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

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

DIRECT CASE OF AT&T CORP.

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SUMMARY

Although the Commission's continued examination of these accounting issues as to AT&T is an unnecessary exercise of regulatory resources, in its Direct Case AT&T shows that its exogenous adjustment for SFAS 106 OPEB costs was reasonably computed and qualifies fully for exogenous treatment, without any "double count offset" or limitation as to Company funding/employee vesting status. Given the overwhelming evidence that the interexchange market is now fully competitive, AT&T should be classified as a nondominant carrier and freed from the entirely unnecessary and burdensome constraints of price cap regulation. The prospective elimination of exogenous treatment for accounting changes that do not result in economic cost changes (such as for OPEBs) further underscores that the issues under investigation are not matters of ongoing importance. Thus, so long as AT&T's exogenous adjustment is reasonable -- as it unquestionably is -- the Commission should move on to consideration of more compelling matters.

In Section I, AT&T demonstrates that its calculation of SFAS 106 costs eligible for exogenous price cap treatment -- the transition benefit obligation ("TBO") as of the January 1, 1993 <u>mandatory</u> effective date for SFAS 106 adoption -- was based on sound actuarial assumptions, and the subsequent regulatory separations and allocation processes were handled in accordance with Commission requirements. As the Direct Case shows in

detail, the actuarial assumptions used in sizing the AT&T SFAS 106 accrual were, by any measure, reasonable. The size of AT&T's SFAS 106 TBO is conservative in that it includes the capping of post-retirement medical benefits for <u>all</u> employees retiring after March 1, 1990; this reduced the trend rate to zero for all employees affected by the cap. Moreover, the actuarial assumptions underlying AT&T's calculations are identical to those used for external financial reporting purposes. The SFAS 106 expenses for financial reporting purposes were endorsed by AT&T's independent auditors, Coopers & Lybrand, and passed a "peer review" performed by an independent actuarial firm. Most fundamentally, AT&T had every incentive to be reasonable as to the SFAS 106 expense it booked for financial reporting purposes, because the expense constituted a direct charge against the firm's earnings as reported to shareholders.

Additionally, Section I shows that the percentage of the total AT&T Corp. SFAS 106 expense attributed to AT&T Communications achieved a reasonable, cost-causative allocation, based on relevant headcount. The allocation factor was developed by segregating the total AT&T SFAS 106 liability into three categories, in recognition of the fact that the relative relationship between the AT&T Communications workforce and the total AT&T workforce varies over time. The AT&T Communications SFAS 106 TBO expense was then amortized based on the average remaining service lives of active plan participants, in accordance with the

Commission's instructions. Jurisdictional separations factors were then applied to identify the interstate portion of the SFAS 106 expense. AT&T allocated the interstate SFAS 106 costs between capped and noncapped services and among AT&T's price cap baskets on a cost-causative basis. In short, AT&T's SFAS 106 exogenous costs amounts are based on reasoned actuarial standards as to their calculation, and the subsequent regulatory separations and allocations processes are justified.

In Section II, AT&T demonstrates that no adjustment to the exogenous amount claimed for the OPEB TBO need be made to avoid a "double count," because SFAS 106 costs are <u>not</u> reflected in the inflation component of the price cap formula, for two independent reasons. Most notably, SFAS 106 costs are accounting changes only; they are <u>not</u> economic costs. Moreover, 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 <u>not</u> result in double recovery.

Section III shows that exogenous treatment should <u>not</u> be limited to those OPEB costs that a carrier has "funded" or to benefits in which employee interests have "vested." Neither GAAP, regulatory accounting rules nor price cap regulation requires that a carrier prefund its

OPEB costs or that it 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 funding or vesting status. In these circumstances, imposing either a "prefunding" or "vesting" requirement for exogenous treatment is foreclosed by the Court of Appeals' ruling that the Commission may not deny exogenous treatment for SFAS 106 OPEB costs simply because the carrier could "control" the underlying benefit expense (for example, by failing to set aside funds or modifying benefit provisions for nonvested employees).

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DIRECT CASE OF AT&T CORP.

Pursuant to the Order Designating Issues for Investigation, DA 95-1485, released June 30, 1995 ("Designation Order"), AT&T Corp. ("AT&T") submits this response to the Common Carrier Bureau's questions relating to AT&T's inclusion of post-retirement benefits other than pensions ("OPEBs") as exogenous cost adjustments to its price cap indices ("PCIs") based on mandatory adoption of Statement of Financial Accounting Standards No. 106 ("SFAS 106").

