services to consumers by $230 million.[36]

- Pacific Bell has had great success in selling additional lines, with a 28% penetration. Revenue gains of approximately $134 million are expected through the sale of additional lines by applying Pacific's best practices..[37]

- Data services provide another opportunity for the merger. The merger provides the opportunity to apply best practices and marketing techniques to a host of technologies, including ISDN, frame relay, and others. SBC estimates the revenue impact to be $65 million.[38] As with Centrex and other technologies above, it is important to note that the market for data services is increasingly competitive.

- Other areas where SBC estimates synergies and additional sales are in directory publishing, wireless sales, and public pay phones.

F Fixed v. Marginal Cost Savings

54. In its recent ruling on the Bell Atlantic-Nynex merger, the FCC emphasized the role of marginal costs in consideration of the competitive effects resulting from the merger, noting that "Merger generated efficiencies can offset unilateral effects to the extent that such efficiencies reduce marginal costs and thereby counteract the merged firm's incentive to elevate price."[39] Many of the merger efficiencies discussed in this section have a direct impact on reducing the merged firm's marginal cost of operations. Marginal cost reductions cited by the FCC in the Bell Atlantic-Nynex merger, such as procurement savings and savings in the costs to provide long-distance

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[36] Kaplan Affidavit ¶ 8.

[37] Kaplan Affidavit ¶ 10.

[38] Kaplan Affidavit ¶ 12.

[39] Paragraph 169 in FCC Decision and Order in the Matter of NYNEX and Bell Atlantic.

services, should be realized in the instant merger as well.[40] Based on the experience of the recent SBC-PacTel merger, there exists ample evidence of reductions in marginal costs directly attributable to the merger of two RBOCs. For example, Ameritech will no longer have to outsource its data centers to a third party since SBC-PacTel operates its own data centers. Marginal costs of adding new Ameritech subscribers can be reduced through utilization of SBC data processing facilities. Consolidation of these functions is expected to yield annual operating savings of $227 million.[41] In addition, consolidation of switching operations should result in lower marginal costs.

55. Other efficiencies from the merger affect long run marginal costs and therefore have consequences for pricing and entry decisions. Costs that are fixed in the short run become variable in the long run, and thus reductions in fixed costs can result in lower prices or improved entry opportunities over the longer term.

IV. Past Experience Shows That SBC Can Meet Estimated Efficiencies Gains

56. Because of its recent assimilation of Pacific Bell and Nevada Bell, SBC is well-positioned to estimate the types of products where synergies and cross-selling opportunities arise. It is also well-positioned to understand the size of the increases it can expect. As noted above, many of the areas where best practices and know-how apply already face competitive alternatives, and the impact of the merger is to make these markets even more competitive through the application of knowledge and experience gained across the combined firm.

57. In its merger with Pacific Telesis, SBC asked its business managers to evaluate the likely efficiencies of the merger. It then made these managers personally responsible for achieving the

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[40] FCC Decision, ¶ 170.

[41] Kaplan Affidavit ¶ 20(b).

projected results.[42] The effect was that SBC was able to meet most of the efficiencies claims it made.[43]

58. After the PacTel merger, SBC was able to eliminate or reduce duplicative support functions and expenditures on new products, more fully exploit economies of scale and scope, and implement best practices to reduce costs and increase quality. One specific area where scale economies enabled SBC to reduce costs post-merger is purchasing, where the goal was to reduce expenditures by $500 million. Since the merger with Pacific Telesis, SBC has already achieved 40% of the projected savings, with another 30% nearing completion.[44] These results are all the more remarkable given that the short time since the merger means that many existing contracts have not expired or been renegotiated.

59. SBC was also able to reduce or eliminate duplication in support functions, such as accounting and finance, corporate strategy and legal. SBC estimates that these savings amounted to $201 million in the PacTel merger.[45]

60. SBC has also demonstrated quality improvements as a result of its merger with Pacific Telesis. SBC significantly improved quality in repair times for the PacTel area. Post-merger repair times were reduced by an average of 60%. Installation times were reduced by 80%, from as much

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[42] Kaplan Affidavit ¶ 6.

[43] In SBC's report on second quarter 1998 earnings, chairman and CEO Edward E. Whitacre Jr noted that "We remain on target to achieve all of the synergies associated with the Pacific Telesis merger, particularly revenue growth at Pacific Bell which increased 6.3 percent, driven in large part by our ability to sell vertical services as we continue to share expertise from Southwestern Bell." See "SBC Grows Second Quarter Earnings Share 18%," July 16, 1998 SBC Press Release, July 21, 1998. See also the Kaplan and Kahan Affidavits for the efficiencies results SBC was able to achieve in the PacTel merger.

[44] Kaplan Affidavit ¶ 20(a).

[45] Kaplan Affidavit ¶ 24.

as 2-3 weeks to 3-4 days.[46] SBC also met or exceeded the conditions imposed by the California PUC on repair and business office answer times.

V. Conclusions

61. The telecommunications marketplace is changing rapidly and the participants in the industry are struggling to keep pace with these changes. What may have sufficed in yesterday's marketplace will not be adequate for tomorrow's. The information provided here has demonstrated the kinds of changes that are occurring and what firms are doing to position themselves to survive in the new telecommunications world. The only way to succeed is to serve customers. That means providing the services they want, in the ways they want them, and at prices they are willing to pay. Clearly, these marketplace demands are imposing pressures on all members of the industry and each is responding with its own business strategy. SBC's and Ameritech's strategy is apparently to position itself as a major player in the evolving marketplace, and, in order to pursue that goal, they wish to combine their assets, their people, their skills and their markets. By doing so they will stand a good chance of succeeding as a global supplier of telecommunications services.

62. The task of this effort is to assess how consumers are affected by the merger. It is evident that the benefits are many. Moreover, the consumer benefits do not all come from the internal operations of a combined SBC/Ameritech. The influence of this newly combined entity on the marketplace also heightens incentives of other firms to develop and introduce new products and to become at least as efficient as SBC/Ameritech. Consumers will benefit from these market responses.

