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

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| In the Matter of | ) | |
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| 1993 Annual Access Tariff Filings | ) | CC Docket No. 93-193, Phase I |
| | ) | |
| 1994 Annual Access Tariff Filings | ) | CC Docket No. 94-65 |
| | ) | |
| NYNEX Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 328 | ) | CC Docket No. 94-157 |

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# NYNEX DIRECT CASE

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Telegraph Company

New York Telephone Company

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Dated: August 14, 1995

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## SUMMARY

This Direct Case by NYNEX responds to the Designation Order released by the Chief, FCC Common Carrier Bureau. The Designation Order sets forth issues for investigation of various carriers' tariff filings requesting exogenous treatment under price cap regulation of additional costs incurred as a result of implementing Statement of Financial Accounting Standards No. 106 (SFAS-106). SFAS-106 essentially requires accrual instead of cash basis accounting for other post-employment benefits (OPEBs), chiefly health care benefits to retirees.

As demonstrated in this Direct Case, the NYNEX OPEB tariffs under investigation are fully justified, satisfy the applicable standard for exogenous cost treatment as expressed in the D.C. Circuit's OPEB Decision,* and should be made permanent.

Regarding that applicable standard, first, NYNEX's OPEB costs underlying those tariffs have been incurred as a result of the mandated SFAS-106 accounting change, over which NYNEX lacked control. Second, as demonstrated by the Godwins Study, those costs have not been double-counted in the GNP-PI element of the price cap formula and, as a further conservative step, have been shown not to have been recovered through a suppression of wages.

Furthermore, concerning the issues designated by the Bureau, we show that we correctly, reasonably and justifiably calculated the SFAS-106 costs for exogenous treatment under price cap regulation (Issue A). On Issue B, NYNEX has not made any

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* Southwestern Bell Tel. Co. v. FCC, 28 F.3d 165 (1994).

exogenous claims for SFAS-106 costs incurred prior to January 1, 1993, as NYNEX implemented SFAS-106 starting January 1, 1993. Further, NYNEX correctly and reasonably allocated and separated amounts associated with implementation of SFAS-106 in accordance with the Commission's rules and Responsible Accounting Officer letters (Issue C). Concerning Issues D and E, exogenous treatment of additional OPEB costs arising from implementation of SFAS-106 should be granted independent of the use of Voluntary Employee Benefit Association trusts or other funding mechanisms, and independent of any "vesting" of employee interests in OPEBs. Finally, we explain how deferred tax applicable to OPEBs should be reflected in exogenous cost calculations.

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| Tariff F.C.C. No. 1, Transmittal No. 328 | ) | |

# NYNEX DIRECT CASE

The NYNEX Telephone Companies[1] (NYNEX) submit this Direct Case in response to the Order Designating Issues For Investigation (Designation Order) released June 30, 1995 by the Chief, FCC Common Carrier Bureau in the above-captioned matter.

## I. BACKGROUND AND NYNEX POSITION

The Designation Order sets forth issues for investigation of various carriers' tariff filings requesting exogenous treatment under price cap regulation of additional costs incurred as a result of implementing Statement of Financial Accounting Standards No. 106 (SFAS-106). SFAS-106 essentially requires accrual instead of cash basis accounting for other postretirement employee benefits (OPEBs), chiefly health care benefits to retirees.[2]

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1 The NYNEX Telephone Companies (NTCs) are New England Telephone and Telegraph Company and New York Telephone Company.

2 In December 1990, the Financial Accounting Standards Board (FASB) adopted SFAS-106. The FASB directed that SFAS-106 be implemented for fiscal years beginning after December 15, 1992, with earlier implementation encouraged. In December 1991, the FCC Common Carrier Bureau issued an Order requiring carriers to adopt SFAS-106 on or before January 1, 1993, for regulatory accounting purposes. Southwestern Bell, 6 FCC Rcd. 7560.

Five NYNEX OPEB tariffs are under investigation in this matter. First, in April 1993, NYNEX submitted its 1993 Annual Access Tariff Filing which contained a $12.1 million upward exogenous cost adjustment limited to the portion of the Transition Benefit Obligation (TBO)[3] relating to retirees as of January 1, 1993 only. That filing was made in response to the Commission's OPEB Order[4] denying price cap LECs exogenous treatment of OPEB costs.[5] In the OPEB Order the Commission indicated it would entertain further consideration of exogenous treatment of TBO amounts in the 1993 Annual Access Tariff Filings.[6] The Bureau initiated an investigation of the 1993 Annual Access/OPEB tariff filings in 1993, and permitted NYNEX's tariff to go into effect subject to accounting order and possible refund.[7]

The second NYNEX OPEB tariff under investigation here is our 1994 Annual Access Tariff Filing submitted in April 1994. That filing adjusted price cap indices (PCIs) to remove $4 million of the OPEB exogenous cost increase contained in the 1993 Annual Filing (i.e., the amount that related to January - June 1993). In June 1994, the Bureau released an Order permitting NYNEX's 1994 Annual Filing to go into effect

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3 The TBO reflects the unrecognized liability for benefits earned in the past as of the date SFAS-106 is implemented (January 1, 1993 for NYNEX). The Commission directed carriers to amortize the TBO. Southwestern Bell, 6 FCC Rcd. 7560.