The Direct Case that follows first reviews the relevant accounting and legal precedents governing the

Commission's investigation of this issue. In Section I, AT&T demonstrates that its calculation of the amount of SFAS 106 costs eligible for exogenous price cap treatment was reasonable. Section II demonstrates that no adjustment to the exogenous amount that AT&T claimed for the OPEB transition benefit obligation ("TBO") need be made to avoid a double count, because SFAS 106 costs are not reflected in the inflation component of the price cap formula. Section III shows that the Court of Appeals' ruling that the Commission may not deny exogenous treatment for OPEB costs, simply because the carrier could "control" the underlying benefit expense, forecloses limiting exogenous treatment to "prefunded" or "vested" amounts.[1]

Although this Direct Case responds fully to the detailed factual and policy questions raised in this investigation, it is also apparent that the Commission's continued examination of these types of issues as to AT&T -- alone among interexchange carriers ("IXCs") -- is unwarranted and superfluous. AT&T's pending motion to be reclassified as a nondominant carrier establishes by overwhelming evidence that the entire interexchange market is now fully competitive and that AT&T must be allowed to

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1 Appendix A contains detailed responses to each of the Commission's enumerated issues to the extent that they are not fully addressed in the pleading. Appendices B through J provide further support for AT&T's responses to the investigation issues.

compete on an equal footing with its interexchange competitors.[2] This investigation starkly confirms the harms -- to AT&T, to competition, and to the public interest -- that increasingly flow from the Commission's misapplication to AT&T of rules that long have lost any rationale or basis. Here, the Commission is considering action that could require AT&T (but no other IXC) to change its prices based solely on a second-guessing of old accounting assumptions, and totally without regard to the competitive forces that truly govern the interexchange market.

Because price cap regulation (including rules regarding exogenous costs) is only an interim regulatory scheme until the advent of full competition renders it unnecessary, the Commission is improperly devoting its resources to this endeavor which examines arcane accounting

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2 See Motion for Reclassification of American Telephone and Telegraph Company as a Nondominant Carrier, CC Docket No. 79-252, filed September 22, 1993; Reply Comments of AT&T, CC Docket No. 79-252, filed December 3, 1993; see also Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Nondominant Carrier, CC Docket No. 79-252, filed April 20, 1995 (updating evidence submitted in 1993); additional Ex Parte in id., filed June 12, 1995; Reply Comments of AT&T, CC Docket No. 79-252, filed June 30, 1995. See also AT&T's Comments, filed July 3, 1995, and AT&T's Reply Comments, filed July 24, 1995, Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, and Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197.

rules and their associated price cap treatment.[3] That intense competition in the interexchange market is exerting substantial downward pressure on AT&T's rates is confirmed by the fact that AT&T's Basket 1 prices are and have been substantially below its price cap ceiling in 1995.[4]

Moreover, the Commission's prospective elimination of exogenous treatment for accounting changes that do not result in economic cost changes (such as for OPEBs) further confirms that the issues under investigation are not matters of ongoing importance.[5] Thus, particularly given that

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3 As the Commission recognizes, reliance on price cap regulation in a competitive environment provides no benefits and simply facilitates anticompetitive behavior on the part of AT&T's rivals. See, e.g., Revisions to Price Cap Rules for AT&T Corp., CC Docket No. 93-197, Report and Order, 76 R.R.2d 1375, 1381, ¶ 27 (1995); Implementation of Sections 3(n) and 332 of the Communications Act, Regulatory Treatment of Mobile Services, GN Docket No. 93-252, Second Report and Order, 9 FCC Rcd. 1411, ¶ 178 (1994).

4 See Letter, dated August 1, 1995, from G. A. Matisse, Chief, Tariff Division, Common Carrier Bureau, FCC, to E. Shakin, Bell Atlantic, and J. W. Bogey, Pacific Bell, regarding these LECs' Petitions to Deny AT&T 1995 Price Cap Filing, June 22, 1995.