63. A combined SBC/Ameritech will be able to stand up to the giants that are now well-

[46] Kahan Affidavit ¶ 97.

entrenched in the global telecommunications marketplace. It is SBC and Ameritech's common desire to assume a position in the top echelon of telecommunications firms. As has been said, if one wants to set a world record in a race, get in a race with world class runners. SBC and Ameritech evidently want to compete against the major global telecommunications suppliers in the supply of a broad range of telecommunications services. Consumers will be the beneficiaries of this aggressive competition.

Pursuant to 47 C.F.R. §§ 1.743(c), 1.913(c), 5.54(c), the preceding document is a copy of the original signed affidavit, which was filed as an attachment to Exhibit 2 to the Form 490 applying for the Commission's consent to transfer control of Part 22 licenses held by Detroit SMSA Limited Partnership from Ameritech Corporation to SBC Communications Inc. That Form 490 was filed concurrently with this application.

SBC's 1997 Audited
Financial Statements

SBC Communications Inc.

1997 Audited Financial Statements

from

SBC Communications Inc. 1997 Annual Report

SELECTED FINANCIAL AND OPERATING DATA

Dollars in millions except per share amounts

At December 31 or for the year ended:	1997[1]	1996	1995	1994	1993[2]
Financial Data					
Operating revenues	**$24,856**	$23,445	$21,712	$21,006	$20,084
Operating expenses	**$21,686**	$17,609	$16,592	$16,056	$17,077
Operating income	**$ 3,170**	$ 5,836	$ 5,120	$ 4,950	$ 3,007
Interest expense	**$ 947**	$ 812	$ 957	$ 935	$ 1,005
Equity in net income of affiliates	**$ 201**	$ 207	$ 120	$ 226	$ 250
Income taxes	**$ 863**	$ 1,960	$ 1,519	$ 1,448	$ 658
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes[3]	**$ 1,474**	$ 3,189	$ 2,958	$ 2,777	$ 1,589
Net income (loss)	**$ 1,474**	$ 3,279	$ (3,064)	$ 2,800	$ (2,474)
Earnings per common share:* **Income from continuing operations before extraordinary loss and cumulative effect of accounting changes[3]**	**$ 0.81**	$ 1.73	$ 1.61	$ 1.52	$ 0.88
Net income (loss)	**$ 0.81**	$ 1.78	$ (1.66)	$ 1.54	$ (1.37)
Earnings per common share – Assuming Dilution:* **Income from continuing operations before extraordinary loss and cumulative effect of accounting changes[3]**	**$ 0.80**	$ 1.72	$ 1.60	$ 1.52	$ 0.88
Net income (loss)	**$ 0.80**	$ 1.77	$ (1.66)	$ 1.53	$ (1.37)
Total assets	**$42,132**	$39,485	$37,112	$46,113	$47,695
Long-term debt	**$12,019**	$10,930	$10,409	$10,746	$10,588
Construction and capital expenditures	**$ 5,766**	$ 5,481	$ 4,338	$ 3,981	$ 4,021
Free cash flow[4]	**$ 1,204**	$ 1,935	$ 2,452	$ 2,952	$ 2,147
Dividends declared per common share*[5]	**$ 0.895**	$ 0.86	$ 0.825	$ 0.79	$ 0.755
Book value per common share*[6]	**$ 5.38**	$ 5.28	$ 4.57	$ 7.29	$ 8.34
Ratio of earnings to fixed charges	**2.66**	5.34	5.24	5.01	2.91
Return on weighted average shareowners' equity[7]	**14.75%**	33.73%	23.97%	19.43%	11.06%
Debt ratio[6]	**56.19%**	55.49%	61.73%	48.57%	45.30%
Operating Data†					
EBITDA[8]	**$ 8,092**	$ 9,945	$ 9,154	$ 8,774	$ 6,750
Network access lines in service (000)	**33,440**	31,841	30,317	29,147	28,234
Access minutes of use (000,000)	**129,817**	123,303	112,874	100,800	93,877
Wireless customers (000)	**5,493**	4,433	3,672	2,992	2,049
Number of employees	**118,340**	109,870	108,189	110,390	113,755

* Restated to reflect two-for-one stock split declared January 30, 1998.

† Operating data may be periodically revised to reflect the most current information available.

[1] As detailed in management's discussion and analysis of Results of Operations, 1997 results include charges for several items including strategic initiatives and ongoing merger integration costs, gain on the sale of SBC's interests in Bell Communications Research, Inc. and a first quarter after-tax settlement gain. Excluding these items, SBC reported an adjusted net income of $3,364 for 1997.

[2] As noted in management's discussion and analysis of Other Business Matters – Restructuring Reserve, 1993 results include restructuring costs at Pacific Telesis Group. Excluding these costs, SBC reported income from continuing operations before extraordinary loss and cumulative effect of accounting changes of $2,450.

[3] 1996, Change in directory accounting; 1995, Discontinuance of Regulatory Accounting; 1994-1993, Income (loss) from spun-off operations; and 1993, Early Extinguishment of Debt and Cumulative Effect of Changes in Accounting Principles.

[4] Free cash flow is net cash provided by operating activities less construction and capital expenditures.

[5] Dividends declared by SBC's Board of Directors; these amounts do not include dividends declared and paid by Pacific Telesis Group prior to the merger.

[6] Shareowners' equity used in book value per common share and debt ratio calculations includes extraordinary loss and changes in accounting principles.

[7] Calculated using income before extraordinary loss and changes in accounting principles. These impacts are included in shareowners' equity.

[8] EBITDA is earnings before interest, taxes, depreciation and amortization (operating income plus depreciation and amortization). SBC considers EBITDA an important component in our economic value added systems as an indicator of the operational strength and performance of our businesses. It is provided as supplemental information and is not intended to be a substitute for operating income, net income or net cash provided by operating activities as a measure of financial performance or liquidity.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Dollars in millions except per share amounts

SBC Communications Inc. (SBC) is a holding company whose subsidiaries and affiliates operate predominantly in the communications services industry. SBC's subsidiaries and affiliates provide landline and wireless telecommunications services and equipment, directory advertising and cable television services.

