

data used in making forecasts from the model, and the results of any sensitivity analyses performed to determine the effect of using different assumptions. (¶ 25)

See Pleading Section II and Appendix J.

34. Provide a complete copy of all actuarial reports and studies used to determine SFAS 106 amounts and provide descriptions and justifications of the actuarial assumptions, and the assumptions unique to postretirement health care benefits, made in computing SFAS 106 expenses. The assumption should include, but are not limited to, the time value of money, expected rate of return on plan assets, participation rates, retirement age, per capita claims cost by age, health care cost trend rates, medical reimbursement rates, salary progression (if a company has a pay-related plan), and the probability of payment (turnover, dependency status, morality, etc.). Discuss what assumptions, if any, were made about other future events such as capping or elimination of benefits, or the possible advent of national health insurance. (¶ 26)

See Appendix B.

35. Submit all options provided by actuaries from which information was selected to derive SFAS 106 amounts including, but not limited to: the ranges of data on the age of the workforce; the ages at which employees will retire; mortality rates; the gross eligible charge table by age; and the length of service of retirees. For comparison purposes, provide the actuarial assumptions and data used for SFAS 112 computations. Provide information on whether the possibility of future downsizing of the workplace was taken into account. Provide information on what adjustments have been made to SFAS 106 amounts for downsizings in the workforce that have occurred since the adoption of SFAS 106. Give full details of these adjustments. (¶ 27)

AT&T did not consider options with respect to ages of the work force, ages at retirement, mortality rates and length of service. Rather, AT&T used the exact ages and years of service of employees and retirees. With respect to ages at retirement, mortality rates and other demographic assumptions, the assumptions were consistent with those used for SFAS 87 and SFAS 112, which enhances their reliability.

Consistency of the SFAS 112 downsizing assumptions and the assumptions used for SFAS 87 and SFAS 106 is assured for the following reason. The same rates of withdrawal and retirement were used for SFAS 87, SFAS 106 and SFAS 112 purposes. The employees assumed to be downsized are reflected in the rates of withdrawal and retirement. For example, the anticipated downsizing is always less than the number of anticipated withdrawals and retirements. Therefore, future anticipated downsizing is already reflected in the SFAS 106 expenses and no further adjustments were necessary or made.

The SFAS 112 assumption for 1993 as to rates of mortality, rates of separation, rates of disability, rates of retirement, and rates of pay increases are the same as those shown in Appendix F for SFAS 106 expenses for 1993.

36. Since the part of the growth in GDP-PI occurs due to the growth in medical costs, what adjustment, if any, should be made in the exogenous adjustment to avoid any double counting. If an adjustment has been made, document how the adjustment was computed. Describe and quantify any wage changes that will be reflected in the GDP-PI that are expected to occur as a result of the introduction of SFAS 106. Comment on what adjustment, if any, should be reflected in the exogenous adjustment for this change. (¶ 28)

There should be no double count adjustment. See Pleading Section II and Responses to Issue Nos. 32 and 33.

Miscellaneous Supporting Information

37. Provide information on average total compensation per employee and the amount of this total compensation represented by OPEBs. Provide similar data for the economy as a whole for comparison. (¶ 29)

See Response to Issue No. 33.

38. Describe the provisions made, if any, to return to ratepayers the over accrual, if any, of the non-cash expenses if exogenous treatment is given for these amounts. Describe plans to return monies to customers through voluntary PCI reductions or other means. Describe how gains from such over accruals are recognized on the books of account. (¶ 30)

AT&T's SFAS 106 exogenous adjustment did not include any specific mechanism for returning over-accruals, if any, to ratepayers. First, it was assumed that over-accruals would be counterbalanced by under-accruals in subsequent years. Second, competition will -- as it already does -- exert downward price pressure on AT&T's rates, thereby eliminating the need to make an adjustment for this one particular cost factor.

Moreover, the assumptions as to the TBO were reasonable when made and are fully supportable. The plan changes that have taken place since January 1, 1993 in fact indicate that the TBO sized on that date represents an under-accrual. This under-accrual results from the fact that the 1995 collective bargaining agreement resulted in increases to the post-retirement health caps.

In terms of how gains and losses are recognized on the books of account, the net unrecognized losses or gains for current and prior years is recognized on an amortized basis, to the extent it exceeds a specified threshold. The threshold is 10% of the APBO or the market-related value of plan assets. The amortization period is the average remaining service period of active participants expected to receive benefits.

