through the normal operation of the price cap formula since the start of price cap regulation. The result of $362 million was then multiplied by an interstate separations factor of 81.43%, which yields an interstate SFAS 106 incremental TBO expense value of $295 million.[43]

The $295 million incremental annual expense was then multiplied by 150%, to arrive at a figure of $442 million, which reflects the fact that AT&T's initial filing for exogenous treatment was based on accrual of OPEB expenses for an 18-month period. Finally, AT&T's $442 million expense was increased to $451 million after taking into account the effects of taxes.[44]

As noted above, as of July 1, 1994, the 18-month figure for the exogenous cost was subsequently reduced by one-third, leaving an annual interstate SFAS 106 increase of $300.7 million, of which $162 million is reflected as exogenous adjustments in AT&T's PCIs. AT&T allocated the SFAS 106 interstate cost between interstate price capped and

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43 The interstate separations factor of 81.43% was derived in accordance with applicable Commission procedures. The total AT&T Communications OPEB accrual was booked into the regulated accounts in accordance with the Part 32 Rules and RAO Letter 20, Re: Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, 7 FCC Rcd. 2872 (1992). Part 36 jurisdictional separations factors were then applied by expense line to arrive at the interstate amount. A weighted total of each of these lines yields a composite interstate factor of 81.43%, which was used for ease of display. See Appendix C, Note 4.

44 See Appendix A, Responses to Issue Nos. 30 and 31.

noncapped services and among AT&T's price cap baskets on a cost-causative basis, consistent with the Commission's rules.[45] Specifically, AT&T utilized 1992 price cap study data to determine the initial allocation as of July 1, 1993 to Baskets 1, 2, and 3 and to noncapped communications, as well as for the one-third removal effective July 1, 1994.[46]

In short, AT&T's SFAS 106 exogenous cost amounts are based upon reasoned actuarial standards as to their calculation, and further, the subsequent regulatory separations and allocations processes are justified.

II. EXOGENOUS TREATMENT WILL NOT RESULT IN A DOUBLE COUNT OF OPEB-RELATED COSTS.

The Designation Order (¶ 28) states that "since part of the growth in Gross Domestic Product Price Index (GDP-PI) presumably occurs due to growth in medical costs, [the Commission seeks] information on what adjustment, if any, should be made in the exogenous adjustment to avoid any double-counting." No adjustment to the exogenous amount that AT&T claimed for the OPEB TBO need be made to avoid a

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[45] See Price Cap Rules, 47 C.F.R. § 61.44(c)(5).

[46] The allocation methodology is described in a Letter, dated August 14, 1992, from J. E. Lubin, Regulatory Vice President, AT&T, to Donna R. Searcy, Secretary, FCC ("Lubin Letter"). See Appendix C. AT&T's allocation of exogenous interstate OPEB costs was based on the approach described in the Lubin Letter, issued in the context of the Commission's Price Cap Performance Review for AT&T, Notice of Inquiry, 7 FCC Rcd. 5322 (1992); Report, 8 FCC Rcd. 6968, 6970, ¶ 22 (1993).

double count, because SFAS 106 costs are not reflected in the GDP-PI.

SFAS 106 costs are not included in GDP-PI for two independent reasons. Most fundamentally, SFAS 106 costs are accounting changes only -- they are not economic costs; and the SFAS 106 TBO is, in any case, a "sunk" cost that would not be reflected in competitive firms' pricing decisions. Because the GDP-PI reflects only economic changes that are included in pricing decisions, SFAS 106-related costs are not accounted for in that index, and thus exogenous treatment will not result in double recovery.[47]

A. The SFAS 106 TBO Is Not An Economic Cost.

There is no GDP-PI double count because OPEB costs are not economic costs, but rather are solely bookkeeping entries. As such, it is undisputed they have no direct impact on cash flow and, hence, on pricing/cost decisions that might influence the GDP-PI. The Commission expressly recognized this in its recent LEC Price Cap Performance Review Order (¶ 282), indicating that ". . . GAAP changes of the type required by SFAS 106 . . . represent only a change in how books are kept and costs are recorded, not an economic cost change that might be expected to affect price . . . ."

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[47] Nonetheless, for completeness, AT&T has performed a double count study, which assumes (incorrectly, in AT&T's view) that OPEBs are real costs that have an impact on GDP-PI. See Appendix J

SFAS 106 is simply a change in the timing of the recognition of OPEB-related costs on firms' books of account.[48] The accounting requirement has no direct impact on cash flow, because OPEB reserves set up on company books are not required to be funded. Moreover, as the Commission acknowledged in the OPEB Order (¶ 74), SFAS 106 "does not change the actual flow of benefits payments the companies make over time." As such, SFAS 106 does not represent a change in the economic costs of the firm. The Commission has also recognized this:

> "most accounting changes will not have an economic cost associated with them . . . . Financial accounting books are designed primarily to give the financial markets an accurate portrayal of the true economics of the corporation. Changes to the accounting books are merely an attempt to make the portrayal more accurate, not necessarily an attempt to make the company behave differently." LEC Price Cap Performance Review Order, ¶ 306.