5 The Commission has already changed the local exchange carrier ("LEC") price cap rules relating to exogenous treatment of accounting standards changes and has similarly proposed changing the AT&T price cap rules. See Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 77 R.R.2d 783, ¶¶ 292-320 (1995) ("LEC Price Cap Performance Review Order"); see also Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Further Notice of Proposed Rulemaking, FCC 95-198, released May 18, 1995, ¶¶ 68-70. Assuming that there were any further need to continue price cap regulation of AT&T (which there is not), AT&T does not oppose the Commission's proposal. See AT&T's

(footnote continued on following page)

AT&T's SFAS 106 exogenous adjustment is reasonable -- as this Direct Case unquestionably shows -- the Commission should move on to consideration of more compelling matters.

BACKGROUND STATEMENT

Based on a change in generally accepted accounting principles ("GAAP") implemented in SFAS 106 and adopted by the Commission, all carriers were required to change their method of accounting for other post-retirement benefits (principally the health care and life insurance benefits paid to retired employees) from a cash to an accrual basis no later than January 1, 1993.[6] Prior to SFAS 106, companies generally accounted for OPEBs on a cash or "pay-as-you-go" basis, recognizing the benefit amounts actually paid to retirees in the current accounting period. SFAS 106 required companies to account for ongoing OPEB benefits on an accrual basis, in effect treating them as a form of deferred compensation earned by employees during their

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(footnote continued from previous page)

Comments, filed July 3, 1995, CC Docket Nos. 87-313 and 93-197, p. 3 n.4.

6 Statement of Financial Accounting Standards No. 106 (Financial Accounting Standards Board, Financial Accounting Series No. 098-D, December 1990), ¶ 108 ("SFAS 106"); Southwestern Bell and GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions", 6 FCC Rcd. 7560 (¶ 3) (1991) ("SFAS 106 Adoption Order").

working years.[7] SFAS 106 additionally required companies to recognize on their books the amounts of their unfunded OPEB obligation for retired and active employees existing as of SFAS 106 adoption. This unfunded obligation, referred to as the "TBO," reflects the amount a company would have accrued on its books as of SFAS 106 adoption, if it had been employing accrual accounting all along. Although SFAS 106 allows companies to recognize the TBO as an immediate expense or to amortize it over a period of years, the Common Carrier Bureau required carriers to use the SFAS 106 option of amortizing the TBO expense over a period of twenty years or the average remaining service period of active plan participants.[8]

After the Bureau required carriers to conform their regulatory accounting practices to SFAS 106,[9] several LECs in 1992 filed for exogenous price cap treatment for the

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7 Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers' Accounting for Postretirement Benefits Other Than Pensions", 8 FCC Rcd. 1024 (¶ 3) (1993) ("OPEB Order"); reversed and remanded sub nom. Southwestern Bell Telephone Company v. FCC, 28 F.3d 165 (D.C. Cir. 1994) ("DC Circuit OPEB Order"), vacating OPEB Order, Memorandum Opinion and Order, CC Docket No. 92-101, FCC 95-219, released July 3, 1995.

8 SFAS 106 Adoption Order, 6 FCC Rcd. 7560 (¶ 4).

9 Regulatory financial reporting includes, e.g., book entry into the Part 32 Uniform System of Accounts ("USOA"); expense recognition on the regulated income statement; Form M; ARMIS and Form 492 rate-of-return reports for LECs, and 87-503 quarterly reports for AT&T.

change in OPEB costs resulting from SFAS 106 implementation. Under price caps, a carrier may raise its PCIs to reflect an "exogenous" cost to the extent that those costs: "are not otherwise represented in the formula used to set the PCI and are not within the carrier's control."[10] In the OPEB Order, the Commission denied exogenous treatment for both the LECs' ongoing OPEB accruals and their TBOs;[11] however, it permitted the LECs to provide better support for exogenous treatment for the TBO in the 1993 access tariff filings.[12] The Bureau subsequently allowed the TBO expenses to be included in the LECs' PCIs and rates, subject to an accounting order and investigation.[13] AT&T thereafter adjusted its PCIs to recover its own TBO expenses, as well as LEC access charges that included the LECs' exogenous SFAS 106 TBO costs. As with the LEC filings, the Bureau allowed AT&T's tariff to take effect subject to an

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10 Designation Order, ¶6, citing 47 C.F.R. § 61.45; OPEB Order, ¶ 52.

11 Specifically, the Commission concluded that "ongoing OPEB costs" are not entitled to exogenous treatment because of the substantial control that LECs have over their ongoing health care benefit plans. See OPEB Order, ¶¶ 53-55. Furthermore, the Commission denied exogenous treatment for the OPEB TBO without determining whether the LECs could control this cost, because no LEC had shown that this cost was not already reflected in the price cap formula. Id., ¶¶ 59-60.