39. On an ongoing basis, document any and all changes made in OPEBs offerings to employees. Any new contracts with employees and their representative unions shall be submitted as they are negotiated (§ 31). The Commission is interested because any 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 determining whether the former calculations were reasonable. In particular, the Commission is interested in whether the underlying actuarial assumptions have changed.

If the plan changes summarized below had been in effect on January 1, 1993, the \$9,109.5 million Transition Benefit Obligation would have been higher by approximately \$700 million and the associated amortized SFAS 106 expense of \$1,285 million would have been higher by approximately \$100 million on a company-wide basis. See Responses to Issue Nos. 12 and 13.

Summary of Principal Plan Changes Since January 1, 1993

- ◆ Prescription Drug Program - 1995
 - Retail Pharmacy Network (34-day supply)
Copayment \$5 - Generic; \$10 - Brand Name
 - Mail Order Option (90-day supply)
Copayment \$8 - Generic; \$15 - Brand Name
 - \$750 annual out-of-pocket maximum effective 1/1/96
- ◆ Dental - Schedule Increase 1996 - 15%; 1997 - 20%
- ◆ Increase in Medical Caps on Company Cost Per Retiree (post-3/1/90 retirees)

		From	To (1997 & beyond)*	Percent Increase
Pre 65	Single	\$2,650	\$3,300	25%
	Family	5,650	6,750	19%
Post 65	Single	850	1,325	56%
	Family	2,350	3,150	34%

* No retiree contributions before 1997

- ◆ Medicare Part B Reimbursement - Limit on Company Reimbursement per Month (post-3/1/90 retirees)

	From (effective 7/1/95)	To (effective 1/1/96)
Retiree only	\$33	\$46
Spouse	33	33*

* No reimbursement for lawful spouses of employees who retire after 5/31/98.

♦ Retiree Care Account - Company Paid for all retirees

1997 and 1998 only

Pre 65	Single	\$130
	Family	\$250
Post 65	Single	\$70
	Family	\$130

♦ Managed Care Program 1996, Pre 65*

- High Point-of-Service (POS) Option for those residing in network area.

In-Network \$0 deductible, annual out-of-pocket maximum of \$750; company co-insurance generally 100%; \$10 per visit; \$40 per usage emergency room visit; \$1 million lifetime maximum.

Out-of-Network \$400/\$800 deductible; annual out-of-pocket maximum of \$2,500/\$5,000 excluding deductible; 80% company copayment; \$150 per hospital admission; \$40 per usage emergency room visit; \$1 million lifetime maximum.

- Standard POS Option for those residing in network area (1997).

In-Network same as High Option In-Network with following exceptions: \$0 deductible, \$1,500 annual out-of-pocket maximum, \$250 per hospital admission; \$25 per visit; \$80 per usage emergency room visit.

Out-of-Network same as High Option Out-of-Network with following exceptions: \$500/\$1,000 deductible; annual out-of-pocket maximum of \$3,000/\$6,000; co-insurance of 70%; \$80 per usage emergency room visit; \$400 per hospital admission.

- Residing out-of-network area (1997).

Deductible of \$50 plus 1% of annual pension with minimum of \$75/\$225 maximum of \$200/\$600. Annual out-of-pocket maximum of \$1,000/\$3,000 excluding deductible; company co-insurance - 100% (80% for occupational, physical and speech therapy, acupuncture). \$50,000 lifetime maximum for other covered charges.

- Mental health and chemical dependency to be separately administered for all non-HMO programs - 1996 Benefits will be based on in-network, out-of-network benefit levels.
- Health Check changes (for out-of-network or out-of-network area)
 - elective, urgent, emergent requirements
 - outpatient procedures requirement
- Centers of Excellence (for out-of-network or out-of-network area)
 - Travel and lodging costs for up to one family member

* Election of managed care is expected to be minimal for pre-3/1/90 retirees.

Changes in Assumptions after 1993

The assumptions used to determine SFAS 106 expenses for 1994 and 1995 are the same as 1993 except as follows:

♦ Discount Rate

1993	8.25%
1994	7.50%
1995	8.75%

The discount rate is supposed to be reevaluated each year under SFAS 106 because it is a market value rate-of-return.

In particular, AT&T did not change its health care trend rates in 1994 or 1995.

Response to Issue No. 34

The SFAS 106 costs for purposes of exogenous treatment were determined using the methodology provided for under SFAS 106. The cost components and amounts are as follows in \$ millions.

