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FCC 93-47

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In the Matter of	)	
	)	
Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions"	)	CC Docket No. 92-101
	)	
Bell Atlantic Tariff F.C.C. No. 1	)	Transmittal Nos. 497, 536
	)	
US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4	)	Transmittal No. 246
	)	
Pacific Bell Tariff F.C.C. No. 128	)	Transmittal No. 1579

MEMORANDUM OPINION AND ORDER

Adopted: January 22, 1993; Released: January 22, 1993

By the Commission:

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I. INTRODUCTION

1. Bell Atlantic Telephone Companies (Bell Atlantic), US West Communications, Inc. (US West), and Pacific Bell (Pac Bell) filed the above-captioned tariffs to increase the limits set on their rates under the price cap plan, in order to recognize accounting changes for postretirement employee benefits, primarily medical benefits.[1] The accounting change is referred to as SFAS-106. On April 29, 1992, the Common Carrier Bureau suspended the Bell Atlantic and US West tariffs[2] for five months and designated for investigation issues arising from the carriers' claim that the incremental change in accounting cost should be treated as a one-time exogenous cost change under

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[1] See Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 497 (Filed Feb. 28, 1992 to be effective July 2, 1992); US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4, Transmittal No. 246 (Filed Apr. 3, 1992 to be effective August 1, 1992); Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1579 (Filed Apr. 16, 1992 to be effective January 1, 1993).

Effective November 25, 1992, under Transmittal No. 534, Bell Atlantic withdrew Transmittal No. 497. Subsequently, on December 4, 1992, under Transmittal No. 536, Bell Atlantic refiled the same material it had previously withdrawn, with a revised effective date of January 1, 1993.

2 Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions," CC Docket No. 92-101, 7 FCC Rcd 2724, n. 3 (Com. Car. Bur. 1992) (Suspension and Investigation Order).

On December 31, 1992, the Common Carrier Bureau released an Order suspending Pacific Bell Transmittal No. 1579 and Bell Atlantic Transmittal No. 536 for one day and adopted an accounting order directing all three carriers to keep accurate account of all amounts received by reason of the increased charge, in the event that refunds might eventually be ordered. Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions," _ FCC Rcd ____ (Com. Car. Bur. 1992).

price caps. Based on the record in this investigation, we find that these local exchange carriers (LECs), and the other price cap LECs designated as parties in this proceeding, have not met their burden of demonstrating that implementation of SFAS-106 should be considered an exogenous cost change under the Commission's price cap rules. We thus find the tariffs unlawful and direct the three carriers to refund the rate increases assessed under these tariffs. We do not foreclose these carriers or others from making a more persuasive showing in the context of the 1993 annual access tariff filings.

II. BACKGROUND

A. SFAS-106

2. In December 1990, the Financial Accounting Standards Board (FASB) adopted Statement of Financial Accounting Standards - 106 (SFAS-106). For those companies subject to Generally Accepted Accounting Standards (GAAP), SFAS-106 establishes new financial accounting and reporting requirements for accounting periods beginning after December 15, 1992, for any employer offering postretirement benefits other than pensions (OPEBs) to its employees. OPEBs are typically health and dental care benefits and life insurance.

3. Prior to implementation of SFAS-106, OPEBs have been accounted for on a "pay-as-you-go" or cash basis, recognizing the amounts actually paid in the current accounting period for the benefit of retired employees. SFAS-106 requires companies to account for OPEBs on an accrual basis, treating OPEBs as a form of deferred compensation earned by employees during their working years.

4. In addition to the change to accrual accounting, SFAS-106 also requires companies to recognize on their books the amount of their unfunded obligation for OPEBs to retirees and active employees existing as of the date of the adoption of SFAS-106. This unfunded obligation is referred to as the transition benefit obligation (TBO). SFAS-106 permits companies whose plans have active participants to either recognize the TBO as an immediate expense or defer and amortize it over the average remaining service period of active plan participants. If the average remaining service period is less than 20 years, the employer may elect to use a 20-year period.

B. Common Carrier Bureau SFAS-106 Adoption Order

5. Since 1985, the Commission has implemented a policy of conforming regulatory accounting to GAAP, including new FASB standards, unless adoption of the principle or practice conflicts with the Commission's regulatory objectives. See 47 C.F.R. § 32.16.

6. In December, 1991, the Common Carrier Bureau issued an Order approving the requests of two LECs to adopt SFAS-106-type accounting for OPEB, on or before January 1, 1993.[3] However, noting that an immediate recognition

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[3] See Southwestern Bell Corporation, GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employer's Accounting for Postretirement Benefits Other Than Pensions, 6

of the TBO would be so large as to distort the LECs' operating results, the Bureau declined to allow carriers to adopt the FASB option of flash-cut accounting for the TBO. Instead, the Bureau authorized the carriers to use the other SFAS-106 option of spreading the TBO over a 20-year period or over the average remaining service period of active plan participants.[4]

C. Price Caps and Changes in GAAP

7. In its price cap decisions,[5] the Commission replaced cost-plus rate of return regulation with an incentive-based system of regulation that rewards carriers whose performance exceeds a benchmark measure of efficiency improvements. The benchmark, known as the price cap index or PCI, is adjusted each year based on inflation in the economy (Gross National Product Price Index, or GNP-PI), minus a productivity factor.[6] The productivity factor is set to reflect the historical productivity growth of the telephone industry, which has exceeded the productivity of the economy as a whole, plus a 0.5 percent Consumer Productivity Dividend. Taken together, these factors established a reasonable, "rough justice" target of efficiency growth, based on historical trends. Carriers that are able to generate productivity gains in excess of the target will generate earnings higher than those experienced under rate of return regulation. Carriers also benefit because price cap regulation provides increased rate flexibility and is simpler to administer. Ratepayers

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FCC Rcd 7560 (Com. Car. Bur. 1991) (SFAS-106 Order).

[4] Id. See also Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32 (May 4, 1992) (RAO Letter 20).

[5] See Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice, 4 FCC Rcd 3379 (AT&T Price Cap Order), modified on recon., 6 FCC Rcd 665 (1991) (AT&T Price Cap Reconsideration Order), appeal docketed, AT&T v. FCC, No. 91-1178 (D.C. Cir. Apr. 15, 1991); Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990) (LEC Price Cap Order), modified on recon., 6 FCC Rcd 2637 (1991) (LEC Price Cap Reconsideration Order), recon. dismissed, FCC 91-344, released December 20, 1991, further modified on recon., 6 FCC Rcd 4524 (1991) (ONA Part 69 Order), petitions for recon. of ONA Part 69 Order pending, appeal docketed, District of Columbia PSC v. FCC, No. 91-1279 (D.C. Cir. June 14, 1991); Competition in the Interstate Interexchange Marketplace, Report and Order, 6 FCC Rcd 5880 (1991) (Interexchange Order) (further streamlining and removing from price cap regulation most of AT&T's business services), on recon., 7 FCC Rcd 2677 (1992).

[6] The price cap rules mandate a productivity offset of 3.3 percent, and include in the cap mechanism a means of inducing LECs to pursue even higher productivity gains if possible. LECs may elect to set their price caps by using a 4.3 percent productivity offset. Election of the higher productivity offset lowers the price cap, thereby benefitting ratepayers. However, election of the higher offset permits the LECs to retain a larger share of its earnings, thereby benefitting the LEC if it can increase its productivity. LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2641.

benefit because the benchmark is designed to decrease rates relative to inflation at a faster pace than rates have historically decreased.

