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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
1993 Annual Access Tariff Filings	)	**CC Docket No. 93-193**
	)	**Phase I**
	)	
1994 Annual Access Tariff Filings	)	**CC Docket No. 94-65**
	)	
AT&T Communications	)	**CC Docket No. 93-163** 193
Tariff F.C.C. Nos. 1 and 2	)	**Phase II**
Transmittal Nos. 5460, 5461, 5462 and 5464	)	
	)	
Bell Atlantic Telephone Companies	)	**CC Docket No. 94-157**
Tariff F.C.C. No. 1	)	
Transmittal No. 690	)	
	)	
NYNEX Telephone Companies	)	
Tariff F.C.C. No. 1	)	
Transmittal No. 328	)	

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DIRECT CASE OF
ROCHESTER TELEPHONE CORP.

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The amounts that Rochester claimed in its 1993 and 1994 Annual Access Tariff Filings for the TBO-portion of the incremental expenses associated with SFAS-106 are correct and qualify for exogenous cost treatment under the rules as they existed at the time.

The D.C. Circuit has unequivocally held that the costs in question so qualify. In so holding, the Court concluded that whether companies possess control over the underlying benefits costs is legally and factually irrelevant. What is relevant under the former rules is that exchange carriers had no control over the one-time *accounting* change. The Court further held that the additional possibilities of double-counting -- inter-temporal double-counting, effect on the authorized rate of return, effect on the productivity offset -- could *not* be relied upon by the Commission as grounds for denying or limiting exogenous treatment of SFAS-106 amounts. Thus, such issues are no longer relevant to these investigations.

In this Direct Case, Rochester demonstrates four points. *First*, Rochester properly estimated its SFAS-106 expenses that are attributable to regulated interstate operations. The SFAS-106 costs were developed by Buck Consultants, Rochester's actuarial consultants, and represent the "best estimates" of such expenses at that time as required by SFAS-106.

Second, the implementation of SFAS-106 had only a minuscule effect on GNP-PI. As the NERA study demonstrates, the implementation of SFAS-106 had no effect upon the economic costs of providing OPEBs. Because firms in sectors of the economy that are not

price regulated set the prices for the goods and services based upon economic -- not accounting -- costs, the implementation of the new accounting standard had no effect on the economic costs of those companies' provision of OPEBs. Indeed, the implementation of SFAS-106 would only be expected to affect the prices of rate-regulated firms -- principally regulated companies and those operating under cost-plus contracts. NERA estimated that the effect on these companies -- if they were permitted fully to reflect the accounting change in rates -- would increase GNP-PI by approximately 0.12%, a factor Rochester took into account in calculating the amount of its TBO-related expenses for which it claimed exogenous cost treatment.

Third, Rochester applied appropriate separations and allocation factors in apportioning its TBO-related expenses to regulated interstate access services and properly allocated those costs among the price cap baskets.

Fourth, there is no basis in the rules or in economic reality for limiting exogenous cost recognition only with respect to those SFAS-106 expenses that a company has funded or with respect to employee interests that have vested.

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DIRECT CASE OF
ROCHESTER TELEPHONE CORP.

Introduction

Rochester Telephone Corp. ("Rochester") submits this Direct Case in response to Bureau's Designation Order in these consolidated proceedings.[1] Rochester will demonstrate herein that the amounts associated with the implementation of Statement of Financial Accounting Standard ("SFAS")-106 governing the accounting treatment of other

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[1] *1993 Annual Access Tariff Filings, et al.*, CC Dkts. 93-193 (Phase I), *et al.*, Order Designating Issues for Investigation, DA 95-1485 (Com. Car. Bur. June 30, 1995) ("Designation Order").

post-employment benefits ("OPEBs") for which Rochester claimed exogenous cost treatment in the 1993 and 1994 Annual Access Tariff Filings were properly calculated.