4 Treatment Of LEC Tariffs Implementing SFAS-106, CC Docket No. 92-101, 8 FCC Rcd. 1024 (1993). As discussed infra, the U.S. Court of Appeals for the D.C. Circuit reversed and remanded the OPEB Order. Southwestern Bell Tel. Co. v. FCC, 28 F.3d 165 (D.C. Cir. 1994) (OPEB Decision). The Commission recently released an Order vacating its OPEB Order and terminating the Docket 92-101 proceeding. CC Docket No. 92-101, FCC 95-219, Memorandum Opinion and Order released July 3, 1995.

5 In its filing (D&J, p. 48) NYNEX reserved the right to file tariffs seeking full recognition of OPEB costs as exogenous depending upon the outcome of the appeal.

6 OPEB Order at ¶¶ 1, 76.

7 1993 Annual Access Tariff Filings, CC Docket No. 93-193, 8 FCC Rcd. 4960.

subject to investigation, accounting order and possible refund. The Bureau incorporated the OPEB issues into the pending investigation of the 1993 Annual Filings.[8]

In July 1994, the D.C. Circuit issued its OPEB Decision. The Court held that the price cap carriers had met the lack-of-control test for exogenous treatment of OPEB cost increases arising from the mandated accounting change. The Court also addressed the second prong of the test for exogenous treatment: whether the costs are not double-counted in the GNP-PI element of the price cap formula.[9] The Court held that the Commission had imposed "impossible burdens" as to Gross National Product Price Index (GNP-PI) double-counting, and the Court rejected the Commission's criticisms of the Godwins Study.[10] The Court also rejected the Commission's invocation of several new criteria on the double-counting issue relating to intertemporal double-counting, rate of return and productivity factors.[11] The Court went further to suggest that the price cap LECs' evidence (including the Godwins Study) was reasonable.[12] In fact, as discussed infra, the Godwins Study was very conservative. While it found only a 0.7% double-count in GNP-PI, it also reflected longer term effects from wage suppression.

The third NYNEX OPEB tariff under investigation in the present matter is Transmittal No. 328, filed in September 1994 (and amended in December 1994). That filing was intended to effectuate the D.C. Circuit's OPEB Decision. The filing presented an exogenous cost adjustment to PCIs to reflect OPEB incremental costs not covered in

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8 1994 Annual Access Tariff Filings, 9 FCC Rcd. 3705.

9 28 F.3d at 168-70. The Commission recently began using GDP-PI instead of GNP-PI for calculating the PCI. See Designation Order at n. 35.

10 28 F.3d at 171-72. The Godwins Study, cited in the Designation Order at n. 28, was relied upon by NYNEX and others to show that about 84.8% of the additional costs from the SFAS-106 accounting change would not be captured in GNP-PI or recovered through a reduction in the national wage rate.

11 28 F.3d at 172-73.

12 Id. at 171-73.

previous filings, so as to capture the full cost increase from implementing SFAS-106 (i.e., TBO for retirees and active employees, and OPEB ongoing expenses) from January 1, 1993 forward. The filing contained a make-whole adjustment of $42 million (covering January 1, 1993 to December 30, 1994), to be spread over a 24 month period (i.e., $21 million annually for December 30, 1994 to December 31, 1996), and an annual prospective adjustment of $21 million. The filing contained a rate increase of $2.2 million. On December 29, 1994, the Bureau released an Order permitting NYNEX's Transmittal 328 to go into effect subject to investigation, accounting order and possible refund.[13]

The fifth NYNEX OPEB tariff subject to investigation herein is Transmittal No. 374, submitted in April 1995. That filing increased certain interconnection charge rate elements by $2.3 million based upon PCI "headroom" created by previously filed OPEB exogenous cost adjustments. On April 27, 1995, the Bureau released an Order permitting the tariff to go into effect subject to investigation, accounting order and possible refund.[14]

The present Designation Order is the Bureau's response to the Court's remand in the OPEB Decision, and one set of issues is designated for the combined investigation:[15]

> In general, this combined investigation seeks to determine whether the assumptions the individual LECs and AT&T made in calculating the costs of postretirement benefits are

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[13] CC Docket No. 94-157, 10 FCC Rcd. 1594. In its Price Cap Review Order, the Commission directed carriers to reduce PCIs to eliminate the effect of ongoing OPEB costs. Price Cap Performance Review For Local Exchange Carriers, CC Docket No. 94-1, FCC 95-132, First Report and Order released April 7, 1995. In its May 1995 Annual Access Tariff Filing, NYNEX complied with that Order by reducing PCIs by $29 million. NYNEX did not remove $21 million of the OPEB make-whole adjustment to PCIs referred to above, as that adjustment related to OPEB costs incurred in 1993-94. By Order released July 27, 1995, the Bureau permitted that OPEB tariff to go into effect subject to the Docket 94-157 investigation, accounting order and possible refund (1995 Annual Access Tariff Filings, CC Docket No. 94-157, DA 95-1665). Thus, that tariff represents the fourth NYNEX tariff subject to investigation in this docket.