8. In recognition of the difficulty in determining a single, industry-wide productivity offset that will be accurate for all LECs, the Commission adopted sharing and adjustment mechanisms to adjust rates in the event of unanticipated errors in the price cap formula.[7] Beginning at 12.25 or 13.25 percent, depending on the productivity offset or the amount of initial price decreases selected by the LEC,[8] the sharing mechanism requires LECs to share one half of its profits with its customers. At either 16.25 or 17.25 percent, all profits will be returned to customers.[9] Correspondingly, the Commission also established a low-end adjustment mechanism to ensure that the application of the price cap plan does not subject any individual LEC to low earnings over a prolonged period of time.[10] Should a carrier's earnings drop below 10.25 percent, the low-end adjustment will permit a carrier an automatic prospective upward adjustment in its PCI the following year.[11]

9. The Commission also identified certain cost changes, triggered by administrative, legislative, or judicial action that are beyond the control of the carriers, that should result in an adjustment to the PCI in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.[12] The Commission found that a decision not to recognize these costs in the PCI would either unjustly punish or reward the carrier by treating them as changes in the carrier's level of efficiency.[13] The Commission called these costs "exogenous" or Z factor costs.

10. The Commission determined, however, that not all changes beyond the carrier's control are considered exogenous. For example, a general change in tax rates is outside of the carrier's control, but will be reflected in the national GNP-PI component of the price cap formula.[14] Exogenous treatment of the tax change would thus unfairly "double count" its impact, once in the GNP-PI, and again as an exogenous cost. The Commission concluded that only changes that "uniquely or disproportionately affect LECs" would be considered for

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7 LEC Price Cap Order, 5 FCC Rcd at 6802.

8 See supra note 7.

9 LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2676.

10 LEC Price Cap Order, 5 FCC Rcd at 6801.

11 LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2676; LEC Price Cap Order, 5 FCC Rcd at 6801-02.

12 LEC Price Cap Order, 5 FCC Rcd at 6807; citing AT&T Price Cap Order, 4 FCC Rcd at 3187.

13 LEC Price Cap Order, 5 FCC Rcd at 6807.

14 LEC Price Cap Order, 5 FCC Rcd at 6808.

exogenous treatment.[15]

11. Section 61.45(d) of the Commission's Rules lists the exogenous cost changes under the Commission's price cap plan. Examples of cost changes considered exogenous are Commission-mandated amortization of reserve deficiencies and Long Term Support payments and receipts. Changes in GAAP, the action that triggered these tariff revisions, are not listed in this section and thus are not given routine exogenous cost treatment. In the AT&T Price Cap Reconsideration Order, however, the Commission recognized that not all GAAP changes will be reflected in the GNP-PI, and therefore stated that carriers may request exogenous treatment of GAAP changes. Carriers requesting such treatment, however, would bear the burden of demonstrating that the particular change would not be adequately reflected in GNP-PI.[16]

D. LEC OPEB Tariffs

12. In the transmittals under investigation, Bell Atlantic, US West, and Pac Bell claim that the incremental costs of implementing SFAS-106 should be reflected as exogenous cost changes under the Commission's price cap plan, allowing them to increase their PCIs, and thus their rates.[17] These LECs contend that the accounting change is mandatory and thus outside of their control and that the revised accounting results in a cost increase not otherwise reflected in the GNP-PI. In support of their claim that implementation of SFAS-106 disproportionately affects price cap LECs when compared to the economy as a whole, these LECs submitted industry-wide studies.[18]

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[15] Id.

[16] AT&T Price Cap Reconsideration Order, 6 FCC Rcd at 674; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2663-65. These Orders did not address issues involving costs reflected in other parts of the PCI.

[17] As a result of implementing SFAS-106, Bell Atlantic seeks to increase its price cap index levels $48.9 million (an average of approximately 1.8 percent) for the period January 1, 1991 through June 30, 1993. US West seeks to increase its price cap index levels $19.03 million (1.0 percent) for the period January 1, 1993 through June 30, 1993. Pac Bell seeks to increase its price cap index levels $27 million (1.9 percent) for the period January 1, 1993 through June 30, 1993. These increases in the PCIs would permit these carriers to recover these amounts from ratepayers not only for the years listed above, but for all following years.

[18] United States Telephone Association (USTA), "Post-Retirement Health Care Study Comparison of TELCO Demographic and Economic Structures and Actuarial Basis to National Averages" (1992) (Godwins Study) (submitted in Bell Atlantic and US West transmittals); National Economic Research Associates, Inc., "The Treatment of FAS-106 Accounting Changes Under FCC Price Cap Regulation" (1992) (NERA Study) (submitted in Pac Bell transmittal).

E. Common Carrier Bureau Suspension and Investigation Order

13. In response to these tariff filings the Common Carrier Bureau issued its Suspension and Investigation Order.[19] Noting that the threshold issue presented by these transmittals -- whether costs of SFAS-106 should be treated as exogenous costs -- is important to the price cap plan, the Order set the tariffs for investigation. Because the proposed rate increases are substantial and based on complex arguments and studies, the Bureau also suspended the Bell Atlantic and US West tariffs for five months pending completion of this investigation.[20] Moreover, since the studies submitted by the three carriers address the effects of SFAS-106 on all local telephone companies subject to price caps, and the Commission's price cap plan applies equally to all price cap LECs, the Bureau designated all price cap LECs as parties to this proceeding, including those LECs who have not at this point sought exogenous treatment of SFAS-106 effects.

14. The Bureau designated the following issues for investigation: 1) whether the LECs have borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change under the Commission's price cap rules; and 2) if these cost changes are treated as exogenous: (a) should costs associated with implementation of SFAS-106 prior to January 1, 1993 (when the accounting change becomes mandatory) be treated as exogenous; (b) are the assumptions made by the individual LECs in calculating these costs reasonable; (c) given these assumptions, have the individual LECs correctly computed the exogenous cost changes; and (d) are the individual LEC allocations of these costs among the price cap baskets consistent with Commission rules.[21] In order to develop as complete a record as possible to resolve the issues designated for investigation, the Bureau also requested the filing of specific, detailed information by all LECs made parties to the investigation.[22]

III. PLEADINGS

A. Direct Cases

i. Exogenous Claims

15. The LECs contend that the cost change required to implement SFAS-106 should be afforded exogenous treatment under the Commission's price cap plan because the cost change: (1) is mandatory and outside of their control; (2) is not fully reflected in the measure of inflation in the price cap formula (GNP-PI); (3) disproportionately affects the LECs; and (4) will not otherwise undermine the Commission's price cap policies. More specifically, the LECs argue that since the Common Carrier Bureau concluded in the SFAS-106 Order

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19 See supra note 2.