Organization of This Direct Case

Rochester's Direct Case consists of two parts. First, Rochester sets forth in narrative form its arguments justifying exogenous treatment for the incremental SFAS-106 expenses for which Rochester sought such treatment. To the extent relevant to this narrative, Rochester also responds, in the narrative, to the Bureau's specific data requests. In addition, Rochester provides a series of Appendices that answer more fully the specific data requests contained in the Designation Order.

Background

1. Proceedings Relating to the Exogenous Cost Treatment of SFAS-106

a. Adoption of SFAS-106

On December 26, 1991, the Bureau approved the requests of two exchange carriers to adopt SFAS-106.[2] The adoption of SFAS-106 required employers to account for OPEBs on an accrual basis (recognizing the costs of OPEBs when they are earned by employees) rather than on a cash basis (recognizing such costs when benefits are paid). SFAS-106 also required employers to recognize the unfunded obligation relating to OPEBs as of the date of adoption of SFAS-106 -- the transitional benefit obligation ("TBO"). The Bureau

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[2] *Southwestern Bell Corporation, GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No.-106, Employers' Accounting for Postretirement Benefits Other Than Pensions*, 6 FCC Rcd. 7560 (Com. Car. Bur. 1991).

required carriers to amortize the TBO over the remaining active service years of plan participants or twenty years.[3]

b. The 1992 Investigation

Thereafter, three price cap exchange carriers filed transmittals claiming exogenous cost treatment for the financial effects of implementing SFAS-106. The Bureau suspended the transmittals, instituted an investigation and named all price cap carriers as parties to that investigation.[4]

In its Direct Case in CC Docket 92-101, Rochester quantified the amount attributable to the interstate access services for itself and for Vista Telephone Company of Iowa and Vista Telephone Company of Minnesota (together, "Vista").[5] The amounts quantified were $2,352,200 for Rochester and $344,700 for Vista.[6] Rochester further demonstrated that:

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3 *Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32*, 7 FCC Rcd. 2872 (AAD 1992).

4 *Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions,"* CC Dkt. 92-101, Order of Investigation and Suspension, 7 FCC Rcd. 2724 (Com. Car. Bur. 1992).

5 The latter two companies are now known as Frontier Communications of Iowa, Inc. and Frontier Communications of Minnesota, Inc

6 *See Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions,"* CC Dkt. 92-101, Direct Case of Rochester Telephone Corporation at Exs. III-IV (May 29, 1992) ("Rochester 1992 Direct Case")

The amounts identified in Rochester's 1992 Direct Case covered both ongoing and TBO costs.

(a) the incremental expenses associated with the implementation of SFAS-106 qualified for exogenous cost treatment under the price cap rules then in effect;

(b) the effects of implementing SFAS-106 would be reflected only minimally in the gross national product-price index ("GNP-PI") component of the price cap formula;

(c) Rochester had properly quantified its incremental SFAS-106 expenses; and

(d) Rochester's proposed method of allocating those expenses among the price cap baskets was reasonable.[7]

The Commission, however, rejected the claims of the price cap exchange carriers and concluded that they had failed to meet their burden of proving that the expenses associated with the implementation of SFAS-106 qualified for exogenous cost treatment.[8] The Commission held that ongoing SFAS-106 costs did not qualify for exogenous cost treatment because "the LECs have substantial control over the amount booked as OPEBs, and thus fail the first prong of the exogenous cost test."[9] The Commission further held that, while it was not foreclosing further consideration of TBO-related expenses, it concluded that, on the record presented, the price cap exchange carriers had failed to demonstrate

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7 At the time of the CC Docket 92-101 investigation, Rochester had not filed tariff revisions seeking exogenous treatment of these expenses. It provided the information contained in its 1992 Direct Case in response to the Bureau's Designation Order in that proceeding.

8 *Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards "Employers Accounting for Postretirement Benefits Other Than Pensions,"* Memorandum Opinion and Order, 8 FCC Rcd. 1024 (1993) ("1993 OPEB Order").