On April 1, 1997, SBC completed a merger which resulted in Pacific Telesis Group (PAC) becoming a wholly-owned subsidiary of SBC. Among PAC's subsidiaries are Pacific Bell (PacBell, which also includes its subsidiaries) and Nevada Bell. The merger was accounted for as a pooling of interests and a tax-free reorganization. Accordingly, the financial statements for the periods presented have been restated to include the accounts of PAC (see Note 3 to the Financial Statements).

SBC's largest telephone subsidiaries are Southwestern Bell Telephone Company (SWBell), providing landline telecommunications and related services over approximately 16 million access lines in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area), and PacBell, providing telecommunications and related services over approximately 17 million access lines in California. SBC also provides telecommunications and related services through its Nevada Bell subsidiary over approximately 300 thousand access lines in Nevada. (SWBell, PacBell and Nevada Bell are collectively referred to as the Telephone Companies.) The Telephone Companies are subject to regulation by each of the states in which they operate and by the Federal Communications Commission (FCC).

This discussion should be read in conjunction with the consolidated financial statements and the accompanying notes. All per share data has been restated to reflect the two-for-one stock split, effected in the form of a stock dividend, declared January 30, 1998 (see Note 15 to the Financial Statements).

RESULTS OF OPERATIONS

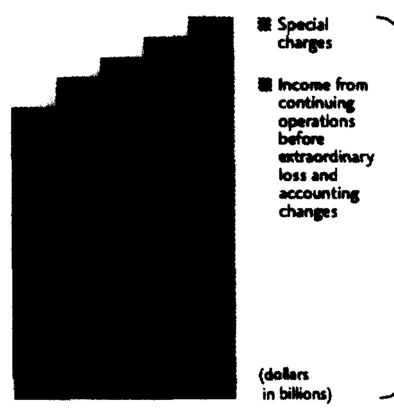
Summary

Financial results, including percentage changes from the prior year, are summarized as follows:

				Percent Change	
	1997	1996	1995	1997 vs. 1996	1996 vs. 1995
Operating revenues	$24,856	$23,445	$21,712	6.0%	8.0%
Operating expenses	$21,686	$17,609	$16,592	23.2%	6.1%
Income before extraordinary loss and cumulative effect of accounting change	$ 1,474	$ 3,189	$ 2,958	(53.8)%	7.8%
Extraordinary loss	–	–	$ (6,022)	–	–
Cumulative effect of accounting change	–	$ 90	–	–	–
Net income (loss)	$ 1,474	$ 3,279	$ (3,064)	–	–

SBC recognized the cumulative effect of a change in accounting in 1996 relating to recognition of directory publishing revenues and related expenses and an extraordinary loss in 1995 from the discontinuance of regulatory accounting at SWBell and PacBell.

SBC's net income for 1997 includes after-tax charges of approximately $2.0 billion reflecting strategic initiatives resulting from a comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997, costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these items, SBC reported net income of $3,487 for 1997. Net income for 1997 was also favorably affected by $33 representing SBC's after-tax gain on the sale of its interests in Bell Communications Research, Inc. (Bellcore) and a first quarter 1997 $90 after-tax settlement gain at PAC associated with lump-sum pension payments that exceeded the projected service and interest costs for 1996 retirements. Excluding these additional items, SBC reported an adjusted net income of $3,364 for 1997, 5.5% higher than 1996 income before cumulative effect of accounting change of $3,189. The primary factors contributing to this increase were growth in demand for services and products at the Telephone Companies and Southwestern Bell Mobile Systems (Mobile Systems), partially offset by increased expenses at PacBell, including expenses for the introduction of Personal Communications Services (PCS) operations in California and Nevada. The primary factors contributing to the increase in income before extraordinary loss and cumulative effect of accounting change in 1996 were growth in demand for services and products at the Telephone Companies and Mobile Systems.



Income From Continuing Operations Before Extraordinary Loss and Accounting Changes

Results for 1997 and 1995 were affected by special charges

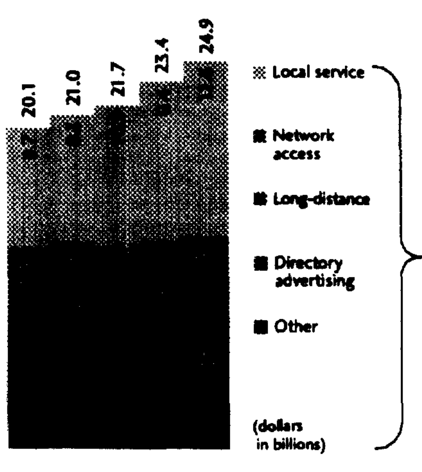
Items affecting the comparison of the operating results between 1997 and 1996, and between 1996 and 1995, are discussed in the following sections.

Dollars in millions except per share amounts

Operating Revenues
SBC's operating revenues for 1997 reflect reductions of $188 related primarily to the impact of several regulatory rulings during the second quarter of 1997. Excluding these reductions, SBC's operating revenues increased $1,599, or 6.8%, in 1997 and $1,733, or 8.0%, in 1996. Components of total operating revenues, including percentage changes from the prior year, are as follows:

				Percent Change	
	1997	1996	1995	1997 vs. 1996	1996 vs. 1995
Local service					
Landline	$ 9,568	$ 8,754	$ 8,118	9.3%	7.8%
Wireless	3,034	2,635	2,247	15.1	17.3
Network access					
Interstate	3,946	4,008	3,770	(1.5)	6.3
Intrastate	1,869	1,823	1,744	2.5	4.5
Long-distance service	2,115	2,240	2,072	(5.6)	8.1
Directory advertising	2,111	1,985	1,984	6.3	0.1
Other	2,213	2,000	1,777	10.7	12.5
	$24,856	$23,445	$21,712	6.0%	8.0%