20 See supra notes 1 and 2.

21 Suspension and Investigation Order, 7 FCC Rcd at 2725-26.

22 Id. at 2726.

that adoption of SFAS-106 is consistent with the Commission's regulatory objectives, this finding indicates that SFAS-106 costs are an appropriate regulatory cost of service. Furthermore, the LECs claim that they have done all that can be reasonably expected to minimize these costs.[23]

ii. Godwins and NERA Studies

16. The LECs' direct cases particularly focus on the extent to which implementing SFAS-106 will be reflected in the GNP-PI. These LECs commissioned the Godwins and NERA studies to support their contention that implementation of SFAS-106 disproportionately affects price cap LECs, and that exogenous treatment would cause little or no double counting.[24]

a. Godwins Study

17. The Godwins Study is based on the assumption that the SFAS-106 accounting change creates a cost change for LECs and other firms, and the Study seeks to quantify the extent to which the effect of this change for price cap LECs is double-counted in GNP-PI. The Study consists of two parts; an actuarial analysis and a macroeconomic model. The actuarial analysis constructs a hypothetical company (TELCO) which is based on data from most price cap LECs. For TELCO and the economy as a whole (GNP), the Study computes a Benefit Level Indicator (BLI), the proportion of OPEB charges paid by the employer. This BLI is 0.5850 for TELCO and 0.2568 for GNP. The ratio of GNP BLI to TELCO BLI, which is 0.4390, which the Study claims is the portion of TELCO's SFAS-106 costs that would be reflected in the GNP-PI, if the OPEB conditions were the same for the average TELCO and the economy as a whole. However, these conditions are not the same and Godwins therefore makes several adjustments to this ratio.

18. First, demographic adjustments are made to reflect the facts that, on average, TELCO employees are older, leave the company before retirement less often, and retire at a younger age than do employees in GNP. Second, TELCO has a higher retiree/employee ratio than does GNP. Third, TELCO has pre-funded

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[23] See Southwestern Bell Telephone Company (SWBT) Direct Case at 12. We note here that two LECs claim that the Commission previously stated that additional costs recognized as a result of implementing SFAS-106 would likely be exogenous costs. Bell Atlantic Direct Case at 2; BellSouth Corporation and BellSouth Telecommunications, Inc. (BellSouth) Direct Case at 6. Citing, AT&T Tariff Order, 5 FCC Rcd 3680 (Com. Car. Bur. 1990) That Bureau Opinion is not binding on the Commission and the discussion of possible exogenous treatment of "costs" resulting from implementation of SFAS-106 is, at most, speculative dicta. Since SFAS-106 was not adopted at that time, the issue was not ripe for consideration. See also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2663-65.

[24] Except for Rochester Telephone Company (Rochester) and Pac Bell, all of the price cap LECs submitted the Godwins Study in support of their direct cases. Rochester and Pac Bell submitted the NERA Study in support of their direct cases.

some of its SFAS-106 obligation, through Voluntary Employee Benefit Association (VEBA) trusts. The Godwins Study assumes that GNP did not pre-fund at all. Fourth, a higher proportion of TELCO employees are covered than are covered in GNP. Fifth, TELCO has higher per-unit labor costs. Finally, even though TELCO's per-unit labor costs are higher, total labor costs are a lower percentage of TELCO's costs than of GNP's. After these adjustments, the GNP/TELCO BLI ratio is 0.2833, which means that the average employer in the GNP will see its costs rise due to SFAS-106 by only 28.33 percent of the cost rise experienced by TELCO.

19. To determine the portion of the cost change due to SFAS-106 which will be passed through into GNP-PI, Godwins employs a mathematical macroeconomic model. This model divides the economy into two sectors, one which provides OPEB and one which does not. The values of several parameters in the model (such as the elasticity of supply of labor and the cross elasticity of goods in the two sectors) are assumed, based on a survey of economic studies of these values. The values of the remaining parameters are selected to make the model conform to the current economy.

20. SFAS-106 is assumed to increase labor costs in the sector which offers OPEB by 3 percent.[25] The model estimates that, after the economy has adjusted to SFAS-106, by changing prices, output, labor and capital, GNP-PI will rise by only 0.01236 percent. However, one of the adjustments made in the economy is to lower the wage rate, as firms adjust their compensation packages to reflect the higher OPEB costs. The Study estimates that the combined effect of the change in the wage rate and the flow-through in the GNP-PI of the SFAS-106 change is that only about 15 percent of the cost increase due to SFAS-106 for LECs will be recovered without an exogenous change. Specifically, Godwins concludes, 84.8 percent of LEC OPEB increase due to SFAS-106 should be reflected as an exogenous cost change under price caps.[26]

b. NERA Study

21. The NERA Study assumes that SFAS-106 more nearly reflects true economic costs than does pay-as-you-go accounting, and thus reasons that the economic theory of efficient markets implies that these economic costs have already been recognized in prices of firms operating in such markets. By contrast, according to NERA, regulated firms such as the LECs have charged prices based on their accounting costs, which recognized OPEBs on a pay-as-you-go basis. Based on this reasoning, NERA divides the U.S. economy into two sectors; a cost-plus (price regulated) sector and all other industries. The cost-plus sector includes utilities (telephone, gas, water, etc.) and all government contracts (on the assumption that the latter are all cost-plus

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[25] This is based on the change in TELCO's labor costs, adjusted for the demographic differences between TELCO and GNP.

[26] Bell Atlantic, which relies on the Godwins Study, does not adjust its exogenous request to reflect a decrease in the wage rate. It therefore seeks as an exogenous cost change almost 100 percent of its OPEB increase due to SFAS-106.

contracts).[27] The cost-plus sector so defined makes up 10.49 percent of the GNP. The NERA Study assumes that only this cost-plus sector will pass through the effects of SFAS-106 in its prices; the other 90 percent of the economy is assumed to be already reflecting the effects of SFAS-106 in its prices.

22. The economy-wide effect of SFAS-106 is estimated at $69 billion, in a GNP of $6,260 billion, or about 1.10 percent of GNP. Assuming this 1.10 percent change applies to the cost-plus sector, the effect on GNP-PI is thus 10.49 percent of 1.10 percent, or a 0.12 percent increase. In other words, the NERA Study concludes that SFAS-106 will increase GNP-PI by 0.12 percent but will increase costs to LECs by 1.1 percent. Thus, according to NERA, only about 7 percent of the effect of SFAS-106 on the price caps will be recognized in the GNP-PI, and the remainder should be allowed as an exogenous adjustment.

B. Oppositions

23. Oppositions were filed by Ad Hoc Telecommunications User Committee (Ad Hoc), American Telephone and Telegraph Company (AT&T), International Communications Association (ICA), and MCI Telecommunications Corporation (MCI). Ad Hoc, ICA and MCI claim that the costs of implementing SFAS-106 should not receive exogenous treatment. Generally speaking, these opposing parties believe that affording exogenous treatment of these cost changes conflicts with price cap policies because such action interferes with the orderly administration of the Commission's price cap system and will disrupt the balance of risk and reward inherent in the price cap system. AT&T, which in the past has sought exogenous treatment of SFAS-106 in its own price cap plan,[28] states that the accounting change should be considered an exogenous cost change, but only within the specific limits discussed below.

