comments through July 27 on a wide range of issues under the 1990 law, including whether interpretive or regulatory guidance is needed.

■ As a recent federal appeals court ruling shows, employers who freeze pension benefit accruals without adhering to ERISA's participant notification requirements can expect little sympathy from the courts. ERISA requires employers to notify plan participants after the adoption of any plan amendment that significantly reduces the rate of future pension accruals and at least 15 days before the amendment's effective date. In the recent case, participants weren't notified until two months after the freeze took effect. And the company's board didn't formally adopt the change (retroactively) until several weeks after that. The court held the amendment to be void and ordered the employer to pay legal fees for the union that brought the case (*Local 504 v. Roadmaster Corp.*).

■ A new SEC no-action letter illustrates how a plan can be structured to make automatic and elective grants of restricted stock to a company's outside directors without running afoul of the insider-trading rules. The plan approved by the SEC automatically awards 20% of the directors' annual retainer in restricted stock and allows directors to make irrevocable elections to receive all or part of the remainder in stock (six months before granting). The SEC said the plan's automatic awards fall under the Rule 16b exemption for stock grants based on a specific formula, while the elective awards satisfy the exemption for participant-directed transactions (*Adolph Coors Company*).

■ A study by the Group Health Association of America indicates that HMO premiums will rise about 11% on average for 1992, compared to 12.9% in 1991 and 16% in 1990.

Now Available...

Employment Practices Under the ADA

Facing FAS 106: Where Employers Stand

Retiree Welfare Costs: Toward an Expensing Strategy (MEDBase)

Workforce 2000 Today: A Bottom-Line Concern

Skill-Based Pay: Experiences From the Front Lines

For copies of these publications, call 1-800-525-6741.

FAS 106

(continued from page 3)

In particular, employers seem to be using more optimistic assumptions about medical cost inflation (or "trend"), according to a recent analysis of *MEDBase*, a Towers Perrin database of benefit valuations designed to assist employers in adapting to the new accounting requirements. As the table on page 3 shows, nearly 80% of the 1991 valuations assumed a long-range cost trend of 7% or less, while only 15% in the 1988 sample and 36% in the 1990 sample were as optimistic.

Significantly, the *MEDBase* analysis found that the median company had a slightly lower total annual FAS 106 cost last year than the year before ($2,360 per employee in 1991, down from $2,500 per employee in 1990). In other words, the move toward lower inflation-trend assumptions, coupled with any plan design changes, more than offset the effects of medical cost increases from 1990 to 1991. (Copies of the survey report and the *MEDBase* analysis are now available. See above.) □

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Facing FAS 106: Where Employers Stand

As the deadline for accrual accounting approaches, companies offering retiree welfare benefits are stepping up efforts to measure their liabilities, assess the financial consequences and explore expense reduction strategies. Towers Perrin recently conducted a survey of 150 *Fortune* 1000 companies to find out where employers stand.

While most of the respondents have taken some action, further efforts will be necessary in many cases, particularly where the bottom-line impact of FAS 106 exceeds levels acceptable to management. Moreover, a significant number of the survey companies *have yet to measure their liabilities* — and just under half have yet to complete a valuation under the final standard released in late 1990.

Not surprisingly then, 1992 will be a watershed year for many of the participants in our survey. One in four said there is a high chance that they'll adopt the new accounting standards in the coming months, and an additional 42% said there is some chance that they'll adopt early. Just about as many (66% altogether) said there is at least some chance that they'll take the "hit" upfront (i.e., recognize the "transition obligation" for past employee service immediately, rather than amortizing it over future years).

How well positioned are they? And what issues do they still face? Here's a quick snapshot:

- The relatively generous (although not atypical) benefit commitments reported by the survey companies will mean significant liabilities under FAS 106.
- In reviewing those commitments, the survey participants will have to decide whether to "grandfather" benefits for current retirees, since this group represents a substantial portion of the cost.
- Average FAS 106 expense for the survey companies currently amounts to 7% of payroll (about six times the typical pay-as-you-go cost); one in four respondents reports FAS 106 expense at 10% of payroll or higher.
- These expense levels translate into an average reduction in corporate pretax earnings of 17%; one-quarter of the responding companies report reductions of 20% or more.
- If they recognize the transition obligation immediately, the survey respondents would see an average reduction in net worth of 13%.
- So far, efforts to reduce expense focus on benefit cost-sharing; nearly three-quarters (73%) of the survey respondents have already increased retiree contributions or are planning/considering increases.
- Nevertheless, the survey does show that employers are beginning to explore other cost-control approaches; nearly a quarter of the survey companies have implemented or are planning some form of managed care for retirees.
- As part of their FAS 106 strategies, many of the survey respondents are changing the way they communicate retiree welfare benefits.