Corporate management reacts to changes in actual financial and market conditions (e.g., changes in cash flow from either the revenue or expense side). SFAS 106 does not effect such a change.

The Commission has also recognized that financial markets value a company's stock in terms of the discounted

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48 See Duff & Phelps, Credit Decisions, October 9, 1989, p. 8 (". . . [I]t is important to understand that financial statement recognition of the OPEB liability does not constitute an economic event.") See also Moody's March 1991 Special Comment on SFAS 106, p. 3 ("We must recognize that the new reporting, as it involves accrual accounting, is not expected to change our assessment of the prospective cash flow of companies.")

cash flow of the streams of cash payments to and from the firm and that accounting changes that do not affect cash flow will not affect the return on equity.[49] That financial markets, in fact, "look through" accounting changes that do not affect cash flow is borne out by a number of econometric studies. For example, Kaplan and Roll examined the effect on stock prices of two accounting changes in the 1960s that affected only the financial reports prepared for shareholders and had no effect on taxes, cash or any other real economic asset or liability.[50] The accounting changes that were studied boosted reported earnings in the year the change was made, but neither one had an impact on any real factor affecting the firm. The Kaplan and Roll study finds that "[w]e have difficulty discerning any statistically significant effect that [the accounting changes cited above] had on security prices."[51] The authors did see stock prices rise briefly around the date when the firm announces inflated earnings, but that price rise is seen to be

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49 LEC Price Cap Performance Review Order, ¶ 295.

50 The two accounting changes studied were: (1) the shift, in 1964, to the flowthrough method of reporting the investment tax credit, and (2) the switch-back from reporting accelerated depreciation to reporting straight-line depreciation (while continuing to use accelerated depreciation for tax purposes). Robert S. Kaplan and Richard Roll, "Investor Evaluation of Accounting Information: Some Empirical Evidence," The Journal of Business, Vol. 45, No. 3, April 1972, pp. 225-57.

51 Id. at p. 245.

temporary, and is gone by the next quarterly earnings report.[52]

More recently, Tung examined the impact on security returns of SFAS 87, which requires recognition on balance sheets of unfunded pension liabilities, similar to the recognition required by SFAS 106 for OPEBs.[53] Although the central hypothesis of the study was that firms with underfunded pensions would see their stock price adversely affected by SFAS 87, the finding was exactly the opposite: "Statement 87 had no material impact on the stock returns of the firms with underfunded pensions."[54]

Taken together, these studies confirm that accounting changes which do not impact cash flow or any real economic factor of the firm have no significance in terms of how those firms are valued. By extension, it follows that

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52 Archibald, independently, also looked at the stock price performance of 65 firms that switched back from accelerated to straight-line depreciation for reporting purposes, during the period 1955 to 1966. See T. Ross Archibald, "Stock Market Reactions to the Depreciation Switch-Back," The Accounting Review, Vol. 47, No. 1, January 1972, pp. 22-30. Archibald concluded that "[t]he switch-back announcement and resultant profit improvement had no immediate substantial effect on stock market performance." Id. at p. 30.

53 Samuel S. Tung, "Stock Market Reactions to Mandatory Changes in Accounting for Pensions," Doctoral Dissertation, University of Wisconsin - Madison 1987, 113 pp. Tung's analysis used both econometric models and a comparison of risk-adjusted abnormal returns between firms with underfunded pensions and those with overfunded pensions.

54 Id. at p. ii.

such accounting changes have no real impact on firm behavior, and hence, on the types of decisions on costs and prices that would be reflected in the GDP-PI.

B. The TBO Is A "Sunk" Cost.

Moreover, even if it were an economic or cash flow affecting cost, the OPEB TBO is a "sunk" cost and, as such, has no bearing on corporate pricing decisions. Because rational firms do not consider "sunk" costs in their pricing decisions, the OPEB TBO will not have an impact on GDP-PI. By definition, the entire OPEB TBO accrual is associated with services rendered in the past (whether by retired or current employees), and as such, it represents a sunk cost.

Economic theory is clear that sunk costs do not enter into pricing decisions. Rather, prices are determined by economic forces of supply and demand that drive marginal cost and marginal revenue toward equality.[55] Thus, even if

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[55] William S. Brown, Principles of Economics, West Publishing Co., Minneapolis-St. Paul 1995, pp. 266-69.