24. As a threshold matter, MCI, Ad Hoc and ICA argue that while the lack of control over the FASB ruling is apparent, the LECs make no case as to why the effect of SFAS-106 is exogenous, and outside of their control. MCI states that SFAS-106 is nothing more than an accounting change that alters the temporal recognition of costs on financial statements. The implementation of SFAS-106, asserts MCI, does not, by itself, alter the underlying economic costs of providing interstate telecommunications services, but rather formally recognizes costs already being incurred by the LECs.[29] MCI asserts that the Commission must therefore reject this attempt to manipulate the price cap rules to minimize risk while maximizing earnings.[30] The price cap LECs, MCI states, would receive perverse incentives to reduce the cash wage rate since they could

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[27] NERA claims that its assumption that all government contracts are cost-plus is a conservative one, which inflates the cost-plus sector and may result in a larger effect on GNP-PI of SFAS-106 than may actually be the case.

[28] AT&T Tariffs F.C.C. Nos. 1, 2 and 13, 5 FCC Rcd 3680 (Com. Car. Bur. 1990).

[29] MCI Opposition at 10.

[30] Id. at 11.

increase their earnings while recovering the costs of the substitute through exogenous SFAS-106 adjustment.[31] The interrelationship of both wage and benefit expenses, says MCI, precludes the treatment of one form of labor compensation -- SFAS-106 related costs -- as exogenous and the other as endogenous.[32]

25. All four of the opposition argue that if exogenous treatment is allowed for this accounting change, the proposed PCI adjustments must be reduced because the LECs have all overstated their exogenous claims. Economics and Technology, Inc. (ETI) was retained by Ad Hoc to analyze the direct cases and the Godwins and NERA studies. ETI reports that LECs can, to some extent, strategically manipulate costs categorized as exogenous.[33] Moreover, it states that the SFAS-106 accrual process includes very liberal and generous provisions accepting many actuarial estimates of future OPEB effects.[34] For example, the carrier must project discount rates, returns on plan assets, medical care cost trends and demographic features. In short, Ad Hoc and ETI argue that the costs of implementing SFAS-106 would be determined, in large part, by unverifiable actuarial and demographic assumptions.[35] AT&T agrees, stating that because SFAS-106 accrual is inherently imprecise and measurement of its impact is extremely difficult to assess, it is not possible to predict fully how SFAS-106 will affect prices in the economy generally (as both Godwins and NERA attempt to do).[36]

26. Moreover, the opposition allege, these unverifiable assumptions would require the Commission to resolve a number of disputes regarding the actuarial and demographic assumptions underlying the carriers' PCI adjustments. ICA argues that these were the very types of disputes price caps was intended to eliminate.[37] The inherent flaws in these studies, AT&T maintains, render the measurement of the GNP-PI impact unreliable.[38] The opposition maintain that all of the uncertainty surrounding the studies and the LEC SFAS-106 amounts compel a Commission finding that the LECs have not met their burden of

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31 Id. at 10.

32 Id. at 2.

33 AT&T echoes this conclusion stating, "although SFAS-106 accounting treatment is mandatory (citation omitted), the underlying OPEB expense is not totally outside of the LECs' control and the LECs should be provided with the proper incentives to become more efficient in this area." AT&T Opposition at 17.

34 Ad Hoc Opposition at 13; ETI Report at 8.

35 ETI Report at 2, 8-9, 28, See also MCI Opposition at 27.

36 AT&T Opposition at 12-13.

37 ICA Opposition at 1.

38 AT&T Opposition at 12.

proving that no double counting would occur as a result of giving exogenous treatment to their implementation of SFAS-106.[39]

27. For example, MCI and ETI contend that the LECs have failed to quantify some significant portion of SFAS-106 costs that have already been captured by the cost of equity calculations conducted by the Commission in the rate of return proceeding.[40] MCI attaches an affidavit by Professor Allan Drazen that concludes that the LECs and shareholders have already been at least partially compensated for costs associated with accrual of SFAS-106 costs.[41] Because experience indicates that knowledge concerning the costs of SFAS-106 was embedded in share prices prior to the final adoption of SFAS-106, and the Commission used these share prices to determine the cost of equity for the LECs, MCI states the LECs must quantify this amount and reduce their corresponding SFAS-106 amounts for which they desire exogenous treatment.[42] Any attempt to include these amounts again, MCI alleges, would result in double recovery.

28. Additionally, MCI states that since SFAS-106 expenses will be accruing over several decades before the expected disbursement of these funds, LECs would enjoy the use of ratepayer funds used to cover these accruals. Should the Commission afford exogenous treatment, MCI asks that the Commission establish special reporting requirements to track the flow of funds and the resulting assets for OPEBs, and further require that the LECs not use the funds collected from ratepayers except for covering SFAS-106 costs.[43]

29. Finally, MCI notes that neither study addresses the low-end adjustment formula and how it relates to this case. This is a key omission, says MCI, because the low-end adjustment formula would serve as an adequate transition mechanism if price cap LECs do not receive exogenous treatment.[44] MCI states that the low-end adjustment will serve as a backstop for the LEC earnings in the first year or two following the FASB ruling's becoming effective as the LECs attempt to minimize the cost impacts of SFAS-106, and will protect the LECs from inordinately sharp drops in earnings.[45]

30. AT&T suggests that the Commission develop an alternative approach to these issues by adopting certain limitations on SFAS-106 accruals for exogenous treatment. Limitations, say AT&T, are appropriate to provide price

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39 See Id. at 7.

40 MCI Opposition at 2, 11.

41 Id. at 12, Appendix A.

42 Id. at 17.

43 Id. at 11.

44 Id. at 23.

45 Id. at 24.

cap LECs incentives to become more efficient in their management of OPEB expenses because they are to some degree within the control of the LECs,[46] the amounts are highly speculative,[47] and full exogenous treatment SFAS-106 amounts could give the LECs an unearned windfall.[48] AT&T explains that while SFAS-106 is good for accounting purposes because it reveals OPEB liabilities to shareholders, affording exogenous treatment for the same amount requires more scrutiny because exogenous treatment of the effects of SFAS-106 would immediately impact prices. Imposing limitations on exogenous treatment of SFAS-106 accruals, alleges AT&T, would protect ratepayers from paying for accruals based on OPEB benefits levels that may never be paid by the LECs.[49] If exogenous claims are overstated, AT&T explains, there is no price cap mechanism for making the ratepayer whole again as the price cap rules would treat any savings that are realized as an apparent productivity gain.[50]

31. Given the imprecise nature of SFAS-106 and the difficulty, if not impossibility, of assessing its impact upon particular companies, AT&T urges the Commission to establish uniform assumptions, or parameters, to govern exogenous claims. This alternative approach, says AT&T, would be both simpler and more reliable a means for ensuring no double counting and would avoid the numerous unverifiable assumptions used in the Godwins and NERA studies.[51] Then, as a safeguard to ensure that the amounts paid by ratepayers are used only for their intended purpose, AT&T proposes that only OPEB costs that are prefunded should be considered for exogenous treatment.[52] Without this, AT&T says, nothing would prevent the LECs from recovering SFAS-106 accrual amounts, then reducing or refusing to pay benefits at all in the future.[53] AT&T notes that, of the several funding vehicles available, the tax effective ones, such as IRS Code Section 501(c)(a) VEBA Trusts, 26 U.S.C. § 501(c)(a), generally forbid removal or transfer of funds except for the purpose for which they were established.

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46 AT&T Opposition at 20-21.