[14] NYNEX Telephone Companies, Transmittal No. 374, CC Docket No. 94-157 (DA 95-966).

[15] Designation Order at ¶¶ 8, 14-15.

> just and reasonable, in accordance with the Commission's rules and in the public interest.[16]

In this Direct Case, NYNEX responds to the various issues in the order of their designation by the Bureau. We show that our OPEB tariffs under investigation are fully justified, satisfy the applicable standard for exogenous cost treatment as expressed in the OPEB Decision, and should be made permanent.

Regarding that applicable standard, first, NYNEX's OPEB costs underlying those tariffs have been incurred as a result of the mandated SFAS-106 accounting change, over which NYNEX lacked control. Second, as demonstrated by the Godwins Study, those costs have not been double-counted in the GNP-PI element of the price cap formula and, as a further conservative step, have been shown not to have been recovered through a suppression of wages.

Furthermore, concerning the issues designated by the Bureau, we show that we correctly, reasonably and justifiably calculated the SFAS-106 costs for exogenous treatment under price cap regulation (Issue A). On Issue B, NYNEX has not made any exogenous claims for SFAS-106 costs incurred prior to January 1, 1993, as NYNEX implemented SFAS-106 starting January 1, 1993. Further, NYNEX correctly and reasonably allocated and separated amounts associated with implementation of SFAS-106 in accordance with the Commission's rules and Responsible Accounting Officer letters (Issue C). Concerning Issues D and E, exogenous treatment of additional OPEB costs arising from implementation of SFAS-106 should be granted independent of the use of Voluntary Employee Benefit Association trusts or other funding mechanisms, and

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[16] Id. at ¶ 15.

independent of any "vesting" of employee interests in OPEBs. Finally, we explain how deferred tax applicable to OPEBs should be reflected in exogenous cost calculations.

## II. NYNEX'S OPEB TARIFFS UNDER INVESTIGATION SATISFY THE STANDARD FOR EXOGENOUS COST TREATMENT, ARE WELL-SUPPORTED AND SHOULD BE MADE PERMANENT

### 1. General Information On OPEB Costs Claimed

**Issue A:** Have AT&T and the individual LECs correctly, reasonably and justifiably calculated the gross amount of SFAS-106 costs that may be subject to exogenous treatment under price cap regulation?[17]

**Designation Order ¶ 17** *(regarding derivation of gross amount of incremental costs that is the basis of the exogenous claim)*:

17.1: NYNEX implemented SFAS-106 effective January 1, 1993.

17.2: Regarding "the cost basis of the pay-as-you-go amounts that supported the rates in effect on the initial date that the carrier became subject to price cap regulation," it should be noted that the NYNEX Telephone Companies became subject to FCC price cap regulation effective January 1, 1991. The initial price cap rates were based on projected cash payments, reflected as operating expense, for retirees' medical, dental and group life insurance for the period July 1, 1990 to June 30, 1991 (i.e., the rate year for the 1990 Annual Filing). The amounts underlying the tariffs of New England Telephone (NET) and New York Telephone (NYT) were $53.2 million and $114.8 million, respectively.

17.3: The Bureau asks for an explanation of the effect of the price cap formula on the pay-as-you-go amounts that supported the rates in effect on the initial date of price caps, up to the date of conversion to SFAS-106. The exact intent of the Bureau's question is somewhat unclear. However, the price cap formula does impact PCIs through

[17] Designation Order at ¶16.

the inflation factor.[18] The impact of inflation in the formula is determined by the amount of the inflation factor less the productivity offset (X factor).[19] For NYNEX, the pay-as-you-go amount that supported rates in effect at the beginning of price caps was $168.0 million, and those rates were used to set PCIs at 100. These PCIs have changed over time due to the application of the inflation factor less productivity offset in the price cap formula. The inflation factors for the 1991 and 1992 Annual Filings were 4.80% and 3.3972% respectively, and the productivity offset for NYNEX for both years was 3.3%. Growing $168.0 million by 1.5% (i.e., 4.80% - 3.3%) and .0972% (i.e., 3.3972% - 3.3%) equates to $170.7 million for the July 1992 - June 1993 time period.

Since NYNEX adopted SFAS-106 on January 1, 1993, the amount of pay-as-you-go expense that theoretically was in rates at that time was approximately $170.7 million. However, when NYNEX developed the exogenous adjustment for SFAS-106, the amount of pay-as-you-go expense subtracted to arrive at the incremental expense as of January 1, 1993 was $209.2 million. This amount was the actual pay-as-you-go expense in 1993, as opposed to the forecasted amount included in rates for the 1990-1991 tariff year. Therefore, NYNEX subtracted out more pay-as-you-go expense than that which underlied rates impacted by the price cap model.