Marginal cost is the cost associated with producing an extra unit of output. That cost is unaffected by fixed costs, that is, costs that do not vary with output, including sunk costs, such as the OPEB TBO.

That fixed costs do not enter into marginal costs is demonstrated by Watson, as shown below:

Let:
MC = Marginal Cost
n = any volume of output
TFC = Total Fixed Cost
TVC = Total Variable Cost
TC = Total Cost (Total Fixed Cost plus Total Variable Cost)

(footnote continued on following page)

the OPEB TBO were viewed as a real economic cost (instead of what it actually is, simply an accounting entry), it would not affect pricing decisions of firms. As a sunk cost, the TBO will not impact marginal costs, and it is ultimately marginal cost and marginal revenue that determine price. Because the OPEB TBO will not affect price, it obviously has no impact on the GDP-PI. In short, no adjustment of AT&T's exogenous cost for the OPEB TBO is required to avoid a double count.

III. EXOGENOUS TREATMENT SHOULD NOT BE LIMITED ONLY TO THOSE OPEB COSTS THAT A CARRIER HAS "FUNDED" OR TO BENEFITS IN WHICH EMPLOYEE INTERESTS HAVE "VESTED."

The Designation Order (Issues E and F) also inquires whether exogenous treatment should be limited to amounts that a carrier has specifically "funded" or to amounts associated with employee interests that have "vested." The Commission should allow exogenous cost treatment for OPEB costs whether or not they are "prefunded" and irrespective of whether the underlying benefits have "vested" for employees.

(footnote continued from previous page)

It follows that:

$$\begin{aligned} MC(n) &= TC(n) - TC(n-1) \\ &= [TVC(n) + TFC] - [TVC(n-1) + TFC] \\ &= TVC(n) - TVC(n-1) \end{aligned}$$

D. S. Watson, Price Theory and its Uses, Houghton, Mifflin Co., Boston 1963, p. 169.

Neither GAAP, regulatory accounting rules nor price cap regulation requires that a carrier prefund its OPEB costs or accrue such expenses only for employees that have vested interests in post-retirement benefits. To the contrary, SFAS 106 expressly requires employers to accrue their OPEB expenses irrespective of prefunding or vesting.[56] Because many employers have not prefunded their OPEB costs and, for the most part, employees do not have vested rights in OPEBs, a failure to accrue for nonfunded, nonvested OPEB costs would seriously understate employers' disclosure obligations under SFAS 106.[57]

In these circumstances, imposing either a "prefunding" or "vesting" requirement for exogenous treatment is foreclosed by the DC Circuit OPEB Order. As explained above, the Court ruled that the SFAS 106 accounting change was not under the carrier's control "and, once mandated by the Commission, the change satisfies the control criterion" of the exogenous treatment test.[58] It expressly held that it was impermissible for the Commission to attach new meaning to the term "control," for example, by

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56 SFAS 106, ¶ 8.

57 As noted in Section I, pp. 12-13, supra, AT&T's commitment to securing OPEBs for its retirees and employees is reflected in the fact that it maintains plan assets for all OPEBs (medical, dental, life insurance) other than telephone concession.

58 DC Circuit OPEB Order, 28 F.3d at 170.

denying exogenous treatment because the carrier could control the underlying benefit expense.

To condition exogenous treatment on prefunding or employee vesting status would be tantamount to an attempt by the Commission to limit exogenous treatment based on carriers' ability to control the underlying expense, for example, by not setting funds aside or modifying benefit provisions for nonvested employees. Imposing such criteria would directly conflict with the Court's ruling, because under the price cap rules in effect when AT&T filed for exogenous treatment of OPEB, there was no room for the Commission to deny such treatment based on a carrier's ability to control the underlying OPEB cost.[59]

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[59] As noted above (at n.5), recently, the Commission prospectively eliminated exogenous treatment for the LECs' noneconomic accounting costs. See LEC Price Cap Performance Review, ¶ 293. The Commission has similarly proposed (but not yet adopted) such a prospective rule change for AT&T.

CONCLUSION

For these reasons, AT&T's exogenous adjustment for the SFAS 106 TBO was reasonably computed and qualifies fully for exogenous treatment without any "double count offset" or limitation as to Company funding/employee vesting status.

Respectfully submitted,

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LIST OF APPENDICES

A

Specific Responses to Investigation Issues

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?

Yes, AT&T has.