12 OPEB Order, ¶ 76.

13 1993 Annual Access Tariff Filings, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, 8 FCC Rcd. 4960 (June 23, 1993) ("LEC OPEB Investigation Order").

accounting order and investigation (which was designated as Phase II of the 1993 LEC OPEB investigation).[14]

In July 1994, the U.S. Court of Appeals for the District of Columbia Circuit reversed and remanded the Commission's OPEB Order that had denied exogenous treatment of the LECs' OPEB costs, concluding that changes in LEC OPEB costs caused by the implementation of SFAS 106 are eligible for exogenous treatment.[15] Specifically, the Court concluded that the "control" prong of the test for exogenous treatment had been met because carriers were mandated by the Commission to adopt SFAS 106 and thus the accounting change was plainly outside of the carriers' control. Under the Commission's own prior explanations of "control," exogenous costs are "in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers."[16] The Court thus held that it was

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[14] See AT&T Communications Tariff F.C.C. Nos. 1 and 2, Transmittal Nos. 5460, 5461, 5462 and 5464, 8 FCC Rcd. 6227 (1993) ("AT&T OPEB Investigation Order"). The Bureau indicated that it would not designate issues or a pleading schedule for Phase II, until consideration of the record in Phase I. Although the Phase I LEC investigation has been fully briefed, it was never resolved on the merits. As a result, the Bureau did not designate AT&T issues until the June 30, 1995 Designation Order.

[15] DC Circuit OPEB Order, 28 F.3d at 169, 173.

[16] Id., citing Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, 6807 (1990) ("LEC Price Cap Order"), modified on recon., 6 FCC Rcd. 2637 ("LEC Price Cap Reconsideration Order"), further recon. dism'd, 6 FCC Rcd. 7482 (1991)

impermissible for the Commission to deny OPEB exogenous treatment based on the fact that carriers could "control [the underlying expense, i.e.,] the present and future benefit plans they set with their employees and the costs of these plans."[17] For the Commission to have done so, the Court held, essentially constituted a change in its price cap rules which could only be accomplished through another rulemaking.[18]

In the OPEB Order, the Commission had also rejected exogenous treatment for the TBO (without addressing the control prong) because it concluded that the carriers had failed to show the necessary absence of a "double count" under GNP-PI.[19] The Court found, however, that the Commission had improperly rejected the carriers' studies without "express[ing] a reason for doubting some critical

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[17] DC Circuit OPEB Order, 28 F.3d at 169-70; citing OPEB Order, ¶ 53.

[18] 28 F.3d at 169-70 (citations omitted).

[19] OPEB Order, ¶¶ 57-66. The PCI or "price cap" includes three components: (1) an inflation measure (Gross National Product Price Index or "GNP-PI") which reflects economy-wide price changes, (2) a productivity offset to GNP-PI to reflect the historical productivity of carriers which has exceeded that of the economy generally, and (3) exogenous cost changes. LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637, 2667, n.77 (1991). More recently, the Commission has relied on the Gross Domestic Product Price Index ("GDP-PI") as an inflation measure for price cap purposes. LEC Price Cap Performance Review Order, ¶¶ 347-51; see also Designation Order, ¶ 28.

assumption."[20] Moreover, the Court determined that the Commission's decision was otherwise "illogical," for example, by rejecting both LEC economic studies simply because they relied on different assumptions.[21] Similarly, the Court held that the fact that SFAS 106 required carriers to make numerous potentially highly speculative assumptions about the cost of future benefits, could be a basis for rejection only if there was no way of obtaining conservative estimates.[22]

Finally, the Court found that the Commission had impermissibly invoked "several altogether new criteria" for rejecting the LECs' claim for exogenous treatment of the TBO.[23] As the Court held, "whatever the intrinsic merits of these three possible bases for rejecting exogenous cost treatment, the Commission is free to consider them as a basis for <u>amending</u> its current rules, not for concocting a new rule in the guise of applying the old."[24]

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[20] 28 F.3d at 172.

[21] <u>Id.</u>

[22] <u>Id.</u>, <u>citing</u> <u>OPEB Order</u>, ¶ 65.