Local Service Landline local service revenues increased in 1997 and 1996 due primarily to increases in demand, including increases in residential and business access lines and vertical services revenues. Total access lines increased by 5.0% in both years, of which approximately 50% was due to growth in California and over 30% was due to growth in Texas. Access lines in Texas and California account for approximately 80% of the Telephone Companies' access lines. Approximately 32% of access line growth in both years was due to sales of additional access lines to existing residential customers. Vertical services revenues, which include custom calling options, Caller ID and other enhanced services, increased by approximately 20% in 1997 and 29% in 1996. Local service revenues also reflect the implementation of the California High Cost Fund (CHCFB) that went into effect February 1, 1997. The California Public Utilities Commission (CPUC) has stated that the CHCFB is intended to directly subsidize the provision of service to high cost areas and allow PacBell to set competitive rates for other services. The rebalancing provisions of the CHCFB resulted in a shift from long-distance revenues of $84 and intrastate network access revenues of $26 to local service revenues in 1997. For further information on the operations of the CHCFB, see the discussion under the heading "Regulatory Environment – California." Additionally, Federal payphone deregulation in 1997 increased local service revenues and decreased long-distance service revenues and interstate network access revenues; the overall impact was a slight increase in total operating revenues. Rate reductions in 1997 due to CPUC price cap orders partially offset increases in landline local service revenues.



Distribution of Revenues
Operating revenue growth has been driven by local service growth.

Wireless local service revenues increased in 1997 and 1996 due primarily to growth in the number of Mobile Systems' cellular customers of 16.3% and 20.7%, partially offset by declines in average revenue per customer. 1997 wireless local service revenues also include revenues from the introduction of PCS operations in California, Nevada and Oklahoma. At December 31, 1997, SBC had 5,068,000 traditional cellular customers, 60,000 resale customers and 365,000 PCS customers. At December 31, 1996, SBC had 4,398,000 traditional cellular customers and 35,000 resale customers.

Network Access Interstate network access revenues decreased in 1997 due to $187 in charges. These charges include billing claim settlements related to the Percentage Interstate Usage (PIU) factor in California and several Federal regulatory issues including end-user charges, recovery of certain employee-related expenses and the retroactive effect of the productivity factor adjustment mandated in the July 1, 1997 Federal price cap filing. While the change in the PIU factor in California, which is used to allocate network access revenues between interstate and intrastate jurisdictions, also had the effect of increasing intrastate network access revenues, it resulted in a slight decline in total network access revenues. Excluding these impacts, interstate network access revenues increased in 1997 and 1996 due largely to increases in demand for access services by interexchange carriers. Growth in revenues from end-user charges attributable to an increasing access line base also contributed to the increases in both years.

Partially offsetting these increases were the effects of the rate reductions of approximately $100 in 1997 and $115 in 1996 related to the FCC's productivity factor adjustment.

Intrastate network access revenues in 1997 reflect an increase due to the PIU settlements and a decrease due to the effects of the CHCFB described above. Excluding these impacts, intrastate network access revenues increased slightly in 1997 and 1996 as increases in demand, including usage by alternative intraLATA toll carriers, were partially offset by state regulatory rate orders.

Long-Distance Service revenues decreased in 1997 due to the effect of the CHCFB discussed above, regulatory rate orders, price competition from alternative intraLATA toll carriers and the introduction and deployment of extended area local service plans at SWBell. These decreases were somewhat offset by increases due to growth in wireless revenues and demand resulting from California's growing economy. Long-distance service revenues increased in 1996 due principally to increases in demand resulting from California's growing economy and to growth in Mobile Systems' long-distance revenues, including interLATA service that began in February 1996. Additionally, revenues in 1996 increased due to the reduction in 1995 from SWBell intraLATA toll pool settlement payments and accruals for rate reductions relating to an appealed 1992 rate order in Oklahoma. The settlement of the appeals in October 1995 eliminated the need to continue these accruals. These increases in 1996 revenues were somewhat offset by the impact of price competition from alternative intraLATA toll carriers.

Directory Advertising revenues increased in 1997 due mainly to increased demand at Southwestern Bell Yellow Pages, Inc. (Yellow Pages) and Pacific Bell Directory (PBDirectory) and the publication of directories in 1997 that were not published in 1996. Directory advertising revenues were relatively unchanged in 1996 as increased revenues were offset by the decrease resulting from the January 1996 sale of SBC's publishing contracts for GTE Corporation's service areas to GTE Directories. Excluding the impact of this sale, revenues increased 5.1% in 1996.

Other operating revenues increased in 1997 and 1996 due primarily to increased equipment sales at Mobile Systems and Pacific Bell Mobile Services and revenues from new business initiatives, primarily voice messaging services and Internet services. Increased demand for PacBell and SWBell nonregulated services and products also contributed to the increases in both years.

Operating Expenses

SBC's operating expenses for 1997 reflect approximately $2.9 billion of charges related to strategic initiatives resulting from a comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997 (see Note 3 to the Financial Statements), costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these charges, SBC's operating expenses increased $1,188, or 6.7%, in 1997 and $1,017, or 6.1%, in 1996. Components of total operating expenses, including percentage changes from the prior year, are as follows:

				Percent Change	
	1997	1996	1995	1997 vs. 1996	1996 vs. 1995
Cost of services and products	$ 9,488	$ 8,250	$ 7,864	15.0%	4.9%
Selling, general and administrative	7,276	5,250	4,694	38.6	11.8
Depreciation and amortization	4,922	4,109	4,034	19.8	1.9
	$21,686	$17,609	$16,592	23.2%	6.1%

Cost of Services and Products reflects charges of $334 in 1997 relating to SBC's strategic initiatives, operational reviews, costs incurred for customer number portability since the merger and ongoing merger integration costs; excluding these charges, expenses increased $904, or 11.0%, in 1997. A significant part of this increase was caused by the introduction of PCS operations during 1997. Other major factors contributing to the increase included increases in employee compensation, including increases related to force additions and contract labor, growth at Mobile Systems, network expansion and maintenance and interconnection costs. Cost of services and products increased in 1996 due primarily to increases in employee compensation, growth at Mobile Systems, network expansion and maintenance, and expenses related to local competition preparation and new business initiatives, such as PCS, Internet services and network integration.