9 1993 OPEB Order, 8 FCC Rcd. at 1033, ¶ 56.

that "the cost change at issue is not reflected in the (price cap index)."[10] The Commission suggested the 1993 Annual Access Tariff Filing as one forum to consider these issues.[11]

c. The D.C. Circuit Proceedings

A number of price cap exchange carriers petitioned for review of the 1993 OPEB Order. The D.C. Circuit, in a unanimous decision, vacated that order and remanded the case to the Commission for further proceedings.[12] The Court concluded that the Commission had "concoct(ed) a new rule in the guise of applying the old."[13] Specifically, the Court found that the Commission's "control" test and its newly-minted theories of double counting could not be found within the rule as then written.[14]

d. 1993 Annual Access Tariff Filing

In its 1993 Annual Access Tariff Filing, Rochester claimed exogenous cost treatment for the amortization of the TBO for Rochester for two periods: (1) the 1993/1994 tariff year; and (2) for the first six months of 1993. The total amount for which exogenous cost treatment was claimed was $1.407 million.[15]

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10 *Id.*, 8 FCC Rcd. at 1034, ¶ 60.

In this regard, the Commission suggested a number of means through which the effects of implementing SFAS-106 might have been reflected in the price cap index. These means included inter-temporal double counting, double counting within the productivity offset and double counting within the authorized rate of return. *Id.*, 8 FCC Rcd. at 1035-36, ¶¶ 67-72.

11 *Id.*, 8 FCC Rcd. at 1037, ¶ 76.

12 *Southwestern Bell Telephone Co. v. FCC*, 28 F.3d 165 (D.C. Cir. 1994).

13 *Southwestern Bell*, 28 F.3d at 173.

14 *Southwestern Bell*, 28 F.3d at 169-73.

15 *See Rochester Telephone Corp.*, Tariff F.C.C. No. 1, Trans. No. 187, Description & Justification ("1993 D&J") at § 4.4, Ex. 1-9 (April 2, 1993).

As set forth in Exhibit 1-9, Rochester provided business unit level SFAS-106 expense numbers, removed those expenses associated with Rochester's own unregulated activities, applied an interstate separations factor, netted-out pay-as-you-go expenses, removed the limited effect that the implemention of SFAS-106 might have had on GNP-PI and allocated the resulting amount to the price cap baskets in proportion to base year revenues attributable to each of the baskets.[16]

The Bureau suspended the 1993 Annual Access Tariff Filings for one day, imposed an accounting order and set the filings for investigation.[17]

e. 1994 Annual Access Tariff Filing

In its 1994 Annual Access Tariff Filing, Rochester made one adjustment to the amount that became embedded in its rates as a result of the 1993 Annual Access Tariff Filing. Because the 1993 Filing accounted for eighteen months of SFAS-106 TBO expenses, Rochester backed out an amount attributable to the extra six months. This

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Because Rochester did not seek exogenous recognition for any amounts associated with the implementation of SFAS-106 for its Tier 2 affiliates that concur in its Tariff F.C.C. No. 1 or for Vista, there is nothing for the Bureau to investigate with respect to those companies. Accordingly, this Direct Case relates to Rochester only.

16 This allocation to the price cap baskets differed from that proposed in Rochester's 1992 Direct Case. However, as demonstrated *infra* at 25 n.52, the two methodologies produce only *de minimis* differences and both are appropriately cost-causative methodologies.

17 *1993 Annual Access Tariff Filings*, CC Dkt. 93-193, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, 8 FCC Rcd. 4960 (Com. Car. Bur. 1992).

treatment resulted in a negative exogenous cost adjustment of $548,539 for the 1994-1995 tariff year.[18]

The Bureau suspended the 1994 Annual Access Tariff Filings for one day, imposed an accounting order and set the filings for investigation.[19]

The instant Designation Order followed.

2. A Description of Rochester's Post-Employment Benefits

The following is a general description of the benefits offered by Rochester as of January 1, 1993 -- the date that Rochester implemented SFAS-106 and the first date for which Rochester claimed exogenous treatment of the TBO portion of its OPEB expenses.[20]

Life Insurance -- Active employees were provided term life insurance in an amount equal to their annual salaries. Upon retirement, this level was fixed at the departure salary

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18 *Rochester Telephone Corp.*, Tariff F.C.C. No. 1, Trans. No. 222, Description & Justification ("1994 D&J") at Ex. 1-8 (April 1, 1994).