**17.4**: The Bureau requests the "actual cash expenditures related to SFAS-106 for each year since the implementation of price caps, but prior to the implementation of SFAS-106 accounting methods." Prior to January 1, 1993 (when NYNEX implemented SFAS-106), NYNEX accounted for OPEBs on a pay-as-you-go basis. On this basis, for

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[18] The GDP-PI will be used to calculate the inflation factor beginning with the 1995 Annual Filing. As noted, the GNP-PI has been used previously to calculate the inflation factor used in annual price cap filings.

[19] The measure has been included in the formula as [GNP-PI]-X prior to the Price Cap Review Order.

1991, NET recorded $50.8 million and NYT recorded $101.1 million for OPEB expenses. For 1992, NET recorded $63.7 million and NYT recorded $131.6 million for OPEB expenses. See Appendix A.1.

17.5: For "the treatment of these costs in reports to the Securities and Exchange Commission (SEC) and to shareholders, including specific citations to or excerpted materials from such reports to indicate the amount of liability each party has projected for OPEBs," see Appendix A.2 for relevant excerpts from the 1991 and 1992 10-K Reports for NET and NYT, and from the 1991 Annual Report for NYNEX.

**Designation Order ¶ 18**:

18.1: Regarding a description of "each type of benefit being provided that is covered by the SFAS-106 accounting rules," NYNEX Corporation maintains the following OPEB benefits for management and nonmanagement employees:

- Retiree Health Plans: medical and dental
- Retiree Life Insurance Plans
- Retiree Discounts: concession service

Appendix A.3 describes these types of benefits in detail.

18.2: The pay-as-you-go amounts incurred in 1993 were $67.2 million for NET and $142 million for NYT; and for 1994, those amounts were $75.4 million for NET and $167.1 million for NYT. These pay-as-you-go amounts were independent of adoption of SFAS-106. (See Appendix A.1.)

18.3: NYNEX did not utilize accrual accounting for postretirement benefits before the effective date of price cap regulation.

18.4: For NYNEX, there were no SFAS-106-type (accrual) expenses reflected in rates before they were adjusted for exogenous treatment related to SFAS-106. See responses to 17.2 and 17.3 relative to pay-as-you-go amounts.

**18.5**: Regarding "the level of SFAS-106 expenses that was reflected in the rates in effect on the initial date that the carrier became subject to price cap regulation," as noted earlier, NYNEX implemented SFAS-106 on January 1, 1993, i.e. after the January 1, 1991 inception of price cap regulation. NYNEX's rates in effect on January 1, 1991 reflected pay-as-you-go OPEB expenses, as indicated in the response to 17.2.

**Issue B:** Should exogenous claims be permitted for SFAS-106 costs incurred prior to January 1, 1993, the Commission's date for mandatory compliance?[20]

**Designation Order ¶ 19**:

The Bureau's question contains an internal contradiction. At one point, the Bureau states that its December 1991 Order[21] authorized adoption of SFAS-106 "on or before January 1, 1993." Yet in the next sentence, the Bureau states that "before January 1, 1993 ... is prior to the date that the Bureau authorized adoption of SFAS-106 accounting methods."[22]

Although NYNEX did not adopt SFAS-106 prior to January 1, 1993, nor have we sought exogenous treatment for any costs incurred prior to that date, we are somewhat concerned that the Bureau's above language implies that if the Commission sets a time frame for implementation of a rule change, carriers are not "authorized" to implement the change prior to the latest possible date. That would be an unwarranted position. The Bureau clearly stated that carriers were authorized to adopt SFAS-106 accounting on or before January 1, 1993.

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[20] Designation Order at ¶ 18.

[21] Southwestern Bell, 6 FCC Rcd. 7560.

[22] Designation Order at ¶ 19.

## 2. Regulatory Separations And Allocations

**Issue C:** Have AT&T and the individual LECs correctly and reasonably allocated and separated amounts associated with implementation of SFAS-106 in accordance with the Commission's rules and Responsible Accounting Officer (RAO) letters?[23]

**Designation Order ¶ 20:**

**20.1:** For 1993, the first year of SFAS-106 adoption by NYNEX, on a total company basis NYNEX Corp. incurred $473.6 million, NET incurred $143.0 million and NYT incurred $277.4 million in costs determined pursuant to SFAS-106.

**20.2:** The total company SFAS-106 amounts for the NYNEX Telephone Companies were arrived at through calculations by NYNEX's enrolled Actuary, Hewitt Associates, in accordance with Generally Accepted Accounting and Actuarial Principles. The costs reflect SFAS-106 implementation effective January 1, 1993 with twenty year amortization of the TBO. All key actuarial assumptions and plan provisions utilized in these calculations are disclosed in the attached copies of the Actuarial Reports (Appendix C.1).