Amortization of Transition Benefit Obligation	\$623.9
Interest Charge	840.9
Return on Assets	(179.2)
Total	\$1,285.6

Exclusions From SFAS 106 Costs

The SFAS 106 costs for Global Information Solutions (the former NCR) and AG Communications Systems Corporation are not included.

In addition, although under the terms of the Divestiture Plan of Reorganization, AT&T reimburses the divested Regional Bell Operating Companies ("RBOCs") for a portion of the cost for post-retirement benefits for predivestiture retirees, AT&T's obligation to the RBOCs is not reflected in the SFAS 106 costs above, and thus is not included in AT&T's exogenous cost adjustment.

Description of Cost Components

The determination of the expense components involves calculations which take into consideration active and retiree data, the value of plan assets, average claims per retiree, actuarial assumptions, and benefit plan provisions. Each component is described below and an example is included in item 3, below.

1. Amortization of Transition Benefit Obligation

The Amortization of the Transition Benefit Obligation of \$623.9 million was determined by dividing the Transition Benefit Obligation of \$9,109.5 million by 14.6 years. The amortization period of 14.6 year is the average expected years of future service of active employees expected to receive post-retirement benefits.

2. Transition Benefit Obligation

The Transition Benefit Obligation is the excess of the Accumulated Post-retirement Benefit Obligation (APBO) over the fair value of plan assets less the prepaid amount as of 1/1/93. The amounts of these items in \$ millions are as follows:

APBO	Actives	\$2,442.1	
	Retirees	<u>8,105.6</u>	
	Total		10,547.7
Assets - Prepaid			(1,438.2)
Transition Benefit Obligation			\$9,109.5

The APBO is described below. The Assets less Prepaid is the fair market value of plan assets as of 1/1/93 less Company payments which have not been expensed as of 1/1/93. For example, the Company contributions to the post-retirement group life assets which were made before 1/1/93 were expensed. Therefore, the fair market value of group life assets was not reduced by a prepaid amount. However, the Company contributions in 1991 and 1992 to the two post-retirement health VEBAs were not expensed. Therefore, these contributions were used as a prepaid amount to reduce the amount of plan assets. Because the contributions were included in both the assets and

prepaid amounts, the impact of the contributions on the Transition Benefit Obligation was zero. That is, the asset less prepaid nets to zero, with respect to contributions.

3. Accumulated Post-retirement Benefit Obligation (APBO)

The APBO is the portion of the present value as of 1/1/93 of all future post-retirement benefits allocated to service rendered before 1/1/93. As an example, assume an employee is age 45 with 15 years of service as of 1/1/93 and that the employee will be first eligible to retire and receive full health benefits in 10 years at age 55. The employee, of course, may retire at age 55 or any age thereafter. Further, assume that the present value as of 1/1/93 of the health benefits to be paid for all years after retirement is \$30,000. The \$30,000 present value reflects the probability of retirement at each age beginning with age 55.

The APBO is the portion of the present value of \$30,000 as of 1/1/93 times the ratio of service up to 1/1/93 (15 years) divided by total service from hire up to first eligibility to retire (25 years). That is, the APBO equals $30,000 \times 15/25$ or \$18,000.

The next question would be how is the present value determined? To begin, the present value is determined for all employees (and retirees). Thus, the starting point is the active and retiree data (sex, date of birth, date of hire and pay).

The data are then projected forward to determine when and how many employees will leave the work force before becoming eligible to retire and how many will retire and at what ages. For the period after retirement, the Company needs to know how long employees are expected to live and what the benefit payments will be. This is where the actuarial assumptions are used. (The assumptions are summarized in Appendix F). To determine when and how many employees are likely to leave the work force, rates of termination, death, disability and retirement are used. To estimate how long benefits are likely to be paid after retirement, mortality rates are used.

The last issue is the amount of benefits. For benefits which depend on pay, such as post-retirement group life insurance, a pay growth assumption is used. For other benefits, such as medical and dental, an initial average claim per retiree based on actual claim experience is the starting point. The medical or dental trend assumption is then applied to estimate what the average medical or dental claim per retiree will be in each future year. The initial average claim per retiree may have to be adjusted to reflect plan changes not yet reflected in the actual claim data. The average initial claim per retiree is summarized in Appendix F and, in effect, reflects the plan benefits as summarized in Appendix E.