19 *1994 Annual Access Tariff Filings*, CC Dkt. 94-65, Memorandum Opinion and Order Suspending Rates, 9 FCC Rcd. 3519 (Com. Car. Bur. 1994); *1994 Annual Access Tariff Filings*, CC Dkt. 94-65, Memorandum Opinion and Order Suspending Rates, 9 FCC Rcd. 3705 (Com. Car. Bur. 1994).

20 For purposes of this investigation, the only relevant period of time is calendar year 1993. What is being claimed as exogenous is the one-time *accounting* change occasioned by the implementation of SFAS-106. That exchange carriers possess control over the type, level and costs of post-employment benefits is totally irrelevant to whether the incremental costs associated with the implementation of SFAS-106 qualify for exogenous cost treatment or the amounts thereof that so qualify. *See Southwestern Bell*, 28 F.3d at 169-70.

The Designation Order requests the production of data relating to other periods of time. Although such data is legally and factually irrelevant to the issues presented in this proceeding, Rochester is producing the requested information in compliance with the Designation Order. The postretirement benefits that Rochester offered subsequent to 1993 are described in Appendix B.

rate until the retiree's 66th birthday, at which time that amount is reduced 10% per year until the retiree's 70th birthday.

Health Insurance -- Rochester paid the full cost of single or family coverage for the Blue Cross/Blue Shield traditional plan. This plan provides full coverage of reasonable and customary charges associated with 120 days of hospitalization, surgery and emergency room care. Upon reaching age 65, Rochester paid for the Blue Cross/Blue Shield Complementary Plan that, in conjunction with Medicare as the primary insurer, provided total coverage that is identical to the pre-65 plan.

In addition, Rochester provided coverage for services such as physician's charges, out-patient billing, therapy and prescription drugs that are not covered under the basic plan. Retirees were required to meet an annual deductible of 1% of the premium up to a $100 maximum for each person covered and to pay 20% of any charges in excess of the deductible.

Medicare Part B -- Amounts deducted from Social Security checks for this health care benefit were reimbursable.

Medical Reimbursement -- Retirees were entitled to reimbursement for up to $125 per calendar year for out-of-pocket medical expenses.

Discounted Telephone Services -- Retirees with at least 20 years of active service received 100% discounted local telephone services for calls within Rochester's service territory. Retirees with less than 20 years of active service received a 50% credit on their local telephone service. If the retiree resided within Rochester's territory, the discount was

considered foregone revenue. Those retirees who resided outside Rochester's service territory submitted bills for reimbursement. Rochester included in its OPEB revenue requirement accruals only cash reimbursements to retirees who reside outside Rochester's territory.

3. Rochester's Accounting for OPEBs under SFAS-106

Rochester first implemented SFAS-106 on January 1, 1993.[21] Prior to that time, Rochester accounted for OPEBs strictly on a cash or pay-as-you-go basis. In addition, Rochester did not prefund any of its SFAS-106 expenses.[22] Since January 1, 1993, Rochester has accounted for OPEBs in accordance with SFAS-106. However, the only portion of its SFAS-106 expenses that was included in its rates as of January 1, 1993 was the incremental SFAS-106 expenses attributable to regulated interstate access services for the TBO portion of its SFAS-106 liability.

Summary of Argument

The amounts that Rochester claimed in its 1993 and 1994 Annual Access Tariff Filings for the TBO-portion of the incremental expenses associated with SFAS-106 are correct and qualify for exogenous cost treatment under the rules as they existed at the time.

The D.C. Circuit has unequivocally held that the costs in question so qualify. In so holding, the Court concluded that whether companies possess control over the underlying

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21 *See* Designation Order, ¶ 17(1).