47 Id. at 21-23.

48 Id. at 24.

49 AT&T Opposition at 29. Indeed, AT&T and the other opposition parties all point out that estimates under SFAS-106 are not legally binding and do not reflect a carrier's actual funding obligation. Ad Hoc Opposition at 13; AT&T Opposition at 14-16; MCI Opposition at 7-8.

50 See, e.g., AT&T ex parte comments in CC Docket 92-101 (September 2, 1992).

51 AT&T Opposition at 14.

52 Id. at 14. See also MCI Opposition at 8.

53 AT&T Opposition at 7.

C. Replies

32. The LECs reply that exogenous treatment is warranted because the incremental cost increase due to the adoption of SFAS-106 is the result of actions beyond the control of the LECs and would not be reflected in other components of the PCI. The LECs explain that they do not seek exogenous treatment for a change in the level of benefits, but for the one-time accounting change.[54] Thus, they argue, the fact that the LECs have some control over OPEB expenses does not preclude exogenous treatment, because they have no control over the recognition of this liability on their books or the method of calculating costs associated with SFAS-106.[55]

33. The purpose of SFAS-106, the LECs believe, was to mandate the recognition of actual, unrecovered costs that employees earned but that were not reflected in employer's financial statements under pay-as-you-go accounting. The LECs argue that unless exogenous treatment is also afforded, they will be permanently denied recovery of costs that were prudently incurred in the provision of service to ratepayers.[56] Rochester argues that SFAS-106 accrual amounts are precisely the amounts that would have been embedded in initial price cap rates had SFAS-106 been mandated prior to initiation of price caps.[57] Rochester agrees with the opponents, unlike the other LECs, that the accounting change SFAS-106 does not increase the true economic costs of employee compensation, but argues that this is irrelevant because the NERA Study demonstrates that regulated firms, unlike firms that are not price regulated, have been able to reflect only the accounting costs of OPEBs in their prices.[58]

34. Some of the LECs argue that MCI's rate of return argument[59] is either irrelevant[60] or at least incorrectly assumes that a purported drop in stock prices associated with the adoption of SFAS-106 was caused by an increase in the cost of capital.[61] To the extent that a change in stock prices did occur investor expectations regarding growth in earnings or dividend payment charges must also be considered.[62] Thus, MCI's underlying argument here

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54 BellSouth Reply at 11; Ameritech Reply at 12.

55 E.g., Ameritech Reply at 4, 5.

56 BellSouth Reply at 6.

57 Rochester Reply at 4.

58 Id. at 5, citing NERA Study at 17-18.

59 See supra para. 27.

60 US West Reply at 11.

61 United States Telephone Association (USTA) Reply at 5.

62 Rochester Reply at 5.

ignores a more rational cause; that changes in the cost of capital are caused by changes in risks, not simply by a change in stock price.[63]

35. The LECs also claim that although the companies must estimate their accrual expenses for OPEBs, these estimates are not so uncertain as to justify not implementing the accounting change or rejecting exogenous cost treatment. The actuarial assumptions used are said to be used by the insurance industry for pensions and other costs,[64] limited by the guidelines prescribed by SFAS-106,[65] and a normal part of accrual accounting.[66] US West contends that the opponents' argument that OPEB costs can be changed at will is a gross oversimplification, arguing that the opponents ignore the large portion of costs related to the TBO, which is a liability based on past commitments.[67]

36. Additionally, the LECs argue that the limitations proposed by the opponents would be arbitrary and capricious.[68] For example, these parties say that the creation of a uniform set of FCC-mandated assumptions neglects the fact that the actuarial assumptions upon which the accounting levels are based are, for the most part, founded on experience within the company or the industry, are collected and prepared over a long period of time, and are otherwise consistent with SFAS-106.[69] Various LECs assert that individual LEC demographic data and medical cost trends are necessary to render the calculations valid.[70]

37. Moreover, the LECs maintain that exogenous claims should not be limited to prefunding for OPEB accruals.[71] As with any other accrual expense, they explain, recognition and funding are wholly independent events and they should remain so. Funding the obligation, these price cap LECs claim, is based on management's decisions about the best use of corporate assets, while recognition of SFAS-106 costs flows from the adoption of the accounting change

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63 USTA Reply at 5.

64 BellSouth Reply at 19-20.

65 Ameritech Reply at 9.

66 GTE Reply at 6-7.

67 US West Reply at 9.

68 Rochester Reply at 6.

69 Id.; Southern New England Telephone Co. (SNET) Reply at 5; Ameritech Reply at 20; BellSouth Reply at 20-24.

70 Bell Atlantic Reply at 15; BellSouth Reply at 29; SNET Reply at 6.

71 GTE Service Corporation (GTE) Reply at 23-25; New England Telephone and New York Telephone Company (NYNEX) Reply at 32; Rochester Reply at 6.

of an increased current expense on the company's books.[72] Further, they state that no such mandatory prefunding is necessary to protect ratepayers. Ratepayer protection, United explains, is provided for by the Commission in RAO Letter 20,[73] where the Commission required a LEC's rate base to be reduced by the amount of any unfunded accrued postretirement benefits.[74] A prefunding requirement, maintains United, would require it to borrow funds and incur costs to cover the portion of funding not deductible for tax purposes.[75]

38. Recognizing there may be a need to ensure that LEC claims will not be unreasonable in the future due to significant unforeseen factors, SWBT states that it would not object to a true-up of SFAS-106 liability if major changes occur.[76] US West also would accept an annual true-up to ensure that significant changes in actuarial assumptions will not result in a windfall to LECs. US West states that the true-up should address only those costs associated with the TBO on January 1, 1993. Costs associated with future service cost should not be included, presumably because these are within the control of the LEC.[77] Other LECs, like Ameritech, oppose a true-up mechanism because such a mechanism would impose an unreasonable burden on the LECs and the Commission to track these costs indefinitely.[78]

39. Finally, Rochester disputes MCI's argument that the low-end adjustment mechanism is an appropriate backstop for LEC earnings in the first year or two of the FASB ruling. It argues that the treatment of certain costs as exogenous and the lower end sharing mechanisms exist conterminously. Rochester does not believe that the Commission intended for one to replace the other.[79]

IV. DISCUSSION

40. For the reasons set forth below, we find that the LECs have failed to meet their burden of proof in this investigation and we deny the LECs' request for exogenous treatment of SFAS-106 expenses in these transmittals. We therefore find the specific tariffs filed by US West and Pac Bell unlawful in this investigation, and we also conclude that all price cap LECs who have been

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72 SNET Reply at 7; SWBT Reply at 13; Rochester Reply at 28.

73 See supra note 5.

74 United Telephone System companies (United) Reply at 5.

75 Id. at 4.

76 SWBT Reply at 45.

77 US West Reply at 18.

78 Ameritech Reply at 19.

79 Rochester Reply at 4-5.

parties to this proceeding have failed to meet their burden of demonstrating that exogenous treatment should be afforded for this GAAP change.[80]

41. We are very sensitive to the needs of these, and all companies, that want to provide health care benefits for their employees. Therefore, we would like to make clear that our decision here does not in any way restrict LECs from providing adequate health care benefit packages to their employees. Nor does our decision require these companies to cut back their benefits to their employees. As discussed below, our price cap plan will permit recovery of current and future LEC OPEB expenses. In the face of rising health care costs these LECs, through the incentives built into our price cap regime, will only be subject to the same risks and rewards that all U.S. companies face in making their decisions to provide these benefits to their employees.