Selling, General and Administrative expense in 1997 reflects $1,952 of charges relating to SBC's strategic initiatives, operational reviews and ongoing merger integration costs. As discussed in Note 3 to the Financial Statements, the most significant of these charges included shutdown of the Advanced Communications Network (ACN), regulatory costs related to the approval of the merger with SBC by California and Nevada regulators, and reorganization initiatives. Excluding these charges, expenses increased $74, or 1.4%, in 1997. Significantly increasing expenses was the introduction of PCS operations during 1997. Other major factors contributing to the increase included growth at Mobile Systems, expenses related to new business initiatives, primarily voice messaging and Internet services, and increases in employee compensation, sales agents commissions and uncollectibles. These increases were partially offset by PAC's first quarter 1997 $152 settlement gain associated with lump-sum pension payments that exceeded the projected service and interest costs for 1996 retirements. Selling, general and administrative expense increased in 1996 due primarily to growth at Mobile Systems and increases in contracted services, employee compensation and software costs. Expenses incurred at PAC to prepare support systems for local competition and for new business initiatives also contributed to the increase in 1996.

Depreciation and Amortization in 1997 reflects charges totaling $592 to record impairment of plant and intangibles. As discussed in Note 3 to the Financial Statements, the most significant of these impairments related to the wireless digital TV operations in southern California, certain analog switching equipment in California, certain rural and other telecommunications equipment in Nevada, selected wireless equipment and cable within commercial buildings in California. Excluding these charges, depreciation and amortization increased $221, or 5.4%, in 1997 due primarily to overall higher plant levels. Reduced depreciation beginning with the second quarter of 1997 on analog switching equipment in California at PacBell partially offset this increase. Depreciation and amortization also increased in 1996 due primarily to overall higher plant levels.

Interest Expense increased $135, or 16.6%, in 1997 and decreased $145, or 15.2%, in 1996. The 1997 increase was due primarily to increased average debt levels at SBC. Also contributing to the increase was interest associated with the second quarter 1997 one-time charges, primarily interest on the merger-approval costs. The 1996 decrease was due to a change in PAC's capital structure, which replaced a portion of interest expense with amounts recorded as Other Income (Expense) – Net (see Note 10 to the Financial Statements), lower long-term debt levels in SBC subsidiaries other than PAC, and capitalization of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995. Under regulatory accounting, the Telephone Companies accounted for capitalization of both interest and equity costs during periods of construction as other income.

Equity in Net Income of Affiliates decreased $6 in 1997 and increased $87 in 1996. The 1997 decrease reflects decreased income from SBC's investment in Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company. This lower income resulted from the change in the functional currency used by SBC to record its interest in Telmex from the peso to the U.S. dollar beginning in 1997 and SBC's reduced ownership percentage after the sale of Telmex L shares. Results also reflect preoperating expenses in several international investments including long-distance in France, Switzerland and Israel, and cellular communications in Taiwan. These decreases were mainly offset by income from SBC's May 1997 investment in Telkom SA Limited (Telkom) of South Africa, whose results reflected strong growth and expense management, and lower losses resulting from the reduced involvement in Tele-TV.

The 1996 increase reflects increased income from Telmex, due to the relative stabilization of the peso compared to 1995 and net gains on international affiliate transactions. Results for 1995 include losses on SBC's United Kingdom cable television operations, which were accounted for under the equity method prior to October 1995, and exchange losses on the non-peso denominated debt of Telmex. Results for 1996 and 1995 also reflect reductions in the translated amount of U.S. dollar earnings from Telmex's operations. Operational growth at Telmex in both years somewhat offset these declines.

SBC's earnings from foreign affiliates will continue to be generally sensitive to exchange rate changes in the value of the respective local currencies. SBC's foreign investments are recorded under U.S. generally accepted accounting principles (GAAP), which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries, such as inflation adjustments. SBC's equity earnings in 1998 will reflect SBC's investment in Telkom for a full year of operations (see Note 16 to the Financial Statements for discussion of the Telkom investment).

Other Income (Expense) – Net decreased $5 in 1997 and $276 in 1996. Results for 1997 reflect $26 in second quarter charges related to SBC's strategic initiatives, primarily writeoffs of nonoperating plant. Other decreases relate primarily to the market valuation adjustment on certain SBC debt redeemable either in cash or Telmex L shares and distributions paid on an additional $500 of Trust Originated Preferred Securities (TOPrS) sold by PAC in June 1996. Partially offsetting these increased expenses were the gain recognized from the sale of SBC's interests in Bellcore, royalty payments associated with software developed by an affiliate and the gain on the sale of Telmex L shares. The decrease in 1996 reflects the inclusion in 1995 of the gain recognized from the merger of SBC's United Kingdom cable television operations into TeleWest (see Note 16 to the Financial Statements) and interest income from tax refunds, somewhat offset by expenses associated with the refinancing of long-term debt by the Telephone Companies (see Note 9 to the Financial Statements). Additional decreases in 1996 related to the reclassification of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995 and the change in PAC's capital structure noted in the discussion of Interest Expense (see Note 10 to the Financial Statements).

Income Tax expense decreased $1,097, or 56.0%, in 1997 and increased $441, or 29.0%, in 1996. Income taxes for 1997 reflect the tax effect of charges for strategic initiatives resulting from SBC's comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997, costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these items, income taxes for 1997 were lower. Contributing to the decrease in income tax expense in 1997 was, among other items, realization of foreign tax credits. Income taxes paid, net of refunds, reflect the impact of reduced tax payments due to merger-related and integration costs incurred. The 1996 increase was due primarily to higher income before income taxes. Taxes also increased in 1996 reflecting a full year's effects of the elimination of excess deferred taxes and the reduction in the amortization of investment tax credits resulting from the discontinuance of regulatory accounting, which occurred in the latter part of 1995.