22 *See id.*, ¶¶ 17(4), 18(3), 18(4), 18(5), 21(1-6).

benefits costs is legally and factually irrelevant. What is relevant under the former rules is that exchange carriers had no control over the one-time *accounting* change. The Court further held that the additional possibilities of double-counting -- inter-temporal double-counting, effect on the authorized rate of return, effect on the productivity offset -- could *not* be relied upon by the Commission as grounds for denying or limiting exogenous treatment of SFAS-106 amounts. Thus, such issues are no longer relevant to these investigations.

In this Direct Case, Rochester demonstrates four points. *First*, Rochester properly estimated its SFAS-106 expenses that are attributable to regulated interstate operations. The SFAS-106 costs were developed by Buck Consultants, Rochester's actuarial consultants, and represent the "best estimates" of such expenses at that time as required by SFAS-106.

Second, the implementation of SFAS-106 had only a minuscule effect on GNP-PI. As the NERA study demonstrates, the implementation of SFAS-106 had no effect upon the economic costs of providing OPEBs. Because firms in sectors of the economy that are not price regulated set the prices for the goods and services based upon economic -- not accounting -- costs, the implementation of the new accounting standard had no effect on the economic costs of those companies' provision of OPEBs. Indeed, the implementation of SFAS-106 would only be expected to affect the prices of rate-regulated firms -- principally regulated companies and those operating under cost-plus contracts. NERA estimated that the effect on these companies -- if they were permitted fully to reflect the accounting change in rates -- would increase GNP-PI by approximately 0.12%, a factor

Rochester took into account in calculating the amount of its TBO-related expenses for which it claimed exogenous cost treatment.

Third, Rochester applied appropriate separations and allocation factors in apportioning its TBO-related expenses to regulated interstate access services and properly allocated those costs among the price cap baskets.

Fourth, there is no basis in the rules or in economic reality for limiting exogenous cost recognition only with respect to those SFAS-106 expenses that a company has funded or with respect to employee interests that have vested.

Argument

I. ROCHESTER PROPERLY QUANTIFIED ITS TBO EXPENSE BASED UPON REASONABLE ACTUARIAL ASSUMPTIONS.

Rochester's SFAS-106 expenses for 1993 -- a portion of which Rochester claimed as exogenous -- were developed in conjunction with its actuaries, Buck Consultants. The generally applicable assumptions, *i.e.*, time value of money, medical cost trends, medical reimbursement rates and the rest represented Rochester's and Buck's "best estimates" at the time of the future experience with respect to those items. Similarly, those assumptions that are specific to Rochester, *i.e.*, participation rates, salary progression, possibility of payout and the like, were based upon company-specific data, where available, and appropriate surrogates where they were not. As such, the assumptions underlying Rochester's forecast of its OPEB expenses are reasonable and, indeed, are the "best

estimates" required by SFAS-106. The 1993 actuarial study performed by Buck Consultants, is attached hereto as Exhibit A.[23]

Before describing those assumptions, Rochester notes two points of significance regarding any analysis of the claimed TBO expenses. *First*, the only period of time that is relevant to the study of any particular cost for which exogenous treatment is sought is the time when that treatment was sought -- in this case, in its 1993 Annual Access Tariff Filing. As the D.C. Circuit emphasized, the event that triggered exogenous cost recognition was the implementation of the new accounting standard.[24] It is the financial consequences of this one-time event that qualify for exogenous cost recognition. After the price cap indices are adjusted for the financial consequences of this one-time accounting change, those costs become like any other costs of a company subject to price cap regulation. Further rate changes are no longer dependent upon changes in the level of that item of expense. Indeed, the entire theory underlying price cap regulation is that, because a regulated company's rates are no longer directly tied to its own cost of service, it possesses a much greater incentive to act efficiently and to innovate. By so doing, it may reap the benefits,

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23 The Designation Order assumes that Rochester's OPEB liability was developed utilizing a "tops down" approach. *See* Designation Order, ¶ 20. Actually, the reverse is true. Because benefits plans differ widely among Rochester and its affiliates, Rochester's total company OPEB expense was developed by examining each individual company to determine its SFAS-106 expense. The results were then summed to determine a total company figure. *See* Appendix A.