1. The date company implemented SFAS 106. (¶ 17)

AT&T implemented SFAS 106 as of January 1, 1993 for exogenous price cap treatment, simultaneously with adoption of SFAS 106 on its financial (SEC) books. AT&T had implemented SFAS 106 on its regulated books earlier, on January 1, 1990, for FCC reporting purposes only, but that has no bearing on the issue of exogenous treatment

2. 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. (¶ 17)

AT&T became subject to price cap regulation on July 1, 1989. AT&T Communications' 1988 pay-as-you-go amount, which was included in rates upon commencement of price cap regulation for AT&T, is $161.9 million

3. The effect of the price cap formula on that amount up to the date of conversion to SFAS 106. (¶ 17)

1988 Actual Pay-As-You-Go Expenses	$161.9 million
1989 Growth of GNPPI (4.4) - x (3.0) = 1.4% =	164.2 million
1990 Growth of GNPPI (4.6) - x (3.0) = 1.6% =	166.8 million
1991 Growth of GNPPI (3.6) - x (3.0) = 0.6% =	167.8 million
1992 Growth of GNPPI (3.1) - x (3.0) = 0.1% =	168.0 million

AT&T converted to SFAS 106 as of January 1, 1993 for exogenous treatment purposes.

4. The carrier's 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. (¶ 17)

<u>AT&T Communications Pay-As-You-Go SFAS 106 Expenditures:</u>

1989	$189.2 million
1990	215.1 million
1991	259.2 million
1992	262.4 million

AT&T implemented the SFAS 106 as of January 1, 1993 for exogenous treatment purposes.

5. 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. (¶ 17)

Attached as Appendix D are copies of relevant sections of AT&T's 1993 and 1994 Annual Reports to shareholders, and SEC Quarterly Reports (Form 10-Q) for the periods ending March 31, 1993, June 30, 1993, and September 30, 1993. These reports show that effective, January 1, 1993, AT&T Corp. recorded a one-time pre-tax charge of $11.3 billion on its financial books to reflect the unfunded portions of its SFAS 106 accumulated post-retirement benefit obligation and its obligation (under the Divestiture Plan of Reorganization) to reimburse the divested Regional Bell Operating Companies for part of their costs of providing post-retirement benefits to predivestiture retirees. <u>See</u> 1993 Annual Report (Appendix D, p. 10). In addition, in that Report, AT&T explained why it was making the accounting change (Appendix D, pp. 3-4), and that apart from this one-time charge, the accounting change should have no material impact on net income and no impact on cash flow (Appendix D, p. 10). Line item entries on the income statement, balance sheet, and statement of cash flow indicate the accounting change impact (Appendix D, pp. 6-8), although the balance sheet and statement of cash flow line items include other accounting changes.

The $2.2 billion difference between the $11.3 billion pre-tax charge reported to shareholders and the $9.1 billion AT&T Corp. TBO, which is the starting point for the exogenous treatment calculation, relates primarily to the exclusion of AT&T's RBOC reimbursement obligation from the latter amount

6. Describe each type of benefit being provided that is covered by the SFAS 106 accounting rules. (¶ 18)

The AT&T post-retirement benefits covered by SFAS 106 accounting are: (1) Medical Benefits, (2) Medicare Part B Reimbursement, (3) Dental Benefits, (4) Group Life Insurance, and (5) Telephone Concession.

<u>See</u> Appendix E for a further description of these benefits.

7. Provide, on a year-by-year basis, what the pay-as-you-go amounts would have been had the company not implemented SFAS 106 methods. (¶ 18)

AT&T implemented SFAS 106 accounting methodology as of January 1, 1993 for exogenous treatment purposes. The pay-as-you-go or actual cash expenditures for post-retirement benefits would not have changed had the Company not implemented SFAS 106 accounting methods, because (as the Commission has recognized) SFAS 106 adoption has no impact on a company's cash flows; it is an accounting change only. AT&T Communications had $234.3 million of actual SFAS 106 pay-as-you-go expenses in 1993 and $236.2 million in 1994. <u>See</u> <u>also</u> Response to Issue No. 4

8. Describe the forms of postretirement benefit accrual accounting, if any, that were utilized before the effective date of price cap regulation (¶ 18)

    Prior to the January 1, 1989 effective date of price cap regulation for AT&T, AT&T used pay-as-you-go accounting for OPEBs other than for post-retirement group life insurance

    Since the mid-1950s, AT&T has funded in advance, i.e., during the working lives of employees, the post-retirement group life insurance program. The dollar amount of the company contributions to these insurance funds was also the expense for accrual accounting purposes.

    The method used to determine the contribution or expense was the aggregate cost method. Under the aggregate cost method, the contribution and expense would be calculated to be level (either a dollar amount per employee or as a percent of payroll) over the average expected working lives of the current active employees. In the case of AT&T, the contribution is calculated to be level (constant) as a percent of payroll

    The aggregate cost method is a widely-recognized actuarial cost method and is specifically listed in the Employee Retirement Income Security Act (ERISA) as an acceptable cost method for determining pension plan contributions. For example, AT&T used the aggregate cost method for determining contributions to the AT&T Management Pension Plan covering management participants and the AT&T Pension Plan covering nonmanagement participants.