After future post-retirement benefits have been calculated for all actives and retirees, the discount rate is applied to the benefit payments for each year into the future to arrive at the present value. The present value may be viewed as the lump sum value or premium today for all future benefit payments.

4. Interest Cost

The interest cost for 1993 is determined by multiplying the discount rate of 8.25% by the APBO and adjusting the results to reflect the expected benefit payments to be made during the year. Specifically, the interest charge is the interest on the APBO at the beginning of the year less the interest on benefit payments which reduce the APBO during the year. On the average, the benefit payments may be assumed

to be paid in the middle of the year resulting in half year's interest on the benefit payment being a credit.

5. Return on Assets

This last component is determined by multiplying the assumed rate of return on assets of 9% by the market-related value of assets. The results are adjusted to reflect any contributions to, or benefit payments from, plan assets during the year. See Appendix C, Note 3.

Justification of Actuarial Assumptions

1. The discount rate of 8.25% and the return on assets of 9% were selected based on the requirements of SFAS 106. As a guide in selecting the discount rate, the yield as of 12/31/92 on long-term high quality bonds was reviewed. In addition, the 8.25% Discount Rate was also used for SFAS 87 and 112.

The 9% Return on Assets assumption was also used for SFAS 87, but it was not used for SFAS 112 downsizing because there are no plan assets.

Based on Spencer Company surveys (cited in Pleading Section I), AT&T's discount rate of 8.25% was in the mid-range of discount rates used by the companies surveyed. The average discount rate was 8.14%. The AT&T return on asset assumption of 9% compares to the average of 9.13%. Thus, the survey results, which did not become available until mid-1994 (well after AT&T was required to size its SFAS 106 costs), support the reasonableness of these two AT&T assumptions.

2. The SFAS 106 assumptions regarding leaving the work force (withdrawal, death, disability and retirement) and post-retirement mortality assumptions were also used to determine the SFAS 87 and SFAS 112 expenses for 1993.

These assumptions are based on AT&T's actual experience to a greater extent than the assumptions used by the vast majority of other companies and, therefore, have a high degree of reliability.

3. The health care trend rate assumptions are used to estimate the year-by-year future increases in average claims per retiree. The trend rates reflect anticipated price inflation, anticipated changes in utilization of health services, the effects of Medicare and the impact of current plan provisions. SFAS 106 precludes firms from reflecting in their trend rates possible future changes in legislation, such as potential legislation affecting Medicare or national health insurance.

Separate trend rates are used for medical, dental and Medicare Part B. The trend rate assumptions are shown in Appendix F. The section below addresses the selection and appropriateness of the trend rates for these three benefits.

4. The reasonableness of the trend assumptions is supported by the fact that an independent actuarial consulting firm compared the trend rates used by AT&T with the trend rates used by other firms to measure their obligations under SFAS 106. The consulting firm determined that the trend rates of AT&T were within the range that other employers have been using.

Medical Care Trend Rate

The two major factors affecting trend are price inflation and changes in health care utilization.

Medical care price inflation reflects not only general inflation but also those factors unique to medical care, such as malpractice costs, new technology and cost-shifting. As a result, the medical care component of the CPI has outpaced general inflation for many years. However, as a practical matter, there is a limit to the extent by which this spread can continue in the future. Otherwise, health expenditures would eventually consume a disproportionate share of the GNP.

Therefore, in projecting the medical care component of the CPI for retirees under age 65, the overall CPI was used as the measure for general inflation and it was assumed that the spread between general inflation and the medical care component of the CPI would disappear by the year 2000.

For retirees age 65 and over the same approach was used, except that to project hospital costs HCFA's Input Price Index (IPI) was used in place of the hospital care component of the CPI. (The IPI is used by HCFA to set hospital cost levels under the Prospective Payment System.)

A number of changes embodied in OBRA89 and OBRA90 which will substantially affect price inflation were also reflected in the projected trend. These include the new Resource-Based Relative Value Schedule, the Balance Billing limits on provider charges and additional limits on hospital reimbursements that have been enacted into law to control Medicare expenses. It was assumed that any reduction in provider income resulting from these changes will be shifted to other payors, including retirees under age 65. However, it was also assumed that some payors, including Blue Cross, which administers the hospital portion of the AT&T program for retirees under age 65, will be able to avoid some of this cost shift.