The manner in which Rochester derived its regulated interstate TBO amount for which it sought exogenous cost treatment is set forth in Part III, *infra*.

24 *Southwestern Bell*, 28 F.3d at 169-70.

in the form of higher earnings than might have otherwise been possible under traditional, cost-of-service regulation.[25]

Thus, whether the underlying postretirement benefits costs are within the control of the price cap-regulated company or, for that matter, the relative success or failure of the affected company to control those costs, is immaterial. In this case, those OPEB costs for which Rochester claimed exogenous treatment are like any other costs. If Rochester is successful in controlling them, it will benefit under price caps, compared to cost-of-service regulation; if it does not, it will suffer.[26] On this basis, Rochester takes strong exception to the Bureau's assertion the "[a]ny change in OPEBs will affect future accrued amounts and will be useful to compare prior calculated accruals to the new OPEB contracts to aid in

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25 *See Policy and Rules Concerning Rates for Dominant Carriers*, CC Dkt. 87-313, Second Report and Order, 5 FCC Rcd. 6786, 6787, ¶ 2 (1990); *see also Price Cap Performance Review for Local Exchange Carriers*, CC Dkt. 94-1, First Report and Order, FCC 95-132, ¶¶ 67-69 (April 7, 1995) ("Price Cap Performance Review Order").

26 For this reason, among others, Rochester's actuarial assumptions at the time relevant hereto did not take into account the possibility of future downsizing. *See* Designation Order, ¶ 27. It also did not take into account the possibility of the emergence of national health insurance or similar governmental programs. *See id.* The likelihood that such programs will actually materialize or the financial effect of any such programs that might be enacted are far too speculative events to take into account in any actuarial forecast.

Similarly, Rochester did not include in its actuarial forecast or in its requests for exogenous treatment of its TBO expense any plan for returning to ratepayers (or saddling ratepayers with) any over-accrual (or under-accrual) of OPEB expenses. *See id.*, ¶ 30. Such plans would, for the reasons described in the text preceding this footnote, be completely inconsistent with the theory of price cap regulation. In addition, Rochester has not renegotiated any of its labor contracts in a manner that affects OPEB offerings to its unionized employees. *See id.*, ¶ 31. Its actuarial assumptions changed in 1994. Appendix B contains the 1994 actuarial valuations. The 1995 study is in progress. For Rochester Telephone, total company SFAS-106 expenses were $16.4 million in 1994 and $18.7 million in 1993. *Compare* Appendix A *with* Appendix B.

Rochester sets forth in Appendix J hereto a description of its treatment of deferred taxes. *See* Designation Order, ¶ 23.

determining whether the former calculations were reasonable."[27] That assertion is simply untrue.

Second, that the amount claimed as exogenous is based upon actuarial assumptions that reasonably must depend upon a degree of prediction affords no basis for rejecting those studies. Other expense components are based upon the same types of actuarial studies -- in particular, pension expense. Since the initiation of price caps, Rochester is aware of no instance in which the Commission has adjusted a price cap exchange carrier's pension expense for any of the factors that the Commission has suggested might warrant an adjustment for OPEB expense. Yet the two types of expense are conceptually identical, and any differences in treatment under price caps can be nothing but arbitrary and capricious.

With these two principles in mind, Rochester sets forth in the assumptions underlying the actuarial study upon which it relies.[28]

A. External Assumptions

The actuarial cost method utilized is the projected unit credit with benefits attributed ratably to service from date of hire until date of full eligibility for benefits. This is the attribution method specified in SFAS-106. The study assumed a discount rate of 8% per annum, compounded annually. In addition, medical plan costs were assumed to increase

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[27] *Id.*

[28] The actuarial assumptions set forth in the text are described in more detail in Appendix A. The assumptions underlying the 1994 valuations are set forth in Appendix B. For comparative purposes, Rochester also includes its actuarial valuations for SFAS-112 in Appendix C.