    The post-retirement group life insurance plan assets are held by major insurance companies. Technically, these assets do not reside in a VEBA trust. However, the assets are maintained separate from AT&T's other assets, similar to funds held in a VEBA trust, and may not be used by the Company for any purpose other than to pay benefits under the group life insurance program. These assets are considered plan assets under SFAS 106

9. Describe the type and level of SFAS 106 type expenses reflected in rates before they were adjusted for any exogenous treatment related to SFAS 106 (¶ 18)

    See Responses to Issue Nos 3 and 6

10. Provide 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 (¶ 18)

    See Response to Issue No. 2

Issue B: Pre 1/1/93 Exogenous Claims

11. Should exogenous claims be permitted for SFAS 106 costs incurred prior to 1/1/93, the Commission's date for mandatory compliance? (¶ 19)

No. In accordance with the DC Circuit OPEB Order, the "control" prong of the exogenous treatment test is met as of the mandatory SFAS 106 adoption date of January 1, 1993. AT&T's PCIs include exogenous adjustments for SFAS 106 as of that date.

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

Yes, AT&T has

12. The amount associated with implementation of SFAS 106 for the total company (including telephone and non-telephone operations). (¶ 20)

The costs for the SFAS 106 TBO on an AT&T company-wide basis, excluding Global Information Solutions (the former NCR) and AG Communications Systems Corporation, are as follows in $ millions:

These figures represent an amortization of the TBO on a company-wide basis for FCC purposes on the entire expense in 1993.

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

See also Response to Issue No. 13

13. An explanation of how the carrier arrived at the total company SFAS 106 amounts. (¶ 20)

The amounts in the Response to Issue No. 12 were determined as follows in $ millions

Amortization of Transition Benefit Obligation

The amortization of the TBO was determined by amortizing the total TBO of $9,109.5 million over 14.6 years, the average remaining years of service of those employees expected to receive benefits.

Transition Benefit Obligation

The TBO is the excess of the Accumulated Post-retirement Benefit Obligation (APBO) over the Plan Assets reduced by any Prepaid Amounts as follows in $ millions:

APBO

Actives	$2,442.1	
Retirees	8,105.6	
		$10,547.7
Assets - Prepaid		(1,438.2)
Transition Benefit Obligation		$ 9,109.5

<u>Accumulated Post-retirement Benefit Obligation (APBO)</u>

The APBO is the present value (on the date of calculation) of benefits that will be paid to current active employees, retirees, and eligible dependents of both (with the present value of benefits to active employees and their dependents pro-rated to reflect the service rendered to date vs. the service expected to be rendered by the date on which the employee qualifies for unreduced post-retirement benefits).

For example, if the value of a group life insurance benefit of $100,000 upon retirement at age 60 is $40,000 and an active employee is now age 45 with 15 years of service, one would first find the present value at age 45, which might be $12,000, and then pro-rate that amount by the ratio of 15 years of completed service to 30 years of total service, arriving at an APBO of $6,000.

In determining the APBO the Company had to make actuarial assumptions as to rates of mortality, termination of employment, disability, retirement, etc. as well as an assumption of the discount rate needed to produce a present value. In all cases, the relevant assumptions used by AT&T to produce the APBO are identical to those used to produce pension expenses under SFAS 87. <u>See</u> Response to Issue No. 34.

Additional assumptions as to benefits payable for medical benefits, dental benefits, Medicare Part B reimbursement, and telephone concession, are discussed in the Response to Issue No. 34. Assumptions as to future salary increases for group life insurance are identical to that used to produce pension expenses.

<u>Interest Cost</u>

Interest cost is the product of the discount rate (8.25%) and the APBO (adjusted for expected benefit payments during the year).

<u>Return on Plan Assets</u>

Offsetting the other elements is the product of the Long-Term Rate of Return (9%) and the Market-Related Value of Assets at the beginning of the year (adjusted for expected benefits and contributions during the year).

As with other elements which mirror elements in SFAS 87, the Market-Related Value of Assets is calculated according to the same methodology (<u>i.e.</u>, a five-year phase-in of realized and unrealized gains or losses) and the same Long-Term Rate-of-Return is used.

<u>Actuarial Assumptions</u>

The actuarial assumptions used to calculate the expense amounts identified in the Response to Issue No. 12 are summarized in Appendix F

These assumptions are the same as those used to calculate the 1993 SFAS 106 expenses for financial reporting purposes. The SFAS 106 costs for financial reporting purposes underwent an independent actuarial audit by a consulting actuarial firm not affiliated with AT&T. Furthermore, the assumptions, where appropriate, are the same as the assumptions used to calculate SFAS 87 expenses for the AT&T Management Pension Plan and the AT&T Pension Plan. The discount rate and return on assets were 8.25% and 9%, respectively, for both SFAS 106 and SFAS 87 purposes.