An annual increase in the utilization of medical care services of from 1½-2½ was projected based on utilization data in the Financial Executives Research Foundation's research book "Retiree Health Benefits - Field Test of the FASB Proposal." An exception to these utilization trends was made for retirees age 65 and over where AT&T assumed no increase in utilization of inpatient hospital care in recognition of the inpatient utilization controls under the Medicare program.

The underlying trend rates described above were adjusted to a net trend to reflect the leveraging effect of the plan's deductible and out-of-pocket maximum.

Dental

The methodology for determining dental care trend was similar to that for medical care, but reflects the fact that approximately 75% of AT&T's dental benefits are based on a set schedule.

Medicare Part B

Medicare Part B Premiums were those promulgated by law through 1995. Trend thereafter is based on the projected increases in Social Security COLA adjustments (the basis in the law for Part B premium increases).

Capping

As a result of collective bargaining in 1989 and 1992, the post-retirement costs (claims per retiree) to be paid by the Company were limited to the following amounts effective July 1, 1995.

	<u>Retirees Under 65</u>	<u>Retirees Aged 65 or Older</u>
Single	\$2,650	\$ 850
Family	5,650	2,350

These caps apply to all current and future retirees whose dates of retirement are on or after 3/1/90. The caps have a significant impact. For example, if the caps were not reflected, the APBO for participants affected by the caps would be more than three times what the APBO was as of 1/1/93. This would have increased the 1993 SFAS 106 costs of \$1285.6 million by roughly \$600 million or more.

Assumptions Unique to Post-retirement Health Care Benefits

Several assumptions unique to health care include the following which are summarized in Appendix F.

- Health care trend rates (previously discussed)
- The percent of retirees who have spouses eligible for Medicare Part B reimbursement
- The percent of retirees who have dependents eligible for post-retirement medical and dental coverage.

The last two items (not previously discussed) were derived from Company-maintained data.

- Average health care claims per retiree.

The average claims for retiree were determined for medical coverage, dental coverage and Medicare Part B reimbursement.

Although some companies utilize outside claims data, for SFAS 106 purposes, AT&T used only its own retiree claims data.

The determination of the average claims per retiree and additional information about the AT&T claim data are provided in Appendix G. The final average claims by sex and age groups are summarized in Appendix F.

SFAS 106 OPEB EXOGENOUS COST ADJUSTMENT
7/1/93, Subsequently amended 7/1/94
(\$ in Millions)

AT&T APBO	
Active Employees	2,442.1
Retirees	8,105.6
Total APBO	10,547.7
Less (Plan Assets Minus Prepaid Assets)	(1,438.2)
(1) Total AT&T TBO (See Note 1)	9,109.5
(2) Regulated AT&T Communications Allocation Factor (See Note 2)	0.5435
(3) Total Pre-amortized Regulated AT&T Communications TBO (9109.5 x Comm. Alloc. Factor of 54.35%)	4,951.0
(4) Amort. of Regulated AT&T Communications TBO (4951.0 divided by 14.6 yrs. average remaining service lives)	339.1
(5) Interest (@ 8.25%) on Active & Retiree APBO (840.9 x Comm. Alloc. Factor, 54.35%) (See Note 3)	457.0
(6) Less Interest (@ 9%) on Corresponding Assets (179.2 x Comm. Alloc. Factor, 54.35%) (See Note 3)	(97.4)
(7) Regulated AT&T Communications TBO - Annual Total	698.7
(8) Less Regulated AT&T Communications 1993 Projected Pay-As-You-Go Expense	(336.7)
(9) Regulated AT&T Communications Net Pre-Separations TBO	362.0
(10) Interstate Separations Factor (See Note 4)	0.8143
(11) Incremental Expense - 12-Month Impact	294.8
(12) Incremental Expense - 18-Month Impact (294.8 @ 150%)	442.2
(13) Revenue Requirement - July 1993 Filing (18-Month Impact)	451.0
(14) Adjusted Revenue Requirement - July 1994 Revision (12-Month Impact) (450.9 @ 66.67%)	300.7

	Allocation Percentages	Dollar Value 18 Mos. July 93	Dollar Value 12 Mos. July 94
Basket 1	53.37%	240.7	160.5
Basket 2	0.07%	0.3	0.2
Basket 3	0.42%	1.9	1.3
Other - Noncapped Services	46.15%	208.1	138.8
Total	100.00%	451.0	300.7

Note: Numbers may not calculate due to rounding.