**20.3:** Concerning "the amounts allocated to the telephone operating companies, including the specific Part 32 accounts used and the amounts allocated to each of those accounts," it should be noted that NYNEX allocated the SFAS-106 costs to all of its telephone and non-telephone subsidiaries on the basis of the companies' relative shares of the total number of active and retired employees at the time of SFAS-106 adoption. NYT's shares were 63.1% of the total non-management cost and 49.6% of the total management cost; and NET's shares represented 32.9% of non-management and 24.8% of management costs.

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[23] Designation Order at ¶ 19.

The NYNEX Telephone Companies initially recorded their allocated costs in clearing Account 8701.2, Benefits and Payroll Taxes-Provision for Postretirement Benefits Other Than Pensions.

The allocation of the SFAS-106 costs to final accounts of NYT and NET, both expense and capital, was based upon factors developed using 1992 benefits cost data. The factors were calculated by dividing 1992 benefits costs charged to final accounts -- obtained from the accounting data underlying the 1992 ARMIS reports (the most recent annual data available prior to SFAS-106 implementation) -- by total benefits costs incurred. The factors, thus developed, were applied to the total SFAS-106 costs to calculate the impact on each account; see the chart below. The details of the Part 32 Account allocation are shown on pages 3, 6, 9, 12, 15, 18, and 21 of attached Workpaper OPEB, which was originally filed in the NTCs' Amended Transmittal No. 328 (Appendix C.2).

| Part 32 Account | Description | 1993 NYT SFAS-106 Cost | 1993 NET SFAS-106 Cost | 1993 NTCs SFAS-106 Cost |
|---|---|---|---|---|
| 6110 | Network Support | $ 41,193 | $ 366,296 | |
| 6120 | General Support | $ 7,414,717 | $ 2,151,709 | |
| 6210 & 6220 | CO Switching & Operator Systems | $ 24,691,007 | $ 8,765,355 | |
| 6230 | CO Transmission | $ 10,020,166 | $ 6,184,776 | |
| 6310 | Info Orig/Term | $ 20,404,889 | $ 7,400,348 | |
| 6410 | Cable & Wire Facilities | $ 45,770,429 | $ 23,249,205 | |
| 6510 | Other Prop Plant & Equip Exp | $ 50,461 | ($ 38,318) | |
| 6530 | Network Operations | $ 53,963,691 | $ 21,704,250 | |
| 6610 | Marketing | $ 12,335,205 | $ 8,565,008 | |
| 6621 & 6622 | Operator Services | $ 18,077,491 | $ 11,258,773 | |
| 6623.1 | Customer Accounting | $ 4,015,275 | $ 1,534,513 | |
| 6623.2 | Business Office | $ 38,655,390 | $ 17,107,568 | |
| 6623.3 - .8 | Customer Services - Other | $ 0 | $ 778,534 | |
| 6710 | Exec & Planning | $ 1,111,178 | $ 1,185,783 | |
| 6720 | Gen'l & Admin | $ 10,972,751 | $ 8,833,965 | |
| | Total Operating Expense | $247,523,841 | $119,047,765 | $366,571,606 |
| | TPIS | $ 29,876,159 | $ 23,966,235 | $ 53,842,394 |
| | Total SFAS-106 | $277,400,000 | $143,014,000 | $420,414,000 |

**20.4**: For "the method of allocating amounts to the telephone operating companies (head counts, actuarial studies, etc.)." see response to 20.3.

**20.5**: Provided below are "the amounts allocated between regulated and non-regulated activities of the telephone company, with a description and justification of the methodology for the allocations."

| | Total Operating Expenses | Net Rate Base |
|---|---|---|
| 1993 NYT Regulated Incremental SFAS-106 | $ 99,335,205 | ($29,076,018) |
| 1993 NYT Non-regulated Incremental SFAS-106 | $ 7,410,621 | ($ 1,276,855) |
| 1993 NET Regulated Incremental SFAS-106 | $ 49,018,379 | ($15,540,541) |
| 1993 NET Non-regulated Incremental SFAS-106 | $ 3,696,619 | ($ 756,318) |
| 1993 NTCs Regulated Incremental SFAS-106 | $148,353,584 | ($44,616,559) |
| 1993 NTCs Non-regulated Incremental SFAS-106 | $ 11,107,240 | ($ 2,033,173) |

The full pay-as-you-go amounts were subtracted from the SFAS-106 costs to determine the incremental cost for SFAS-106. A portion of the incremental cost for SFAS-106 was allocated to nonregulated activities based on factors developed using the separations data underlying the 1992 ARMIS Reports. The details of the regulated/nonregulated allocations are shown on pages 3, 6, 9, 12, 15, 18, and 21 of attached Workpaper OPEB (Appendix C.2).