A. Introduction

42. The price cap plan creates incentives and constraints similar to those in competitive marketplaces, where companies face greater risks, but also can achieve greater profits by operating more efficiently than their rivals. Under price caps, LECs similarly bear the risk of lower profits than under cost-plus rate of return regulation, but are given the incentive of potentially higher earnings for efficiency gains above the historical norm. They are also constrained, and their customers protected, by the price ceiling, which helps assure that the profit increase is in fact a result of efficiency gains. This plan as applied to LECs is scheduled for comprehensive review beginning just over a year from now. In this initial four-year period of operation, however, our intent has been to allow the plan to operate in a stable fashion, both to permit efficiencies to be realized and to enable us to draw valid conclusions about LEC performance under the plan over time. This goal is aided by the "backstop" mechanism that provides an additional safeguard against rates that are unreasonably high or low.

43. The record in this proceeding indicates that the price cap LECs as a whole are seeking the opportunity to raise price indexes industry-wide, on average, approximately 1.2 to 1.4 percent. This amounts to roughly a $233 to 267 million increase in interstate access rates that the IXCs and their customers would pay each year for at least the next 17 to 20 years. The LECs argue that these rate increases are justified as exogenous cost changes, at least in substantial part, basically because they are changes required by GAAP and Commission order, are out of the LECs control, and are not already reflected in GNP-PI. We address first the role of exogenous cost changes in price caps and the standards for determining whether a cost change should be considered endogenous (i.e., included in the price cap formula) or exogenous (i.e., added to the price cap formula).

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[80] Since we decide that the LECs have failed to clear the threshold question raised in the investigation (that is, whether the LECs have borne their burden of demonstrating that implementation of SFAS-106 results in an exogenous cost change under the Commission's price cap rules), we do not address below all of the subsequent questions raised in our Suspension and Investigation Order.

44. This case presents the first opportunity for the Commission to consider and apply its approach to exogenous treatment under price caps to a particularly difficult situation. To summarize the case briefly, the claimed change in costs is the result of a change in accounting rules that applies generally to American businesses, not simply or uniquely to utilities and telephone companies. The effect of the change may therefore be reflected in GNP-PI. The LECs' claim is that, by analysis, they have reasonably identified the extent of the change's effect on GNP-PI, proven that it affects LECs disproportionately, and that a partial, fractional exogenous change has been justified, to the extent that the effect is greater for LECs than for the economy as a whole. The opposition assert that the LECs have failed to meet their burden of justifying exogenous treatment, on grounds including the LECs' ability to control OPEB costs, defects in the LECs' studies of SFAS-106's impact, and the fact that the change is only in the accounting for OPEBs, not in the economic costs of these benefits.

B. Exogenous Cost Changes Under Price Caps

45. The category of exogenous cost changes was created by the Commission as an exception to the incentive structure of price caps. Based on a case-by-case evaluation of specific cost changes, the Commission adopted a list of these exceptional, exogenous cost changes in Section 61.45(d) of the Rules.[81]

46. In establishing this list and applying it in particular cases, we have considered and weighed several factors. Because the designation of any cost change as exogenous removes the incentive for efficiency that is a principle goal of price caps, a major consideration has been the extent to which the cost change may be affected by incentives. An efficiency incentive is effective only for costs which the carrier has some ability to control, for example by adjusting its operations or price structure. Changes in costs triggered by administrative, legislative, or judicial action beyond the control of the carrier have thus been considered as candidates for exogenous treatment, to ensure that the incentive structure of the price cap formula does not produce unreasonably high or low rates.

47. Certain types of cost changes were designated as exogenous in all cases, for example changes in the Separations Manual.[82] Other types of regulatory decisions accorded categorical exogenous treatment include pre-price cap programs such as the amortization of depreciation reserve deficiencies, changes in carrier support funds, and inside wire amortization.[83] However, not

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81 47 C.F.C. § 61.45(d).

82 See 47 C.F.R. § 61.45(d)(1)(iii); LEC Price Cap Order, 5 FCC Rcd at 6807 ("Regulatory decisions that are designed to produce just and reasonable rates must affect the cap in order to ensure that the system results in rates that are just and reasonable.")

83 47 C.F.R. § 61.45(d)(1)(i), (iv), and (viii).

all changes in costs beyond the control of the carrier are likely to result in unreasonably high or low rates, or to otherwise be appropriate for exogenous adjustment. A change in tax law, for example, generally affects all businesses, not just carriers, and is thus likely to be reflected in the GNP-PI component of the formula. Exogenous treatment might thus double-count the change, unless the tax uniquely or disproportionately affects carriers.[84]

48. Moreover, the touchstone for the Commission in determining whether a change should be afforded exogenous treatment has been consistency with the incentive structure of the price cap plan. For example, in the AT&T Price Cap Order we stated that "[e]ven more important than the question of degree of control ... is the question whether exogenous cost treatment ... is consistent with the concept of incentive regulation."[85] The concept of incentive regulation is that an administratively simple mechanism of maximum prices, combined with a widened range of allowable profits, will provide encouragement for the carrier to make business decisions as a competitive firm would, in the knowledge that its earnings will in substantial part and over the long term be determined by how effective those decisions are. In deciding whether a cost change should be endogenous or exogenous, we have sought to maintain this incentive.

49. For example, in some cases where exogenous treatment was urged as necessary to prevent windfalls to the carrier, we have nevertheless required endogenous treatment to foster efficiency. For example, the Commission held that international accounting rate changes by foreign administrations are endogenous to encourage AT&T to negotiate lower rates with those administrations,[86] and bypass of LEC services by AT&T were also held endogenous to provide incentives for AT&T to minimize its costs and LECs to reduce access rates.[87] Similarly, carrier arguments that events outside the carrier's control should be considered exogenous have been denied where appropriate to maintain price cap's efficiency incentives. For instance, extraordinary costs caused by events such as earthquakes and hurricanes are endogenous. The Commission recognized that while the events were outside LEC control, preparing for and coping with such unforeseen costs is part of a firm's functions, and exogenous treatment would create the wrong incentives.[88] Moreover, migration of IXC POPs is endogenous and considered a common business risk for the LECs because exogenous treatment would be "contrary to the goals

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[84] Id. at § 61.45(d)(1)(vi); see also AT&T Price Cap Order, 4 FCC Rcd at 3009.

[85] AT&T Price Cap Order, 4 FCC Rcd at 3016 (finding depreciation rate changes are endogenous, even though prescribed by the Commission).

[86] Id. at 3018.

[87] Id. at 3020-21.

[88] LEC Price Cap Order, 5 FCC Rcd at 6809-10.

of the price cap program."[89]

50. In addition, we have taken into consideration the practical consequences of granting exogenous treatment of cost changes upon the goal of establishing an administratively simpler and less burdensome form of regulation.[90] For example, exogenous treatment of equal access conversion costs was denied, in part, because of the difficulty of reviewing those costs "and the corresponding risk that these carriers could willfully or inadvertently shift switched access costs into the equal access category ..."[91] A request for bifurcated treatment of depreciation rates, with exogenous treatment only of pre-price cap investments, was denied, not only because LEC's control their depreciation expenses and exogenous treatment would risk destroying LEC efficiency incentives, but also because the plan would be "an administrative nightmare."[92] The price cap formula establishes a "rough justice" measure of maximum reasonable rates, subject to adjustment through other mechanisms such as the "backstop", the comprehensive review, requests for waivers, and demonstration of good cause for permitting above-cap rates. In determining whether to treat a cost change as exogenous or endogenous, we have sought to recognize the operation of this framework, and to promote both the efficiency incentives of the price cap plan and the setting of just and reasonable rates.