1993 AT&T SFAS 106 TRANSITION BENEFIT OBLIGATION
(\$ in Millions)

	<u>HEALTH</u>	<u>GROUP LIFE</u>	<u>TELEPHONE</u>	<u>TOTAL</u>
ACTIVE APBO	1,868.5	419.4	154.2	2,442.1
RETIREE APBO	6,978.7	848.2	278.7	8,105.6
TOTAL APBO	8,847.2	1,267.6	432.9	10,547.7
ASSETS - PREPAID	(41.0)	(1,397.2)	-	(1,438.2)
TBO	8,806.2	(129.6)	432.9	9,109.5

REGULATED AT&T COMMUNICATIONS ALLOCATION FACTOR

The Transition Benefit Obligation ("TBO") for Regulated AT&T Communications is derived from the AT&T TBO using the following methodology:

The liability is segregated into three components:

- Incurred up to Divestiture (pre-1/1/84)
- Incurred from 1/1/84 to 12/31/89
- Incurred from 1/1/90 to 12/31/92

1) The pre-1984 liability is allocated based on the relationship of headcount as of 12/31/84. Headcount as of 12/31/83 could not be used because it was still on a Bell System basis. The relationship of Regulated AT&T Communications ("AT&T-C") headcount to the sum of AT&T-C and AT&T Information Systems ("AT&T-IS") headcount was used as a relevant proxy for Regulated AT&T Communications headcount as a percentage of total AT&T headcount. This is appropriate because the predominant balance (97%) of total AT&T headcount was comprised of AT&T Technologies (Western Electric) and Bell Labs, which at that time were internal supplier organizations that principally supported communication services and products. Had the accrual method been in place during this period, higher costs of OPEBs for AT&T Technologies (Western Electric) and Bell Labs would have been reflected in AT&T Communications plant investment, resulting in increased revenue requirements and prices, as well as in AT&T Information Systems products. The TBO impact for the predivestiture period was, therefore, allocated on this basis to reflect most accurately the association of these supplier organizations with AT&T Communications services and AT&T Information Systems products. The numbers used for this calculation came from the 1984 AT&T Annotated Annual Report. The allocation factor is derived as follows:

Total Regulated Communications Headcount	117,100
AT&T Headcount (AT&T-C & IS only)	202,500
Percentage used in calculations	$117,100/202,500 = 57.83\%$

2) The post-1983 (1/1/84 to 12/31/89) liability is based on the average relationship of AT&T Communications headcount and AT&T headcount for the years of 1984 and 1989. Consistent with the above, the AT&T headcount used for 1984 in this calculation represents AT&T (AT&T-C & IS only) headcount. The use of AT&T total headcount for the 1989 component of this calculation reflects that during the postdivestiture period AT&T Technologies and Bell Labs had substantial external customers and no longer only supported AT&T Communications and AT&T Information Systems.

APPENDIX C
PAGE 4 of 13
NOTE 2

Total Regulated Communications	1984	117,100
Headcount	1989	<u>117,588</u>
		234,688/2 = 117,344

AT&T (AT&T-C & IS) Headcount	1984	202,500
Total AT&T Headcount	1989	<u>282,263</u>
		484,763/2 = 242,382

Percentage used in calculations 117,344/242,382 = 48.41%

- 3) The Regulated AT&T Communications allocation factor for the SFAS 106 TBO liability from 1/1/90 to 12/31/92 was determined using a two-step process. First, the percentage of AT&T End User Organization ("EVO") headcount of the total AT&T Corp. headcount was determined. The AT&T EVO represents the portion of the total AT&T Corp. headcount attributable to AT&T-C and AT&T-IS. This percentage, 54.69%, thus excludes all headcount associated with other business units. Second, a wages and salaries factor was employed to allocate between the AT&T-C and AT&T-IS entities that form the EVO. The percentage of regulated wages and salaries attributable to AT&T-C was determined to be 55.40%. This step is necessary and serves as a reasonable proxy to determine headcount solely attributable to Regulated AT&T Communications. The product of these two calculations, 54.69% times 55.40%, is equal to 30.29%. It is this percentage, used in the calculations, that represents a cost-causative allocation to Regulated AT&T Communications for this period.

Incurred from 1/1/90 to 12/31/92.