**20.6**: The allocation of costs to baskets, by year, is provided below:

| | NTCs Interstate Access 1993 Incremental SFAS-106 | NTCs Common Line Basket 1993 Incremental SFAS-106 | NTCs Traffic Sensitive Basket 1993 Incremental SFAS-106 | NTCs Special Access Basket 1993 Incremental SFAS-106 | NTCs Interexchange Basket 1993 Incremental SFAS-106 |
|---|---|---|---|---|---|
| Total Operating Expenses | $ 35,877,545 | $17,797,227 | $12,938,759 | $4,846,395 | $295,114 |
| Net Rate Base | ($ 10,886,071) | ($4,379,845) | ($4,891,624) | ($1,582,485) | ($32,488) |
| Revenue Effect (Adjusted for Godwins) | $ 29,045,345 | $14,559,404 | $10,330,162 | $3,907,979 | $247,800 |

The allocation of costs to the interstate jurisdiction and to the price cap baskets was made based on the separations data underlying the 1992 ARMIS reports. The

interstate access factors represent interstate access and interexchange costs as a percentage of subject-to-separations costs and exclude Billing and Collection costs. This ensures that the allocation of OPEB costs to the price cap baskets is for access services and interexchange service only.

The allocation of costs to price cap baskets was based on each basket's proportion of the costs in accounts that are used to record OPEB costs, as a percentage of total interstate access and interexchange cost. The ARMIS cost categories of Common Line, Traffic Sensitive, Special Access and Interexchange were used for the allocations. Since the price cap baskets were changed to include a Traffic Sensitive and Trunking Basket comprised of different service categories from those included in the 1993 Annual Filing and ARMIS reports, recasted factors were developed to allocate the OPEB adjustment in the 1994 Annual Filing. The OPEB exogenous adjustment was recast to the existing baskets in the NTCs' Transmittal No. 328 as per the allocation shown below:

| | NTCs Interstate Access 1993 | NTCs Common Line Basket 1993 | NTCs Recasted Traffic Sensitive Basket 1993 | NTCs Recasted Trunking Basket 1993 | NTCs Interexchange Basket 1993 |
|---|---|---|---|---|---|
| Revenue Effect (Adjusted for Godwins) | $ 29,045,345 | $14,559,404 | $4,554,943 | $9,683,198 | $247,800 |

The OPEB exogenous adjustment is equal to the total revenue requirement, reduced by 15.2% to adjust for the effect that may be reflected in the GNP-PI (.7%) or otherwise recovered in a wage reduction (14.5%), as determined by the Godwins study. The revenue requirement includes depreciation expense, which was computed by applying the FCC-prescribed rate on a composite basis to the average balance of SFAS-106 costs cleared to Telephone Plant In Service. The revenue requirement also includes the impact of rate base items. The depreciation expense and rate base items were

allocated to nonregulated activities and price cap baskets based on the methods described above. The details of the allocation of the incremental SFAS-106 costs to the price cap baskets and the development of the revenue requirement impacts are shown on pages 4, 7, 10, 13, 16, 19, and 22 of attached Workpaper OPEB (Appendix C.2).

### 3. VEBA Trust Information

**Issue D:** How should Voluntary Employee Benefit Association trusts or other funding mechanisms for these expenses be treated: 1) if implemented before price caps; (2) if implemented after price caps, but before the change required by SFAS-106; and (3) if implemented after the change in accounting required by SFAS-106?[24]

Exogenous treatment of the incremental costs associated with SFAS-106 should be granted independent of whether VEBA trusts or other funding mechanisms were used, and independent of the time frames associated with the creation of such funding mechanisms. As indicated in our Direct Case in Docket 93-193 filed June 1, 1992 and our other previous filings in this matter, and consistent with the OPEB Decision, NYNEX has satisfied the two prong test required to qualify for exogenous treatment of incremental OPEB costs: lack of control over the accounting change; and lack of double-counting in the GNP-PI element of the price cap formula.

With respect to the timing of the creation of such funding mechanisms, NYNEX VEBA trusts were not created prior to the implementation of price caps. As discussed in our response to Designation Order ¶ 21 below, the NYNEX VEBA trusts were initially funded in 1991, i.e. after the inception of price caps but before the change required by SFAS-106. These trusts were funded through excess pension funds in a manner which did not affect operating expenses. The creation of these VEBA trusts represented no

[24] Designation Order at ¶ 20.

incremental expense and did not represent additional costs that would have affected our rates. As such, the amount in our rates for the period prior to the implementation of SFAS-106 (January 1, 1993) for VEBA trusts is zero.

In the case of VEBA trusts established subsequent to the adoption of SFAS-106, it should be noted that in accordance with the principles espoused in that standard the issue of funding is totally separate and distinct from the amount of cost a company recognizes in a period. The amount that a company chooses to fund is completely unrelated to the benefit currently being earned by the employee or the obligation currently incurred by the company. From a cost recovery viewpoint, one could assume that a company's cash payments (pre-SFAS-106) are being fully recovered in rates. SFAS-106 requires that these costs be recognized when earned, rather than when paid, resulting in an acceleration in the timing of recognition of the cost. With the change in accounting being granted exogenous cost treatment, the incremental costs are properly measured by the difference between the accrued cost under the new accounting method and the cash cost under the old accounting method. VEBA funding subsequent to SFAS-106 adoption does not impact either the cost amount prior to SFAS-106 adoption or the cost amount resulting from SFAS-106 adoption. VEBA funding does play a role, however, in the determination of the rate base impact of the exogenous cost change and in subsequent calculations of earned return. To the extent that accrued SFAS-106 costs are not paid or funded, the unfunded liability properly reduces the rate base as ratepayer supplied capital, in accordance with RAO 20.