Extraordinary Loss In 1995, SBC recorded an extraordinary loss of $6 billion from the discontinuance of regulatory accounting. The loss included a reduction in the net carrying value of telephone plant and the elimination of net regulatory assets of SWBell and PacBell (see Note 2 to the Financial Statements).

Cumulative Effect of Accounting Change As discussed in Note 1 to the Financial Statements, PBDirectory changed its method of recognizing directory publishing revenues and related expenses effective January 1, 1996. The cumulative after-tax effect of applying the new method to prior years is recognized as of January 1, 1996 as a one-time, non-cash gain applicable to continuing operations of $90, or $0.05 per share. The gain is net of deferred taxes of $53. Management believes this change to the issue basis method is preferable because it is the method generally followed in the publishing industry, including Yellow Pages, and better reflects the operating activity of the business. This accounting change is not expected to have a significant effect on net income in future periods.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

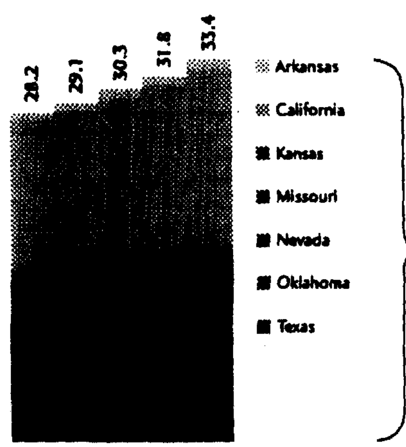
Regulatory Environment The telecommunications industry is in transition from a tightly regulated industry overseen by multiple regulatory bodies, to a more incentive-based, market driven industry monitored by state and federal agencies. The Telephone Companies' wireline telecommunications operations remain subject to regulation by the seven states in which they operate for intrastate services and by the FCC for interstate services. In 1997, new price cap regulatory plans were implemented for the Telephone Companies in Missouri and Nevada, and in Oklahoma, legislation passed allowing alternative regulation. The Telephone Companies under price cap regulation have the freedom to establish and modify prices for some services as long as they do not exceed the price caps, as well as the freedom to change prices for some services without regulatory approval.

Federal Regulation During 1997, the FCC issued an Access Reform Order restructuring access charges paid for interexchange carrier access to the Telephone Companies' networks. The order raises the flat monthly end user charge for primary business lines, and additional residence and business lines, and lowers the price caps on per minute access charges for interstate long distance carriers. These changes, which took effect in 1997 and January 1998, are supposed to shift sources of revenue from carriers to end users without changing the total amount of revenue received by the Local Exchange Carriers (LECs).

The FCC's price cap plan for the LECs provides for changes to be made annually to the price caps for inflation, productivity and changes in other costs. In 1997 the Telephone Companies were ordered to begin using a 6.5% productivity offset, with no sharing. Prior to 1997, there were three productivity offsets, two of which provided for a sharing of profits above a specified earnings level with the Telephone Companies' customers and a higher productivity offset which did not include sharing. The Telephone Companies had elected the higher 5.3% productivity offset without sharing.

With the passage of the Telecommunications Act of 1996 (Telecom Act), the FCC has been conducting further proceedings in conjunction with access reform to address a number of pricing and productivity issues, and is performing a broader review of price cap regulation in the context of the increasingly more competitive telecommunications environment. The Chairman of the FCC has indicated that the FCC intends to act on these proceedings in 1998. The Telecom Act and FCC actions taken to implement provisions of the Telecom Act are discussed further under the heading "Competitive Environment."

Pursuant to the Telecom Act, the local coin rate in the payphone industry was deregulated by the FCC on October 7, 1997, and LECs were required to remove any direct or indirect subsidy of payphone service from their regulated telecommunications operations. Removal of the subsidy caused the Telephone Companies to raise local coin rates throughout their operating territories in 1997.



Access Lines
Access lines in California and Texas account for 80% of total access lines.

State Regulation With the implementation of Nevada's price cap plan which eliminated the sharing provision previously in effect, six of the seven state regulatory plans under which the Telephone Companies operate do not include sharing. The California price cap plan still includes sharing. However, there has been no sharing in California in the last two years.

California The California Public Utility Commission's (CPUC) form of price caps requires PacBell to submit an annual price cap filing to determine prices for categories of services for each new year. The productivity factor used in calculating price caps has been set equal to the inflation factor for the period 1996-1998. The price cap plan includes a sharing mechanism that requires PacBell to share its earnings with customers above certain earnings levels. In December 1997, the CPUC adopted a decision on PacBell's 1997 price cap filing resulting in a revenue reduction in 1998 of approximately $86 effective January 1, 1998. The reduction reflects items accrued in the 1997 results of operations, including, among other things, the rate reduction ordered in the CPUC decision approving the SBC/PAC merger and the gain on the sale of PacBell's interest in Bellcore. Because of these accruals, the order will not materially affect SBC's results of operations in 1998.

In an April 1997 ruling, the CPUC reaffirmed that postretirement benefit costs were appropriately recoverable in PacBell's price cap filings as exogenous costs. The CPUC continued to allow recovery in 1998 consistent with the amount requested by PacBell in an October 1997 filing. The CPUC also ordered a further proceeding to address future procedures and amounts for recovery.

In May 1997, the FCC adopted new separations rules that shifted recovery of a substantial amount of billing and collection costs to the interstate jurisdiction. PacBell filed for a waiver of the requirement and was denied the waiver in December 1997. As a result, PacBell could be required to refund an annualized amount of approximately $21 to customers since July 1997, with refunds commencing in 1999.

In 1996, the CPUC issued an order on universal service and established the CHCFB to subsidize telephone service in California's high cost areas. The estimated $352 cost of the program is expected to be collected from customers of all telecommunications providers who will contribute to the fund through a 2.87% surcharge on all bills for telecommunications services provided in California. The surcharge became effective February 1, 1997. To maintain revenue neutrality, PacBell will reduce its revenues dollar for dollar for amounts it will receive from the fund. This reduction will occur through an across the board surcredit on all products and services (except for residential basic exchange services and contracts) or through permanent rate reductions for those services that previously subsidized universal service. PacBell filed to reduce permanently certain toll and access rates. Hearings were held in October 1997, and a decision is expected in the second or third quarter of 1998.