About the Survey Sample

The Towers Perrin retiree welfare benefit survey includes 150 *Fortune* 1000 companies representing a broad cross section of industry groups. Industrial companies make up the largest category (approximately 60%), while financial services and utilities comprise 25% and 10%, respectively.

Active employee populations among the survey companies range from about a thousand to more than 150,000. On average, the survey companies have about 18,000 active employees and 5,500 retirees.

Benefit Commitments

The survey respondents report relatively generous retiree welfare benefit commitments. Liabilities under FAS 106 will therefore be significant.

Benefit levels at the survey companies are relatively generous, although not atypical of most retiree welfare plans currently in place. Here's a closer look at what these companies offer.

Eligibility. Among the companies responding, 69% offer eligibility for lifetime medical coverage to all employees. Only 7% indicated that fewer than half of their employees are eligible for lifetime coverage.

Among companies offering lifetime life insurance benefits, just under two-thirds (64%) said that all employees are eligible for lifetime coverage. And as with medical coverage, relatively few employers offer lifetime coverage to less than half of their employees.

Nearly half (49%) of the survey companies reported offering one or more of certain ancillary retiree welfare benefits for life — such as dental plans, vision benefits, prescription drug cards and contributions toward the Medicare Part B premium.

Employer contributions. On average, the survey companies pay just over 80% of the cost for both pre- and post-65 medical coverage. Among companies reporting contributions toward lifetime retiree medical coverage, nearly half (42%) pay the premium cost in full. (See *Exhibit 1.*)

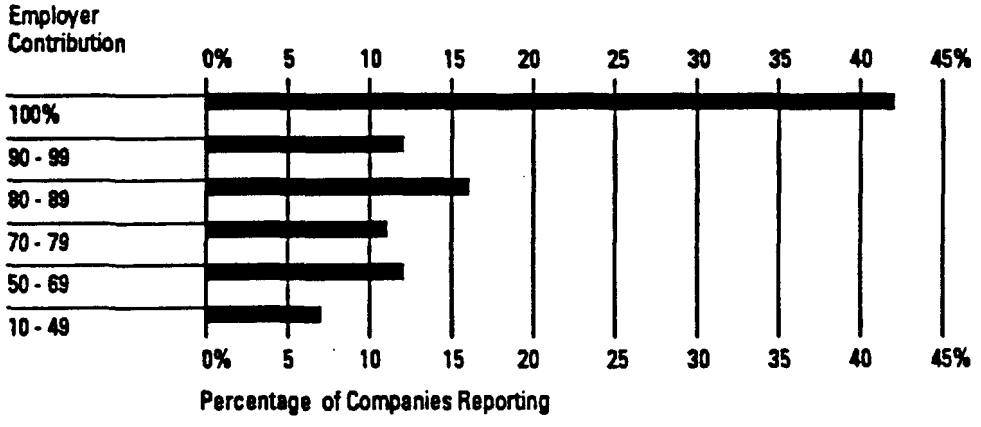
Contributions toward life insurance are, on average, higher — survey respondents offering life insurance benefits typically pay more than 95% of the cost for both pre-65 and lifetime coverage. For ancillary benefits (dental, vision and so forth), employers in the survey group pay, on average, 75% to 85% of the cost.

Commitments to Current Retirees

For the average company in the survey sample, current retirees represent a significant cost. Whether to grandfather benefits for current retirees will therefore be a consideration as these employers review benefit commitments and redesign plans.

On average, the survey companies have approximately 18,000 active employees and 5,500 retirees. This ratio of actives to retirees — typical of companies offering retiree welfare benefits — means that current retirees represent a relatively high cost burden (in terms of both pay-as-you-go and FAS 106 cost).

Exhibit 1: Employer Contribution Toward Lifetime Retiree Medical Coverage*



*Of the total survey group, 91 companies reported contribution rates for lifetime retiree medical coverage.