**Issue E:** Should exogenous treatment for SFAS-106 amounts be limited to costs that are funded?[25]

**Designation Order ¶ 21** *(regarding information to be provided by companies that have VEBA trusts or other funding mechanisms for SFAS-106 expenses that were established prior to the adoption of SFAS-106)*:

Exogenous treatment for SFAS-106 amounts should not be limited to costs that are funded.[26] Exogenous treatment of the additional costs from implementing SFAS-106 should be afforded under the applicable standard discussed herein. That standard includes no requirement that the expense be funded.

Any limitation of SFAS-106 exogenous costs to funded amounts would negate the fact that SFAS-106 results in costs being accrued as the employees earn the benefits, and not when these costs are paid. It is the mandated accounting change which triggers the need for an exogenous cost adjustment. Limiting recovery to funded costs essentially would place recovery back on the same cash basis as it was prior to SFAS-106 adoption.

**21.1**: The following is a description of "any VEBA trust or other funding mechanisms for the expenses that were established prior to the adoption of SFAS-106":

The Omnibus Budget Reconciliation Act of 1990 ("OBRA 1990") added Section 420 of the Internal Revenue Code to permit transfers of certain excess assets from pension plans to a 401(h) account within the pension plan to fund retiree health care benefits. In September 1991 and December 1991, under the provisions of OBRA 1990, portions of excess pension assets were transferred from the two NYNEX pension plans (management and nonmanagement) to health care benefit accounts within the respective pension plans for reimbursement of retiree health care benefits paid by NYNEX during

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[25] Designation Order at ¶ 20.

[26] See also response to Issue D, supra.

the 1990 and 1991 tax years. The September 1991 transfer covered 1990 payments and the December 1991 transfer covered 1991 payments.

NYNEX then established and made contributions to two separate VEBA trusts, one for management and the other for nonmanagement, in amounts equal to the excess pension assets transferred. The VEBA trusts were established to begin funding postretirement health care benefits. An additional OBRA 1990 transfer reimbursement was made and an additional contribution was made to the VEBA trusts in 1992.

In addition to those VEBA trusts, postretirement group life insurance benefits -- a very small part of OPEBs -- have been funded since 1980 on an actuarial basis. Some of these funds are currently held by insurance carriers. In 1994, we transferred some of the life insurance funds to separate VEBAs established for postretirement life insurance benefits.

**21.2**: Provided below are the amounts placed in the VEBA trusts for each year since they were implemented:[27]

| | NYNEX | NYT | NET |
|---|---|---|---|
| 1990 Payment | $133 Million | $68.6 Million | $38.0 Million |
| 1991 Payment | $148 Million | $75.5 Million | $42.1 Million |
| 1992 Payment | $205 Million | $108.1 Million | $58.1 Million |

**21.3**: The amounts in the VEBA trusts were not differentiated between ongoing OPEBs and TBO. The concepts of TBO and service cost pertain to the accounting for OPEBs, not the funding. As discussed earlier, under SFAS-106 the accounting for these costs is independent of the funding.

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[27] See NYT and NET SEC 10-K Forms, p. 38, Postretirement Benefits Other Than Pensions (Appendix A.2 herein); NYNEX OPEB Direct Case in Docket 93-193, filed June 1, 1992, Attachment D. The differences between the NYNEX amounts and the sum of the NYT and NET amounts represent VEBA funding for the NTCs' affiliates.

**21.4**: There were no such economic assumptions associated with the company's decision to create VEBA trusts, or to determine the levels of funding. The economic assumptions described in this question relate to the accounting for OPEBs, not the funding of these costs.[28] The VEBA trusts were established to fund postretirement health care benefits. The VEBA trusts were funded with excess pension funds in amounts allowed under OBRA 1990; the funding reflected actual pay-as-you-go expense amounts for part of the year, and conservative estimates of such expenses for the remainder of the year.

**21.5**: The purpose of the VEBA trusts has been to fund postretirement health care benefits. Regarding such SFAS-106 benefits packages covered by VEBA trusts, see Appendix A.3.

**21.6**: The assets of the VEBA trusts shall not be used for purposes other than the payment of welfare benefits or the expenses incident thereto or expenses of the trust. That is, the funds shall provide for the payment of life, sickness, accident, or "other benefits" to the employees eligible for coverage under the welfare benefit plans covered by the VEBA trusts, or their beneficiaries. To the extent required by Section 501(c)(9) of the Internal Revenue Code of 1986, as amended, "other benefits" shall not, however, include any benefit which is due solely to attainment of age or service and are considered retirement benefits.