51. We were initially inclined to treat accounting changes as categorically exogenous. This included GAAP changes, if the Commission found the changes in GAAP consistent with our regulatory accounting needs, and the change had become effective.[93] However, we later recognized that not all GAAP changes, even if approved by the Commission for accounting purposes, should be given exogenous treatment. For example, GAAP changes generally affect all companies, and exogenous treatment of such changes might, as in the analogous case of tax changes, double count the effect. We therefore decided to consider GAAP changes on a case-by-case basis. In the specific case of OPEBs, we also denied requests for removing pre-funded amounts from price caps and, taking into account "the orderly administration of the price cap system", deferred consideration of whether to allow exogenous treatment of OPEBs until the GAAP change became effective.[94] We reiterated that "the determination of whether a particular GAAP change is exogenous includes an analysis of whether the cost

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[89] Id. at 6809.

[90] AT&T Price Cap Order, 5 FCC Rcd at 3020 (exogenous treatment of extraordinary costs "would be setting the stage for an endless succession of arguments focused on whether a particular cost qualifies as 'extraordinary.'").

[91] LEC Price Cap Order, 5 FCC Rcd at 6808.

[92] Id. at 6809.

[93] AT&T Price Cap Order, 4 FCC Rcd at 3017-18; LEC Price Cap Order, 5 FCC Rcd at 6807.

[94] LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2663-65.

change will be reflected in the inflation variable of the PCI." [95]

52. The test for whether GAAP changes should be treated as exogenous has two prongs. First, are the costs not within the control of the price cap carriers? And second, are the costs not reflected in the price cap formula, for example, in GNP-PI? If the answer to both questions is yes, GAAP changes can be treated as exogenous. We also made it clear that price cap carriers seeking adjustment to their PCIs based on a change in GAAP bear the burden of demonstrating that exogenous treatment should be granted.[96] More generally, in any Section 204(a) rate investigation, carriers bear the burden of proof to show that a rate increase is just and reasonable.[97]

C. Exogenous Treatment of SFAS-106

i. LEC Control Over OPEB Expenses

a. Ongoing OPEB Expenses

53. No party disputes that the change to accrual accounting by FASB was not within the carriers' control, but they differ in the extent to which carriers can control the effects of this change.[98] Some of the parties have argued that the control prong of the test for exogenous treatment is resolved in the LECs' favor once the Commission has decided that a GAAP change is consistent with the Commission's accounting purposes. They note that the particular sections in the price cap decisions on GAAP changes are silent on control except to recognize that GAAP changes must be consistent with FCC regulatory policy before carriers may adopt them. We believe that these parties put forth an overly narrow view of the meaning of control for purposes of evaluating whether a particular cost change warrants exogenous treatment under our price cap plan. In general, we have held that a lack of control over the regulatory action is not enough of a showing to justify exogenous treatment. For example, in our decision to deny exogenous treatment of depreciation rates,[99] the Commission noted that while the change in depreciation rates was set by federal and state regulatory agencies and was thus beyond the control of the carriers, the carriers nonetheless could exercise control over depreciation costs through their decisions to deploy or retire equipment, the major determinant of the amount of depreciation expenses. As in that decision, we find that the LECs have had, and continue to have, control over the present and future benefit plans they set with their employees and the costs of these plans, the major determinants of OPEB expenses. Just as they do for depreciation expense, LECs can exercise substantial control over the level and timing of OPEB expenses. Treating a change in OPEB accounting as exogenous

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95 Id.

96 LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2663-65, 2668.

97 47 U.S.C. § 204(a).

98 Compare MCI Opposition at 7-10 with, e.g., Ameritech Reply at 10-11; Bell Atlantic Reply at 8; GTE Reply at 20-23.

99 LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2671-72.

would, at least for ongoing benefit plans, give the LECs undue power to influence their PCI levels, and would undermine the incentive structure of price caps.

54. As with other forms of compensation, the LECs exercise considerable control over the costs of administering their retiree health care plans. Indeed, the scope for efficiency gains is probably greater for those benefits than for other forms of compensation. For example, to reduce costs of OPEBs, and thereby reduce booked liabilities, companies can explore managed care arrangements, flexible benefit plans, outpatient treatment programs and generic prescription drug programs.[100] Companies can also seek to encourage efficient use of health resources through co-payments, for example, benefit caps and shared expense requirements.[101] The LEC direct cases reveal that companies have begun introducing, or plan to introduce, these types of cost control measures without changing the underlying benefits that are provided.[102] Indeed, NYNEX explains that a benefit cap alone would cut its estimated OPEB accruals under SFAS-106 nearly in half.[103]

55. Moreover, the LECs, like all companies, have considerable control over their underlying benefit plans, especially in relation to their overall compensation packages. When originally negotiating with employees for OPEBs, the LECs are apparently in a position neither more favorable nor less favorable than other firms, either regulated or nonregulated, when competing in the market for hiring labor. In other words, there is no evidence that the LECs need to pay more, or less, than the total wages and benefits set by the market to attract the workers they need. Exogenous treatment of ongoing OPEB costs would be asymmetric, treating compensation in the form of OPEBs differently from compensation in the form of wages and other benefits. This asymmetry could distort LEC incentives, undercutting the efficiency incentives price caps was intended to create. For example, the LECs could substitute wages for OPEB benefits.[104]

56. SFAS-106 may have an effect of highlighting OPEB costs and moving forward the time when they are recognized, but it does not change the total amount that all firms, including the LECs, must pay to attract workers. It also does not change the LECs ability to design overall compensation and benefit packages that attract and keep good employees, as cost-efficiently as possible.

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100 See e.g., Washington Post, Aug. 18, 1992, p. C1; Business Week, Nov. 30, 1992, p. 114-15.

101 New York Times, Nov. 24, 1992, p. D2.

102 See e.g., Ameritech Direct Case at 21; Bell Atlantic Direct Case at 26; Pacific Reply at 18.

103 NYNEX Direct Case, Attachment B. See also BellSouth Reply at 29 (cap to be placed beginning January 1, 1993); SNET Direct Case at 27 (cap will be in effect in 1996); US West Direct Case, Attachment F (20% cap).