The demographic assumptions used by AT&T are based on Company experience to a greater extent than the assumptions of the vast majority of other companies and therefore have a high degree of reliability.

14. The amounts allocated to the telephone operating companies, including the specific Part 32 Accounts used and the amounts allocated to each of those accounts. (¶ 20)

    See Pleading Section I and Appendix C

15. The method of allocating amounts to the telephone operating companies (headcounts, actuarial studies, etc.). (¶ 20)

    See Pleading Section I and Appendix C

16. The amounts allocated between regulated and non-regulated activities of the telephone company, with a description and justification of the methodology for the allocations. (¶ 20)

    See Pleading Section I and Appendix C

17. The allocation of costs to baskets, by year. (¶ 20)

    See Pleading Section I and Appendix C

Issue D: VEBA Trust Information

18. How should VEBA trusts or other funding mechanisms be treated if implemented before price caps? (Issue D)

    Payments that a carrier made to VEBA trusts or other funding mechanisms prior to price caps should not be given exogenous treatment, because these payments would have been included in the carrier's PCIs as of price cap initiation. This was the case with the payments AT&T had made to its post-retirement life insurance funds prior to July 1, 1989.

19. After price caps but before the change required by SFAS 106? (Issue D)

As explained in Pleading Section I, Note 30, the Response to Issue No. 34, and Appendix C, VEBA trusts and other funding mechanisms can serve to reduce the TBO because they are considered "plan assets" under SFAS 106. Under SFAS 106, the fair market value as of January 1, 1993 of "plan assets" less "prepaid amounts" (i.e., the contributions to these funding mechanisms to the extent they were not previously expensed), reduces the TBO. In AT&T's case, the value of AT&T's Post-Retirement Group Life Insurance Funding (established in the 1950s) (see Response to Issue No. 21) as of January 1, 1993 (the date of AT&T SFAS 106 adoption for exogenous treatment purposes) reduced the dollar amount of the TBO for which an exogenous adjustment was claimed, because Company contributions had been previously expensed. In addition, interest on assets of AT&T's Post-Retirement Health Care VEBA Trusts (established in 1991 after price caps) also reduced the TBO. However, Company contributions to the VEBAs did not reduce the TBO because these contributions had not been expensed; thus, for VEBA contributions, the "plan assets" less "prepaid" netted out to zero. The VEBA contributions are therefore included in the TBO as of January 1, 1993 and qualify for exogenous treatment.

20. If implemented after the change in accounting required by SFAS 106? (Issue D)

As noted above, AT&T adopted SFAS 106 for exogenous treatment purposes on January 1, 1993. In sizing the TBO as of that date, AT&T properly included the then unfunded OPEB obligation for retired and active employees. The unfunded obligation as of January 1, 1993 includes amounts that were subsequently funded in 1993, 1994 and which AT&T expects to continue to prefund, at least in part, on behalf of these employees. These amounts included in the TBO all qualify for exogenous treatment.

Issue E: Should Exogenous Treatment Be Limited To Funded Costs?

No. See Pleading Section III

The following information shall 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.

21. Describe any VEBA trust or other funding mechanisms for the expenses that were established prior to the adoption of SFAS 106. (¶ 21)

Prior to the exogenous treatment of SFAS 106 on January 1, 1993, AT&T established the following funding mechanisms.

- Post-Retirement Health Care VEBA Trusts

  The American Telephone and Telegraph Company Represented Employees Post-retirement Health Benefits Trust was established on September 12, 1991 as a result of collective bargaining agreements between the Company and both the Communication Workers of America (CWA and the International Brotherhood of

Electrical Workers (IBEW). The American Telephone and Telegraph Company Management and Nonrepresented Employees Post-retirement Health Benefits Trust was established on December 20, 1991. The purpose of both of these Trusts is to provide a vehicle to fund in advance, on a tax-advantaged basis, for post-retirement medical benefits, dental benefits and the reimbursement of Medicare Part B premiums, on behalf of current and future AT&T retirees and their eligible dependents. The Trusts will be used exclusively to pay post-retirement health benefits and the administrative costs of the health plan and the Trust. The benefits for a relatively small number of management employees, classified as "key employees" under the Internal Revenue Code, are not funded under these Trusts.

The post-retirement health benefits are funded on an actuarial basis. See Response to Issue No. 24.

- Post-Retirement Group Life Insurance Funding

AT&T Post-retirement Group Life Insurance assets (established in the 1950s) are held in Retired Lives Reserve Arrangements with several life insurance companies. A substantial portion of these assets are segregated from the general accounts of the life insurance companies. These assets are used exclusively to pay post-retirement life insurance benefits and administrative costs under the plan.