Percentage of AT&T EVO (the combined AT&T-C & IS) headcount to Total AT&T Headcount	54.69%
---	--------

X

Percentage of AT&T EVO Wages & Salaries attributable to Regulated AT&T-C	55.40% =
---	----------

Percentage used in calculations	30.29%
---------------------------------	--------

In summary, the above three accrual components were calculated separately, multiplied by the headcount percentage associated with Regulated AT&T Communications for each interval, and then the weighted cost of the TBO for each interval was summed to a total accrual associated with Regulated AT&T Communications of \$4.9 billion (54.35% of \$9.1 billion).

COMPONENTS OF AT&T SFAS 106 EXPENSE 1993
(\$ in Millions)

APBO	10,547.7
INTEREST @ 8.25% ON ACTIVE & RETIREE APBO*	840.9
INTEREST @ 9.0% ON CORRESPONDING PLAN ASSETS**	(179.2)

* The interest charge is the interest on the APBO at the beginning of the year less the interest on benefit payments which reduce the APBO during the year. On the average, the benefit payments may be assumed to be paid in the middle of the year resulting in half year's interest on the benefit payment being a credit. The computations are based on the discount rate of 8.25%.

** The return on assets is the interest on the beginning of year assets plus interest on contributions during the year less interest on benefit payments. The computations are based on the expected long-term rate-of-return of 9%.

Computation of AT&T Communications Interstate Portion of TBO
(Columns C and E \$ in Millions)

<u>A</u>		<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
<u>Part 32 Income Statement Lines</u>		<u>Benefit Allocation Percent</u>	<u>AT&T-C Pre-Separations</u>	<u>Interstate Separation Factors</u>	<u>Interstate</u>
Plant Specific	Acct. 6232	3.0%	11	0.8436	9
Plant Nonspecific	Acct. 6534	6.4%	23	0.8566	20
Marketing & Sales	Acct. 6612	7.1%	26	0.858	22
Other Customer Operations	Acct. 6621	12.0%	43	0.7595	33
Other Corporate Operations	Acct. 6728	71.5%	259	0.8124	210
Total TBO		100%	362	0.8143*	295

The AT&T Communications TBO was booked into the regulated accounts in accordance with the Commission's Part 32 Rules and RAO Letter 20, 7 FCC Rcd. 2872 (1992).

* Composite weighted total Interstate Separations Factor used for display purposes.

Note: Numbers may not calculate due to rounding.



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August 14, 1992

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

Attention: Common Carrier Bureau

Re: Price Cap Performance Review For AT&T

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

Basket 1 Performance

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

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

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

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

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

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

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

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

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

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

Impact on Basket 1 of Specified Accounting Events

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

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

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

Respectfully,

Joel E. Kulzin

RESULTS FOR EACH PRICE CAP YEAR

(\$ MILLIONS)

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

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

BASKET IMPACT OF THREE SPECIFIED ACCOUNTING EVENTS
(\$ Millions)

Results

BASKET 1 IMPACT

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

BASKET 1 IMPACT

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

BASKET 1 IMPACT

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

Methodology

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

1. Depreciation Rescriptions

The Commission authorized depreciation rate rescriptions effective January 1989 and January 1991.³ To quantify the impact of these changes on total interstate depreciation expense, AT&T computed its average depreciable Telecommunications Plant in Service for each of the price cap years. AT&T then applied the 1988 Commission-prescribed depreciation rates to these averages to determine what AT&T's depreciation accrual level would have been using the 1988 rates. In addition, AT&T identified the Commission-prescribed amortization amounts by rate category and added those amounts to the computed depreciation accrual amounts to determine the total depreciation expense levels that would have resulted without the 1989 and 1991 rescriptions. The difference between the result of this computation and AT&T's actual booked depreciation expense represents the depreciation expense increase attributable to the Commission's rescriptions.

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

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

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

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

2. Other Post-Retirement Benefits

AT&T's earnings were affected in each of the price cap periods by a change in the accounting treatment for employee post-retirement benefits pursuant to which AT&T recognized (accrued) expenses in current periods to fund future post-retirement benefits. This change in accounting treatment is now required by the Commission's adoption of Statement of Financial Accounting Standards, No. 106.⁵ AT&T calculated the impact of this change on interstate expense by computing the difference between the accrual basis and the pay-as-you-go (cash accounting) method. The resulting increase in expense decreased net income in each of the price cap periods. It also lowered property taxes in those states that impose property taxes based on net income. AT&T computed the property tax impact by comparing actual levied taxes to what they would have been if the accounting change had not occurred.

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

3. Early Retirement Plans

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

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

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