104 See MCI Opposition at 9.

Therefore, we find that at least as to future accrued OPEB expenses, the LECs have substantial control over the amount booked as OPEBs, and thus fail the first prong of the exogenous cost test.

b. TBO Expenses

57. While we thus conclude that going-forward OPEB costs are within the control of the LECs, and thus not eligible for exogenous treatment, it is less clear whether or to what extent the LECs control OPEB costs associated with the TBO for purpose of the test for exogenous treatment. US West, for example, agrees that it exercises control over ongoing benefit costs for OPEBs, but contends it has no control over TBO costs, which represent the accrued amount of benefits promised to retirees before SFAS-106 took effect. US West argues for recognition of at least the TBO as an exogenous cost.[105] Even though the LECs can implement cost cutting measures that would not necessarily require changes to the underlying benefit plans, and these companies controlled these plans when they were originally negotiated, it appears that the LECs may well have less control over some of the amounts included in the TBO because these obligations are based on past contractual obligations, obligations that arose prior to the mandated GAAP change.[106]

58. First, the TBO includes benefits accrued by both those vested in their benefit plans and those not yet vested. Since US West admits that, on a prospective basis, it controls OPEB costs of those who are not yet vested, its argument that the entire TBO should be exogenous appears overbroad. Moreover, it is not clear to what extent either the benefit plans or their costs are fixed even for vested employees. As discussed above, the LECs and other companies are exploring changes in their plans even for current retirees. The extent to which they can control changes in these plans apparently depends upon the specific terms of their labor contracts. Moreover, the level of benefits provided to retirees is not necessarily linked to the cost of the plan. An improvement in efficiency, such as preventative measures to improve retirees' health, or more cost-effective therapy, may reduce costs without reducing benefits.

59. For the present, however, we need not resolve the issue of whether the LECs meet the first prong of the test for exogenous cost treatment. As we discuss below, even assuming lack of control over the TBO, we conclude that the LECs have failed to meet their burden of proving that the TBO meets the second prong of the test.

ii. Unique or Disproportionate Effect

60. The second prong of the test for exogenous treatment of these

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[105] US West Reply at 9.

[106] It is also possible that LECs relied on the initial price cap orders, which indicated that all mandatory GAAP changes would be considered exogenous, when making business decisions on whether to fund OPEBs. The Commission modified this approach on reconsideration. See para. 49, supra.

costs is whether the carriers can show that the cost change at issue is not reflected in the PCI. To satisfy this test, the carriers must show that the cost change has a unique or disproportionate effect on the price cap companies.[107] We have emphasized, for example, that LECs bear the burden of demonstrating that a cost change is not already reflected in the economy-wide GNP-PI component of price caps. For example, where there is a tax law change that affects all companies in the economy, the change is endogenous even though the LECs may be affected to a greater or lesser degree than the average taxpayer.[108] Our review of the current record convinces us that the LECs have not met their burden. The studies provided are flawed in several significant respects and it is impossible for this Commission to determine whether or to what extent OPEBs have been reflected in GNP-PI on the basis of the record.

a. GNP-PI Studies and SFAS-106 Accounting

61. We note, as an initial matter, that the GNP-PI component of the formula is affected by a myriad of influences, each of which affects a company or the industry in differing degrees. Every cost change that affects LECs will be reflected to a greater or lesser degree in the economy as a whole, and thus to a greater or lesser degree in GNP-PI. Thus, there is not necessarily a precise correspondence between any particular endogenous cost change and the extent to which it is reflected in GNP-PI. In determining whether a particular cost change is reflected in GNP-PI for purposes of determining whether it satisfies the second prong of the test for exogenous treatment, we must keep in mind the "rough justice" nature of the GNP-PI element of the price cap formula.

62. The present case illustrates the difficulty of evaluating whether a change in one of these influences can even be identified and reasonably quantified. First, the assumptions on which such an analysis might be made are unclear, as the two LEC studies show. Godwins assumes that SFAS-106 is an economic cost change that will affect all companies' costs and prices in the coming years, and contends that the effect on LECs is disproportionate because they typically differ from other companies in characteristics such as the level of current OPEB benefits and, the demographics of their employees and retirees. Godwins also reasons that SFAS-106 will tend to lower other wage rates. In sharp contrast, NERA argues that SFAS-106 will have none of these effects for most companies, because it does not change their actual economic costs and liabilities. While Godwins assumes that companies respond to their booked costs, NERA reasons that non-regulated companies set prices based on economic costs, which are better reflected in accrual accounting than pay-as-you-go. According to NERA, non-regulated firms thus have already reflected accrued OPEB costs in their prices, but regulated firms did not, because their prices have been based upon accounted-for costs plus profit. The disproportionate impact for the LECs, according to NERA, stems from this constraint on regulated firms such as the LECs.

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107 See Section IV A, supra.

108 Compare AT&T Price Cap Order, 4 FCC Rcd at 3009 and LEC Price Cap Recon Order, 6 FCC Rcd at 2668 with Bell Atlantic Trans. 473, 7 FCC Rcd 1486 (Com. Car. Bur. 1992).

63. Neither study proves that its initial assumptions are in fact correct and any conclusion we might draw from them thus seems speculative. We are given no substantial evidence to indicate that companies either have in the past factored accrued OPEB costs into their prices, as NERA assumes, or that they are beginning to do so now that SFAS-106 has taken effect, as Godwins assumes. The evidence at hand is that many companies have taken one-time write-offs and have undertaken efforts to reduce their long-term OPEB costs. But this applies to the LECs as well as others. Thus, as a starting point, we have no clear basis for determining what effect SFAS-106 will have on GNP-PI.

64. Moreover, we do not believe that, even on their own terms, the LEC studies persuasively demonstrate that the SFAS-106 has a "unique or disproportionate effect" on LECs within the meaning of the test for exogenous treatment. We are particularly concerned that the Godwins and NERA studies rely on assumptions that affect the results and that we have no independent means to verify. For example, we note that the Godwins model assumes the values for several parameters in its model, and estimates several others. In its Supplemental Report attached to several of the LECs' Reply comments, however, Godwins notes that there are 648 possible combinations of the range of values of the parameters whose values were assumed in the model.[109] Godwins reports that proportion of SFAS-106 costs which would not be reflected in the GNP-PI for several, although not all 648, of these combinations. It finds that, using what it terms "unlikely and extreme" values of the parameters, the lowest portion of SFAS-106 costs that will not be reflected in the GNP-PI is 60.1 percent as compared to the 84.8 percent it stated in its original study. Additionally, we are not persuaded by the basic assumption in the NERA Study that the unregulated sector has already fully assessed the effect of the SFAS-106 accounting change. Evidence in the record suggests that many firms in the unregulated sector did not even measure their OPEB liabilities until late in 1992, much less determine how it will affect them as a result.[110]

65. We are additionally concerned that SFAS-106 accounting requires LECs to make many other assumptions which are highly speculative and where small changes to certain key assumptions in their calculations would dramatically alter the computed effect of SFAS-106 and the resulting exogenous claim. As is the case with the assumptions underlying the studies, we have no way to verify most of the assumptions made by the LECs in their claims. For instance, the central subject in this investigation centers on predictions of future health care costs. In view of the current national debate on these issues, such predictions must be viewed as very speculative. As AT&T notes in its opposition, SFAS-106 accrual amounts are very sensitive to changes in the health care trend. AT&T notes, for example, that a one percentage point reduction in the health care trend from the value assumed by Pac Bell would

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[109] See United States Telephone Association, "Analysis of Impact of SFAS 106 Costs on GNP-PI, Supplemental Report: Responses to Objections Raised Regarding Original Study," at 31.

[110] Towers Perrin Monitor, "FAS 106: Preparing to Take the Hit," April 1992, Towers Perrin Survey, "Facing FAS 106: Where Employers Stand," 1, 3-5.