PacBell expects to receive approximately $305 annually from the CHCFB fund based on CPUC estimates of the cost of providing universal service. PacBell believes the new program underestimates the cost of providing universal service and that the average cost of providing service is up to 33% higher per line, per month than the CPUC estimate. As a result, subsidies for universal service will remain in the prices for PacBell's competitive services, which may place it at a competitive disadvantage.

In 1992, PacBell entered into a settlement with tax authorities and others which fixed a specific methodology for valuing utility property for tax purposes for a period of eight years. As a result, the CPUC opened an investigation to determine if any resulting property tax savings should be returned by PacBell to its customers. Intervenors have asserted that as much as $20 of annual property tax savings should be treated as an exogenous cost reduction in PacBell's annual price cap filings and that as much as $90 in past property tax savings as of December 31, 1997, plus interest, should be returned to customers. PacBell believes that, under the CPUC's regulatory framework, any property tax savings qualify only as a component of shareable earnings and not as an exogenous cost. In an interim opinion issued in June 1995, the CPUC ruled in favor of intervenors, but decided to defer a final decision on the matter pending resolution in a separate proceeding of the criteria for exogenous cost treatment under its regulatory framework. To date, the CPUC has taken no further action on the issue.

More than 120 applications for certification to provide competitive local service have been approved by the CPUC, with over 25 more applications pending approval. As a result, PacBell expects competition to continue to develop for local service, but the financial impact of this competition cannot be reasonably estimated at this time.

Texas The Public Utility Regulatory Act, which became effective in May 1995 (PURA), allows SWBell and other LECs to elect to move from rate of return regulation to price regulation with elimination of earnings sharing. In September 1995, SWBell notified the Texas Public Utility Commission (TPUC) that it elected incentive regulation under the new law. Basic local service rates are capped at existing levels for four years following the election. The TPUC is prohibited from reducing switched access rates charged by LECs to interexchange carriers while rates are capped.

LECs electing price regulation must commit to network and infrastructure improvement goals, including expansion of digital switching and advanced high-speed services to qualifying public institutions, such as schools, libraries and hospitals, requesting the services. PURA also established an infrastructure grant fund for use by public institutions in upgrading their communications and computer technology. PURA provided for a total fund assessment of $150 annually on all telecommunications providers in Texas for a ten-year period. The 1997 Texas legislative session changed the funding for the infrastructure grant from annually collecting $150 for ten years to a flat rate (1.25%) applied to all telecommunications providers' sales taxable revenues. The law also provides a cap of $1,500 for the life of the fund. SWBell's annual payments will increase from the current level in 1997 of $36 per year to approximately $50 for each of the next three years. Due to the industry's growth in revenues, the fund should be completely funded before the original ten years.

PURA establishes local exchange competition by allowing other companies that desire to provide local exchange services to apply for certification by the TPUC, subject to certain build-out requirements, resale restrictions and minimum service requirements. PURA provides that SWBell will remain the default carrier of "1 plus" intraLATA long-distance traffic until SWBell is allowed to carry interLATA long-distance. In 1996, MCI Communications Corporation (MCI) and AT&T Corp. (AT&T) sued the state of Texas, alleging that PURA violates the Texas state constitution, and claiming that PURA establishes anticompetitive barriers designed to prevent MCI, AT&T and Sprint Corporation (Sprint) from providing local services within Texas. The FCC, also in response to petitions filed by AT&T and

MCI, preempted and voided portions of PURA that required certain new entrants to build telephone networks to cover a 27-square-mile area in any market they entered. Furthermore, the FCC also preempted rules that excluded competitors from entering markets with fewer than 31,000 access lines and which made resale of Centrex phone services subject to a limited property restriction. AT&T and MCI have dismissed their suits regarding this matter. In October 1997, SWBell filed with the FCC a Petition for Reconsideration regarding the preemption of the property restriction for Centrex services.

More than 170 applications for certification to provide competitive local service have been approved by the TPUC, with over 25 more applications pending approval. As a result, SWBell expects competition to continue to develop for local service, but the financial impact of this competition cannot be reasonably estimated at this time.

Missouri Effective September 26, 1997, the Missouri Public Service Commission (MPSC) determined that SWBell is now subject to price cap regulation. Prices in effect as of December 31, 1996 are the initial maximum allowable rates for services and cannot be adjusted until January 1, 2000 for basic and access services and until January 1, 1999 for non-basic services. On an exchange basis where a competitor begins operations, the January 1, 1999 freeze on maximum allowable rates for non-basic services is removed. After those dates, caps for basic and access services may be adjusted based on one of two government indices while caps for non-basic services may be increased up to 8% per year. In an exchange where competition for basic local service exists for five years, services will be declared competitive and subject to market pricing unless the MPSC finds effective competition does not exist. The Office of Public Counsel and MCI have sought judicial review of the MPSC determination.

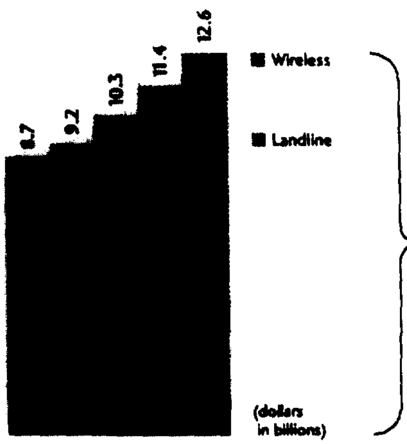
Oklahoma Oklahoma enacted legislation, effective July 1, 1997, which allows for alternative regulation in Oklahoma for telecommunications providers. Key provisions of the new law allow SWBell to apply for alternative regulation at any time, impose a restriction against the Oklahoma Corporation Commission (OCC) initiating a rate case until February 5, 2001, establish a Universal Service Fund (USF), and require SWBell to keep intrastate access rates at parity with interstate rates. SWBell is allowed to seek partial recovery of the access rate reductions from the USF. In addition, the new law allows for streamlined tariff processing procedures and establishes a framework to have services declared competitive and eventually deregulated.