[23] These new criteria included the Commission's theories as to: (1) intertemporal double counting (<u>i.e.</u>, the LECs would effectively collect twice, once on an accrual, once on a cash basis); (2) rate-of-return double counting (investors would have demanded higher rate-of-return if they knew carriers could not raise rates for SFAS 106); and (3) the notion that SFAS 106 costs are already counted in the price cap formula's productivity offset. 28 F.3d at 172-73.

[24] 28 F.3d at 173 (emphasis in original).

Although the Court directed the Commission to grant exogenous treatment, it remanded to the Commission calculation of the specific amount of OPEB-related costs that are eligible for exogenous treatment. The Designation Order responds to the Court's directive.

I. AT&T'S CALCULATION OF THE AMOUNT OF SFAS 106 COSTS ELIGIBLE FOR EXOGENOUS PRICE CAP TREATMENT WAS REASONABLE.

AT&T initially filed for exogenous treatment of its SFAS 106 OPEB expenses on June 30, 1993, with the PCI changes to become effective on July 1, 1993.[25] For that filing, AT&T computed the exogenous adjustment based solely on the TBO related to both active and retired employees beginning January 1, 1993, the mandatory date for SFAS 106 adoption. Therefore, AT&T's initial exogenous amount was for an 18-month period from January 1, 1993 to June 30, 1994, and it did not include any ongoing service costs associated with active employees.[26] The resulting interstate cost increase as shown in AT&T's filing was

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[25] See Letter, dated June 30, 1993, from M. F. DelCasino, AT&T Administrator - Rates and Tariffs, to Secretary, FCC ("June 30, 1993 Letter"), Attachment at 2.

[26] The exogenous cost impact of the SFAS 106 accounting change is that the excess of SFAS 106 accruals above the pay-as-you-go amount is eligible for exogenous cost treatment. Pay-as-you-go expenses were already incorporated in underlying rates upon commencement of price cap regulation for AT&T on July 1, 1989, and were subtracted when calculating AT&T's SFAS 106 exogenous costs. See Appendix C.

approximately $451 million, of which $242.9 million was allocated to interstate capped services, with $240.7 million of that amount allocated to Basket 1.[27]

Effective July 1, 1994, AT&T revised its PCIs, by making a one-third reduction of the exogenous amount previously claimed, to reflect only twelve months of OPEB-related TBO expenses.[28] As a result, commencing July 1, 1994, AT&T has had a total annual interstate cost increase for capped services of $162 million, of which $160.5 million is allocated to Basket 1. As shown below, AT&T's calculation of the amount of SFAS 106 TBO costs eligible for exogenous price cap treatment is both reasonable and appropriate, and thus fully qualifies for exogenous treatment.[29]

The TBO represents the present value (on the January 1, 1993 calculation date) of unfunded OPEB benefits that are expected to be paid to active employees, retirees, and eligible dependents of both. The post-retirement benefits of AT&T covered by SFAS 106 include Medical Benefits, Medicare Part B Reimbursement, Dental Benefits, Group Life Insurance, and Telephone Concession. AT&T's

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27 June 30, 1993 Letter, Attachment at 2-4.

28 See Letter, dated May 17, 1994, from M. F. DelCasino, AT&T Administrator - Rates and Tariffs, to William F. Caton, Acting Secretary, FCC, Attachment at 7-8.

29 See Appendix C, for a numerical display of how AT&T determined its SFAS 106 exogenous amounts.

commitment to securing SFAS 106 benefits is reflected in the fact that plan assets are maintained for all benefits (medical, dental, life insurance) other than for telephone concession. To quantify the amount associated with AT&T's SFAS 106 exogenous cost filing, AT&T first had to calculate the total company (AT&T Corp.) TBO, which was determined to be approximately $9.1 billion. This $9.1 billion is the sum of the $10.5 billion AT&T APBO, valued as of January 1, 1993 for both active and retired employees, less $1.4 billion of Plan Assets minus Prepaid Amounts.[30]

In determining the total AT&T TBO, AT&T was required to rely on actuarial assumptions as to the demographic characteristics of AT&T employees and retirees, including rates of mortality, separation from employment,