The assets are used to pay post-retirement benefits for both management and nonmanagement employees and retirees, with the following exceptions. The benefits for "key employees," as defined under the Internal Revenue Code and Senior Managers active on or after October 1, 1990, are not paid from the plan assets. In addition, coverage in excess of $50,000 is not paid from plan assets other than for employees who retired on or before January 1, 1984 or attained age 55 on or before January 1, 1984.

The post-retirement Group Life Insurance benefits are funded on an actuarial basis. See Response to Issue No. 24.

22. Provide the amounts, placed in these funds for each year since they were implemented, including the 1990-91 tariff year for AT&T. (¶ 21)

The contributions by AT&T on a company-wide basis to the Post-retirement Health Care VEBA Trusts and Group Life Insurance Funding vehicles are as follows in $ millions

Year	Post-retirement Health Represented	Post-retirement Health Management and Nonrepresented	Post-retirement Group Life*
1988	$0.0	$0.0	$25.1
1989	0.0	0.0	27.9
1990	0.0	0.0	26.0
1991	302.8	58.6	23.2
1992	338.7	73.4	1.8
1993	343.8	83.4	0.0
1994	362.4	98.9	0.0

* Although Group Life Insurance funding was begun in the 1950s, it is not possible for AT&T to readily determine the funding amounts for the early years. The $1.8 million contribution shown for 1992 and the zero contributions shown for 1993-94 for Group Life are due to their funded status

23. Describe and provide the amounts in the trust that were for ongoing OPEBs and those that were for the TBO. (¶ 21)

The plan assets less prepaid amounts were used to reduce the TBO by $1,438.2 million on a total AT&T company-wide basis. Therefore, the entire amount of plan assets less prepaid (VEBAs and life insurance funding) are associated with the TBO rather than with ongoing OPEB costs. AT&T has not sought exogenous treatment for ongoing SFAS 106 costs, only for the TBO.

See also Response to Issue No 34

24. Describe the assumptions made when the funds were set up, including, but not limited to, the time value of money, expected long term rate of return on plan assets, future compensation levels, and retirement age factors affecting the amount and timing of future benefits. (¶ 21)

The following assumptions were used to determine Company contributions to the VEBA and life insurance funding mechanisms. In order to determine the Company contributions, it is necessary to estimate the incurred health benefits and post-retirement life insurance benefits that will be paid from the plan assets in future years (to current employees and pensioners and their eligible dependents) and the remaining future salaries of currently active employees. These items are then discounted to the valuation date to estimate their present values

For these calculations, experience is analyzed and actuarial assumptions are developed. The resultant end products of these studies are: mortality rates for active and retired employees, separation rates, disability retirement rates, service retirement rates, wage scale indices, the long-term average rate of earnings on trust funds, percentages of retirees who have beneficiaries, current health benefit costs, and the trend in future health benefit costs. The assumptions have been developed so that each assumption is reasonable and represents the best estimate of anticipated experience under the Plan Summaries of the detailed assumptions are shown in

Appendix H for the 1991 contributions to the post-retirement health VEBAs and in Appendix I for the 1988 contribution for post-retirement group life insurance.

A. <u>Mortality, Withdrawal, Disability, Retirement and Wage Scale Rates</u>

The mortality, withdrawal, disability, retirement, percent of retirees having beneficiaries and wage scale rates used to determine the future benefits and the contribution rate are the same rates that were used to determine the Company's contributions for the AT&T Management Pension Plan and the AT&T Pension Plan.

B. <u>Health Care Net Claims Cost Trend Rates (Post-Retirement Health Only)</u>

The approach used in the valuation is to apply annual health care net claims cost trend rates to the most current net claim costs to develop claim costs for future years. <u>See</u> Appendix H. However, for employees who retire on or after March 1, 1990, the Company limits or "caps" the amount it will contribute toward the cost of retiree medical care coverage and Medicare Part B premium reimbursement, starting July 1, 1995. These limits are described in Appendix E (under "Summary of Medical Cost Sharing Provisions"). For the retirees affected by these limits, the medical care and Medicare Part B premium trend rates are zero for years after the limits become fully effective.

Because of IRS limitations, the trend rates also do not reflect any future changes in plan provisions or legislation. Pursuant to IRS requirements, trend rates after 1991 were used only to calculate contributions to the Represented Employees Trust; trend rates were not used for nonrepresented employees. Therefore, the VEBA contribution for nonrepresented employees does not reflect any inflationary impact.