13.0% in 1992 with the rate of increase gradually decreasing to 6.8% by the year 2006. Moreover, because benefits costs will increase faster than the medical cost trend due to the erosion of fixed dollar deductibles, the valuation assumes that the effect of double leveraging will increase the initial medical cost trend by 0.81%. The study further assumes that this leveraging effect will decrease geometrically by 10% per year.

The study assumes that Part B premiums would rise to $46.10 per month by 1995 and then increase 5% per year thereafter.

B. Internal Assumptions

The following assumptions were also utilized.

Dependents -- For current retirees, representative values of the percentage assumed married is shown in the actuarial study set forth in Appendix A. The costs for any dependent children were assumed to be included in the costs per spouse.

Participation Rates -- The study assumes that all employees, both current and former, who were eligible to participate did so.

Separations from Active Service -- The actuarial study sets forth representative values of the assumed annual rates of termination, disability, death and retirement for Rochester.

Salary Progression -- Assumptions regarding salary progression are set forth in the actuarial study.

C. Per Capita Claims Costs

Rochester's actuarial study did not contain any assumptions regarding per capita claims costs, nor should it have. The claims experience of the group being insured is most appropriate for self-insured medical arrangements or for experience-rated insurance contracts. Projecting the expected claims for Rochester, however, would not give an accurate representation of the costs of the benefits covered. That entity does not pay premiums based upon its own claims experience. Rather, the cost of coverage is based on the experience of a large community-based pool. Actual claims costs for that entity's individual retirees would have virtually no impact on the cost that it would be paying for the coverage. Since the ultimate goal of the calculation is not to measure the actual claims costs of the group, but rather to project the expected costs of coverage to the employer, use of the community-rated premiums is more appropriate and was employed in this study.

Rochester's projections are reasonable and are based on actuarial assumptions, developed by experts, that meet the "best estimate" standard required by SFAS-106.

II. ROCHESTER PROPERLY ACCOUNTED FOR ANY POTENTIAL DOUBLE-COUNT IN GNP-PI.

In its 1993 Annual Access Tariff Filing, Rochester made an adjustment to its claimed TBO expense to remove any potential double-count in GNP-PI resulting from the

implementation of SFAS-106.[29] Rochester based the size of this adjustment on a study performed by the National Economic Research Associates, Inc.[30]

A. The Implementation of SFAS-106 Directly Affected Rochester's Recovery of Its Costs of Providing Interstate Access Services.

As the D.C. Circuit held, the implementation of SFAS-106 was a mandatory accounting change that fit squarely within the definition of exogenous costs contained in the price cap rules as they then existed.[31] The implementation of SFAS-106 also had a substantial effect on Rochester's OPEB-related accounting costs. Indeed, the overall effect on Rochester's book expense ($2.455 million)[32] is significantly greater than the TBO-related amount that it claimed in the 1993 Annual Access Tariff Filing ($1.407 million)[33] and the amount remaining after the negative exogenous adjustment that Rochester recognized in the 1994 Annual Access Tariff Filing ($859,000).[34]

The accounting change affected the level of expense that Rochester was required to recognize on its books beginning in 1993. However, that accounting change never affected the economic costs of providing service. Because the prices of rate-regulated

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29 1993 D&J at Ex. 1-9.

30 National Economic Research Associates, Inc. *The Treatment of FAS 106 Accounting Changes Under Price Cap Regulation* (April 15, 1992) ("NERA Study"), set forth in Appendix D hereto.

31 *Southwestern Bell*, 28 F.3d at 169-70.

32 Rochester 1992 Direct Case at Ex. IV.

33 1993 D&J at Ex. 1-9.