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[30] Specifically, the TBO is the excess of Accumulated Post-retirement Benefit Obligation ("APBO") over the "Plan Assets" reduced by any "Prepaid Amounts." The APBO is the present value (as of January 1, 1993) 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 through January 1, 1993 versus the service expected to be rendered by the date on which the employee qualifies for unreduced post-retirement benefits). The "Plan Assets less Prepaid Amounts" is the fair market value as of January 1, 1993 of funded plan assets (such as, group life insurance assets and Voluntary Employees' Beneficiary Association ("VEBA") health care-related assets) less Company payments to those funds which have not been expensed as of January 1, 1993. <u>See</u> Appendix A, Responses to Issue Nos. 12 and 13; Appendix B, Response to Issue No. 34. Both AT&T's group life insurance assets and VEBA trusts are maintained separate from other AT&T assets and may not be used by the Company for any purposes other than to pay for the specified benefits. <u>See</u> Appendix A, Responses to Issue Nos. 21-26.

disability, as well as retirement. AT&T also had to make assumptions as to a discount rate and rate-of-return on plan assets.

Each of the assumptions used by AT&T was reasonable. The demographic assumptions used by AT&T are based on Company experience and therefore reflect the actual demographic characteristics of the relevant AT&T employee/retiree population.[31] AT&T's 8.25% discount rate for measurement of its SFAS 106 obligation as of January 1, 1993 was based on an analysis of rates-of-return on high-quality, fixed-income investments available in December 1992 and is consistent with those returns given that, at that time, the yield on 30-year U.S. Treasury bonds varied between 7.36% to 7.56%, and the corresponding Moody's Aa bond yield varied between 8 17% to 8.36%. Moreover, a subsequent Spencer Company survey indicated that the average discount rate used by other large corporations for 1993 SFAS 106 calculations was 8.14%, which confirms the reasonableness of AT&T's assumption.[32] AT&T's 9% expected long-term return on plan assets took into account the return of the then-invested plan assets and expected returns on reinvestments. Because (unlike AT&T) many employers do not prefund other post-retirement benefits, data are not readily

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31 See Appendices F and G.

32 See "Reporting Under FAS 106: Survey of Companies' Annual Statements," Spencer's Research Reports on Employee Benefits, § 328.03 -1, September 23, 1994.

available for the long-term return component. However, results of a Spencer Company survey of the 1993 rate-of-return assumption for pension plans under SFAS 87, which indicated an average return of 9.13%, supports the reasonableness of AT&T's SFAS 106 rate-of-return assumption.[33]

All of the actuarial assumptions discussed above that AT&T used to calculate the TBO have a high degree of reliability for the additional reason that they are identical to assumptions that AT&T used to determine pension expenses under SFAS 87, as well as post-employment benefit expenses under SFAS 112. The health care trend rate (which is relevant only for SFAS 106) was the same trend rate used to determine the 1992 and 1993 health care-related VEBA trust contributions for represented employees.[34] Significantly, the actuarial assumptions underlying the TBO are the same as those used to calculate the 1993 SFAS 106 expense for financial reporting purposes. Moreover, the SFAS 106 expenses for financial reporting purposes were reviewed and endorsed by Coopers & Lybrand, AT&T's external auditors. In addition, they underwent and passed an

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[33] See, "Actuarial Factors Companies Use in Accounting for Pension Plans Under FAS 1987: 1991-93," Spencer's Research Reports on Employee Benefits, § 135.03-1, July 8, 1994.

[34] Under IRS rules, companies are not permitted to reflect medical inflation and/or increased utilization in their VEBA contributions for nonrepresented employees.

actuarial "peer review" performed by an independent consulting actuarial firm. Most fundamentally, AT&T had every incentive to be reasonable as to the amount of SFAS 106 expenses it booked for financial reporting purposes, because the expense constituted a direct charge against the firm's earnings as reported to shareholders.

The size of AT&T's TBO is conservative for the additional reason that it includes the capping of post-retirement medical benefits for all employees retiring after March 1, 1990.[35] This capping of medical benefits has the effect of reducing the health care trend rate (the inflation component of the SFAS 106 accrual) to zero for the employees and retirees subject to the cap. Had AT&T not reflected medical benefit capping in its SFAS 106 accrual, its annual amortized Company-wide TBO would have been $600 million higher.[36]

The second step of AT&T's procedure -- to identify the portion of the $9.1 billion total AT&T TBO attributable to AT&T Communications -- was designed to achieve a reasonable, cost-causative allocation. Specifically, AT&T determined, based on the relationship of AT&T Communications headcount to total AT&T headcount, that the percentage of

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35 See Appendix E, p. 9 of 16 ("Summary of Medical Cost Sharing Provisions"); see also Appendix B, Response to Issue No. 34.