25. State the purpose of the VEBA funds and describe what SFAS 106 benefits packages are covered by each VEBA fund. (¶ 21)

The purposes of the VEBA and Group Life Funds are:

1. To reduce the ongoing expenses of the Plan;
2. To provide security for the employees by making the receipt of the benefits independent of what happens to the Company; and
3. To assure investors that provision is being made to meet the future liability entailed by the Plan that could otherwise jeopardize their interests.

The two VEBAs for post-retirement health care benefits were set-up to pay for benefits after 1995. The benefits covered by each funding arrangement are described in Appendix F and the Response to Issue No. 21.

26. Describe the restrictions, if any, that prevent these VEBA funds from being used for other than SFAS 106 benefits. (¶ 21)

For purposes of the VEBAs and life insurance funding mechanisms, the underlying plan assets must be used exclusively to pay benefits under the respective employee benefit plan. Pursuant to Section 4976 of the Internal Revenue Code, if any portion of these assets revert to the benefit of the Company, a 100% excise tax will be imposed. Once all of the liabilities under a plan have been satisfied, any remaining assets may be used to provide other permissible benefits in accordance with the provisions of applicable law.

Issue F: Vesting of OPEB Interests

27. Should exogenous treatment be given only for amounts associated with employee interests that have vested?

No. <u>See</u> Pleading Section III

28. Provide documentation showing when the employees' interests in OPEBs vest. (¶ 22)

Other than represented employees who may have certain "vested" rights during the term of a collective bargaining agreement only, there is no vesting of OPEBs for employees Eligibility requirements for OPEBs are described in Appendix F

29. Explain how you determine when an employee's interest vests in OPEBs. (¶ 22)

<u>See</u> Response to Issue No. 28

Issue G: Treatment of Deferred Tax Benefits

30. How should the deferred tax benefit applicable to OPEBs be treated for purposes of exogenous adjustments?

There is no deferred tax benefit to AT&T as a result of SFAS 106 implementation. Based on IRS regulations, AT&T is not permitted to reduce its taxable income and, as a result, cannot reduce its tax liability until such time as the OPEBs are paid to retirees or funded and expensed. The actual cash benefits of reduced taxes will be achieved in future years

31. Describe on a year-by-year basis any exogenous adjustments made to reflect any deferred tax benefit associated with the OPEB accrual amounts: provide an explanation if there are no such adjustments. (¶ 23)

    As indicated in the Response to Issue No. 30, there is no deferred tax benefit to AT&T as a result of SFAS 106 implementation. However, there is a tax effect. In accordance with Part 65 rate base development principles, the inclusion of OPEB expenses for exogenous treatment should include the full recovery of costs, including all expenses as well as recovery on any related investment base. Related capital would include average net investment represented by property, plant and equipment less any accumulated depreciation reserve, and less any accumulated deferred federal income tax reserve. OPEB has no property, plant and equipment or depreciation reserve related to it. It does, however, cause a decrease in deferred income taxes which results in an increase in average net investment.

    AT&T's July 1, 1993 exogenous adjustment included $9 million of tax effects associated with SFAS 106 (which increased the 18-month AT&T Communications SFAS 106 accrual from $442 million to $451 million). The $9 million tax effect is the net of a $42 million dollar decrease in state and local income and property taxes (in the $442 million accrual) and an increase to recover $51 million in earnings on investment. The $51 million earnings component was computed by multiplying a return of 12.2% by the SFAS 106-related $285 million change in deferred federal income tax reserve and its effect on average net investment. The result was then grossed-up to cover an 18-month period. AT&T's July 1, 1994 filing reduced the entire exogenous adjustment by one-third

    To the extent AT&T's rates recover its SFAS 106 expenses, there is an increased tax expense which is offset by the tax benefit AT&T will receive when the OPEB expenses are actually paid or funded. It is this AT&T Corp. future tax benefit of $4.2 billion that is discussed in AT&T's 1993 Annual Report to Shareholders (see Appendix D, p. 10).

Supporting Studies and Models

32. Provide all studies upon which the company seeks to rely in its demonstration that these accounting changes should receive exogenous cost treatment This includes any studies demonstrating that the change is not reflected in the current price cap formulas, factors for inflation, productivity, allowed exogenous changes, and the rates in effect on the initial date that the carrier became subject to price cap regulation. (¶ 24)

    See Pleading Section II and Appendix J. The D.C. Circuit OPEB Order expressly forecloses the Commission from declining exogenous treatment based on intertemporal double count or the productivity double count theories. See Pleading "Background Statement" Section. As explained in Pleading Section I, pay-as-you-go amounts were netted out from the TBO for exogenous treatment purposes.

33. Parties relying on a macroeconomic model should fully describe and document the model, including the method of estimation, parameter estimates, and summary statistics. Provide this same data for any alternate functional forms that were modeled including the data used to estimate the model, the