### 4. Vesting Of OPEB Interests

**Issue F**: Should exogenous treatment be given only for amounts associated with employee interests that have vested?[29]

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[28] See also response to Designation Order ¶¶ 26 and 27 concerning actuarial assumptions associated with OPEB costs accounted for under SFAS-106.

[29] Designation Order at ¶ 21

**Designation Order ¶ 22**:

The Bureau asks for "documentation showing when the employees' interests in the OPEBs vest. Also, companies must explain how they determine when an employee's interest vests in the OPEBs." Exogenous treatment of SFAS-106 additional costs should not depend upon any such vesting, but rather should depend upon the standard described in the OPEB Decision being met, as discussed herein. That standard does not include any "vesting" condition; rather, we are entitled to exogenous treatment of additional OPEB costs accounted for consistent with SFAS-106, which costs are not double-counted in GNP-PI.

From a legal perspective, an employee's interest in OPEB benefits does not "vest" as does an employee's interest in a service pension. Unlike the pension plan, NYNEX reserves the right to amend or terminate OPEB benefits, subject to collective bargaining agreements and to practical considerations. The employee qualifies for OPEB benefits when the employee becomes eligible to collect a service pension.

### 5. Treatment Of Deferred Tax Benefits

**Issue G**: How should the deferred tax benefit applicable to OPEBs be treated for purposes of exogenous adjustments?[30]

**Designation Order ¶ 23**:

The Bureau requests LECs "to describe on a year-by-year basis any exogenous adjustments made to reflect any deferred tax benefit associated with their OPEB accrual amounts. Companies are also directed to provide an explanation if there are no such adjustments."

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[30] Designation Order at ¶ 22.

To the extent that SFAS-106 additional costs for OPEBs are given exogenous treatment, the deferred tax arising from those amounts should similarly be included in the calculation of the exogenous adjustment. In other words, the adjustment[31] is first computed in revenue requirement terms, prior to being translated into a PCI. The incremental earnings impact is computed net of taxes. The incremental OPEB expense is reduced by the deferred tax benefit. The effect on accumulated deferred taxes is included in the computing the rate base impact, as is the incremental OPEB liability which is a reduction of the rate base. These procedures are in accordance with Parts 32 and 65 of the Commission's rules and in conformance with RAO 20.

### 6. Supporting Studies And Models

**Designation Order ¶ 24**:

NYNEX continues to rely upon the Godwins Study, supra, and Godwins Supplemental Submissions as demonstrating that approximately 84.8% of the NTCs' additional costs from the SFAS-106 accounting change would not be captured in the GNP-PI or recovered through a reduction in the national wage rate. Appendix H.1 provides copies of the Godwins Study (filed in our June 1, 1992 Direct Case in Docket 93-193) and Godwins Supplemental Report (filed in our July 31, 1992 Reply Comments in Docket 93-193) and Godwins Further Supplemental Report (filed in our 1993 Annual Access Tariff Filing).

Also included in Appendix H. 1 is a new affidavit from Mr. Peter Neuwirth, one of the original coauthors of the Godwins Study, summarizing and placing into perspective

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[31] Accumulated Deferred Taxes were calculated by multiplying the incremental cost, which also represents the difference between the amount of expense currently recognized for tax purposes and amount of expense recognized for book purposes, by the tax rate. The resulting amount was then adjusted to reflect a 1993 average balance. See NYNEX Transmittal 328, Description and Justification, p. 16, item 7.

Godwins' demonstrations. Specifically, the original Godwins Study, which used conservative assumptions throughout, found that the increase in GNP-PI caused by SFAS-106 would provide for recovery of only 0.7% of the additional costs incurred by price cap LECs. Over time, price cap LECs could finance up to 14.5% of those additional costs through a reduction in wages, leaving 84.8% (i.e., 100% - 0.7% - 14.5%) of the additional SFAS-106 costs unrecovered. Subsequent to the original study, in response to FCC staff, Godwins produced a "best estimate," and a sensitivity analysis incorporating all combinations of actuarial and macroeconomic parameters including implausible values. On a best estimate basis, Godwins determined that 12.7% of the price cap LECs' additional costs under SFAS-106 would be recovered through a combination of GNP-PI increase (0.3%) and wage rate reduction (12.4%). This underscored the very conservative nature of the original Godwins Study.

**Designation Order ¶ 25**:

See Appendix H.1 for the requested information on the Godwins Study macroeconomic model concerning description and documentation of the model, including method of estimation, parameter estimates, and summary statistics; and the same data for alternate functional forms that were modeled, including the data used to estimate the model, the data used in making forecasts from the model, and the results of any sensitivity analyses performed to determine the effect of using different assumptions.

**Designation Order ¶ 26 And ¶ 27**:

Appendix C.1 contains the Actuarial Reports, prepared by Hewitt Associates, for the SFAS-106 valuation for both the Management Plans and the Non-Management Plans. These reports, which were used to determine SFAS-106 amounts, provide descriptions