36 See Appendix B, Response to Issue No. 34, p. 5 of 5.

that amount attributable to AT&T Communications is 54.35%. This allocation factor was developed by segregating the total AT&T SFAS 106 TBO liability into three categories in recognition of the fact that the relative relationship between the AT&T Communications workforce and the total AT&T workforce varies over time.[37] These three accrual components were calculated separately, multiplied by the headcount percentage associated with AT&T Communications for each category, and then the weighted cost for each category was summed to a total accrual associated with AT&T Communications of $4.9 billion (which is 54.35% of $9.1 billion).[38] Because approximately 80% of the SFAS 106 TBO valued as of January 1, 1993 relates to the predivestiture period, the 54.35% allocation to AT&T Communications is more than reasonable.[39]

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[37] These three categories are: the liability up to divestiture (1/1/84); the liability from 1/1/84 to 12/31/89; and the liability from 1/1/90 to 12/31/92.

[38] For the predivestiture period, the OPEB TBO costs for AT&T Technologies (Western Electric) and Bell Laboratories were assigned between AT&T Communications and AT&T Information Systems. This is appropriate because prior to divestiture these entities principally supported communications services and products and had virtually no external customer base. Therefore, had SFAS 106 accrual accounting been in place during this period, higher costs of OPEBs for these supplier organizations would have been reflected in AT&T Communications' plant investment, resulting in increased revenue requirements, as well as in AT&T Information Systems product prices.

[39] Most (i.e., $8.1 billion of the $10.5 billion Company-wide APBO) is associated with retirees. All of the benefit costs for employees who retired prior to

(footnote continued on following page)

Third, AT&T amortized this $4.9 billion AT&T Communications liability over the remaining years of service of those carrier employees expected to receive SFAS 106 benefits, in accordance with the Commission's directives.[40] Using reasonable actuarial assumptions, AT&T determined that the average remaining service life of such employees is 14.6 years.[41] As a result, the annual amortization of the

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divestiture would, of course, be associated with the predivestiture period. Also, the majority of the liability for employees who retired after divestiture but prior to the January 1, 1993 calculation date for AT&T's SFAS 106 obligation would be for the predivestiture period, because employees in this category could have had at most nine years service (1984-92) after divestiture. In addition, there was no capping of medical benefits for employees retiring before March 1, 1990; therefore, their medical costs would be presumed to grow. By contrast, the remaining liability ($2.4 billion) for active employees is small because of benefit capping. Moreover, most of the liability even for active employees is associated with employees with longer service (some of which was rendered prior to January 1, 1984). As a result, a very high proportion (80%) of the total liability is attributable to the predivestiture period.

40 See SFAS 106 Adoption Order, supra. This is in contrast to AT&T's treatment of the TBO for external financial reporting purposes. As permitted by SFAS 106, on its financial books, AT&T expensed the entire TBO liability in 1993 as a one-time charge. See Appendix A, Response to Issue No. 5, and Appendix D.

41 The average expected years of future service of active employees expected to receive post-retirement benefits is determined by dividing the total expected future years of service for all active employees expected to receive benefits by the number of active employees expected to receive benefits. The total expected years of future service is determined by projecting year-by-year into the future the number of surviving active employees expected to receive benefits and adding up the number of years worked by them. The projected survivors are determined

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AT&T Communications TBO is $4.9 billion divided by 14.6 years, or approximately $339 million. Added to the $339 million is interest on the active and retiree APBO. The interest cost is the product of the discount rate (8.25%) and the APBO (adjusted for expected benefit payments during the year), or $457 million. Offsetting the amortization of the TBO and interest on the APBO is interest on plan assets. This offset, valued at $97 million, 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).[42] The sum of $339 million plus $457 million, less $97 million, yields the AT&T Communications TBO of $699 million annually.

It is this $699 million total annual 1993 AT&T Communications TBO, less projected 1993 pay-as-you-go (cash) expenses of $337 million, that yields an AT&T Communications net pre-separations TBO of $362 million. The projected 1993 pay-as-you-go expenses were subtracted from the total because they were presumed to be already in AT&T's PCIs

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by applying various decrement rates (mortality, retirement, etc.) to the data.

42 As noted above, both the 8.25% discount rate and the 9% return on assets are reasonable for a number of reasons, including that they were in the mid-range based on Spencer Company surveys of discount rates and return on plan assets.