34 1994 D&J at Ex. 1-8.

firms are based upon accounting -- not economic -- costs, those firms have not been able to reflect the true economic costs of OPEBs in the prices of their goods and services. This is true for both price-cap and cost-of-service regulated firms. Although carriers subject to price cap regulation no longer change rates in direct response to changes in costs, the initial price cap rates were established when exchange carriers were required to account for OPEB expenses on a pay-as-you-go basis. Had SFAS-106 been in effect just prior to the implementation of price caps, the initial price cap rates would have reflected the higher book costs associated with accrual accounting for OPEBs.[35]

Unlike their regulated counterparts, non-price-regulated firms have already reflected the true economic costs of providing OPEBs in the prices for their goods and services. Thus, a change in an accounting convention can be expected to have no effect on the prices for their goods and services and, therefore, on GNP-PI. As the NERA Study concluded:

> Competitive forces drive prices toward economic costs, but regulatory rate making sets prices using adopted accounting costs. In unregulated markets, *prices already reflect accrual accounting for OPEBs because those are the actual economic costs.*[36]

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35 In the Price Cap Performance Review Order, the Commission noted that the link between costs and rates for price cap carriers has become attenuated due to the operation of the price cap formula. *Price Cap Performance Review Order*, ¶ 229. Whatever the merits of that assertion today, it was decidedly less true in 1993. Then, Rochester had been subject to price cap regulation for less than two years. The link between rates and accounting costs was then still very strong, a point that the Commission at least implicitly acknowledged. *See id.*, ¶ 228.

36 NERA Study at 17 (emphasis added).

The D.C. Circuit has also recognized that the implementation of SFAS-106, in general, probably had no effect on economic costs:

> The claim of complete lack of support (for the assumption that the implementation of SFAS-106 had no effect on economic costs) is in fact false, for the NERA study pointed to econometric evidence that accounting changes generally have no effect on stock prices which tends to support the proposition that the market sees through such conventions.[37]

This Commission has also recognized that changes in accounting conventions likely do not affect underlying economic costs. In adopting the "economic cost" standard for exogenous treatment of accounting changes, the Commission noted:

> When an accounting change that otherwise meets the existing standards for exogenous treatment also affects cash flow, carriers will be able to raise PCIs to recognize this effect. Without a cash flow impact, carriers will not be able to raise PCIs to recognize an accounting change. Moreover, we believe that this result will produce correct pricing signals in the local telecommunications marketplace. *Economic cost is the proper measure for guiding recourse allocation decisions that will maximize net economic benefits.*[38]

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[37] *Southwestern Bell*, 28 F.3d at 171-72.

The Court further noted that:

> [I]f price level is a function of the quantity and velocity of money and the supply of real goods and services, . . . it is not clear just how implementation of SFAS-106 might have changed any of these.

Southwestern Bell, 28 F.3d at 170 n.3 (citations omitted).

[38] *Price Cap Performance Review Order*, ¶ 294 (emphasis added). *See also id.*, ¶¶ 307-09.

The Commission's conclusion only makes sense if a company's rates already reflect its economic costs of service, a situation that the Commission at least implicitly recognized was not true in 1993. *Id.*, ¶ 298. Thus, whatever the merits of the new rule, the Commission's justification for the rule provides no basis for denying or unduly restricting exogenous cost treatment for the 1993/94 and 1994/95 tariff years.

B. The Implementation of SFAS-106 Only Minimally Affected GNP-PI.

The recognition that, in general, accounting changes do not affect the economic costs of providing service bears directly upon the magnitude of any potential double-count in GNP-PI of exogenous cost treatment of the implementation of SFAS-106. If firms that are not price regulated are already reflecting the accrual accounting costs of OPEBs in their prices, a change in the method of accounting for OPEBs, by definition, will not result in general price level changes.

The NERA Study reflects this result. The NERA Study starts from the fundamental premise that, in competitive markets, prices reflect economic, not accounting, costs. The true economic costs of producing a good or service today includes those obligations incurred in the current period to provide postretirement benefits to a firm's employees.[39] Thus, in those segments of the economy that are not price regulated and to which SFAS-106 applies, the true economic cost of providing OPEBs is already reflected in prices. In other words, unregulated firms have always set prices that have at least implicitly reflected accrual accounting principles.

Indeed, the only effect that implementation of SFAS-106 would have had on GNP-PI would occur if rate-regulated firms and firms that operate under cost-plus contracts with the government were permitted to increase their prices to reflect this accounting change. However, because unregulated firms generate close to 90% of national economic activity,

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[39] NERA Study at 17-18.