Competitive Environment Competition continues to increase for telecommunication and information services. Recent changes in legislation and regulation have increased the opportunities for alternative service providers offering telecommunications services. Technological advances have expanded the types and uses of services and products available. As a result, SBC faces increasing competition in significant portions of its business.

Domestic On February 8, 1996, the Telecom Act was enacted into law. The Telecom Act is intended to address various aspects of competition within, and regulation of, the telecommunications industry. The Telecom Act provides that all post-enactment conduct or activities which were subject to the consent decree issued at the time of AT&T divestiture of the Regional Holding Companies (RHCs), referred to as the Modification of Final Judgment (MFJ), are now subject to the provisions of the Telecom Act. In April 1996, the United States District Court for the District of Columbia issued its Opinion and Order terminating the MFJ and dismissing all pending motions related to the MFJ as moot. This ruling effectively ended 13 years of RHC regulation under the MFJ. Among other things, the Telecom Act also defines conditions SBC must comply with before being permitted to offer interLATA long-distance service within California, Texas, Missouri, Kansas, Oklahoma, Arkansas and Nevada (regulated operating areas) and establishes certain terms and conditions intended to promote competition for the Telephone Companies' local exchange services.

Under the Telecom Act, SBC may immediately offer interLATA long-distance outside the regulated operating areas and over its wireless network both inside and outside the regulated operating areas. Before being permitted to offer landline interLATA long-distance service in any state within the regulated operating areas, SBC must apply for and obtain state-specific approval from the FCC. The FCC's approval, which involves consultation with the United States Department of Justice and appropriate state commissions, requires favorable determinations that the Telephone Companies have entered into interconnection agreement(s) that satisfy a 14-point "competitive checklist" with predominantly facilities-based carrier(s) that serve residential and business customers or, alternatively, that the Telephone Companies have a statement of terms and conditions effective in that state under which they offer the "competitive checklist" items. The FCC must also make favorable public interest and structural separation determinations in connection with such applications.

In July 1997, SBC brought suit in the U.S. District Court for the Northern District of Texas (U.S. District Court), seeking a declaration that parts of the Telecom Act are unconstitutional on the grounds that they improperly discriminate against the Telephone Companies by imposing restrictions that prohibit the Telephone Companies by name from offering interLATA long-distance and other services that other LECs are free to provide. The suit challenged only those portions of the Telecom Act that exclude the Telephone Companies from competing in certain lines of business. On December 31, 1997 the U.S. District Court ruled in favor of SBC and declared certain sections of the Telecom Act unconstitutional, thereby allowing SBC to enter interLATA long-distance in the Telephone Companies' operating areas. If upheld, this ruling is expected to speed competition in the interLATA long-distance markets in SBC's regulated operating areas. The FCC and competitor intervenors have sought and received a stay of the decision by the U.S. District Court.



Local Service
Wireless local service revenues have more than doubled in the last four years.

In August 1996, the FCC issued rules by which competitors could connect with LECs' networks, including those of the Telephone Companies. Among other things, the rules addressed unbundling of network elements, pricing for interconnection and unbundled elements (Pricing Provisions), and resale of retail telecommunications services. The FCC rules were appealed by numerous parties, including SBC.

In July 1997, the United States Court of Appeals for the Eighth Circuit in St. Louis (8th Circuit) held that the FCC did not have authority to promulgate rules related to the pricing of local intrastate telecommunications and that its rules in that regard were invalid. The 8th Circuit also overturned the FCC's rules which allowed competitors to "pick and choose" among the terms and conditions of approved interconnection agreements. In October 1997, the 8th Circuit issued a subsequent decision clarifying that the Telecom Act does not require the incumbent LECs to deliver network elements to competitors in anything other than completely unbundled form.

In September 1997, a number of parties, including SBC, filed petitions to enforce the July 1997 ruling of the 8th Circuit that the right to set local exchange prices, including the pricing methodology used, is reserved exclusively to the states. The petitions responded to the FCC's rejection of Ameritech Corporation's interLATA long-distance application in Michigan in which the FCC stated it intended to apply its own pricing standards to RHC interLATA applications. The petitioners asserted the FCC was violating state authority. On January 22, 1998 the 8th Circuit ordered the FCC to abide by the July 1997 ruling and reiterated that the FCC cannot use interLATA long-distance applications made by SBC and other RHC wireline subsidiaries wishing to provide interLATA long-distance to attempt to re-impose the pricing standards ruled invalid in July 1997 by the 8th Circuit. On January 26, 1998, the U.S. Supreme Court agreed to hear all appeals of the July 1997 8th Circuit decision.

The effects of the FCC rules are dependent on many factors including, but not limited to: the ultimate resolution of the pending appeals; the number and nature of competitors requesting interconnection, unbundling or resale; and the results of the state regulatory commissions' review and handling of related matters within their jurisdictions. Accordingly, SBC is not able to assess the impact of the FCC rules at this time.

Landline Local Service Recent state legislative and regulatory developments also allow increased competition for local exchange services. Companies wishing to provide competitive local service have filed numerous applications with state commissions throughout the Telephone Companies' regulated operating areas, and the commissions of each state have been approving these applications since late 1995. Under the Telecom Act, companies seeking to interconnect to the Telephone Companies' networks and exchange local calls must enter into interconnection agreements with the Telephone Companies. These agreements are then subject to approval by the appropriate state commissions. SBC has reached over 250 interconnection and resale agreements with competitive local service providers, and most have been approved by the relevant state commissions. AT&T and other competitors are reselling SBC local exchange services, and as of December 31, 1997, there were approximately 500,000 SBC access lines supporting services of resale competitors throughout the Telephone Companies' regulated operating areas, most of them in Texas and California. Many competitors have placed facilities in service and have begun advertising campaigns and offering services. Beginning in 1996, SWBell was also granted facilities-based and resale operating authority in territories served by other LECs. SWBell began local exchange service offerings to these areas during 1997.

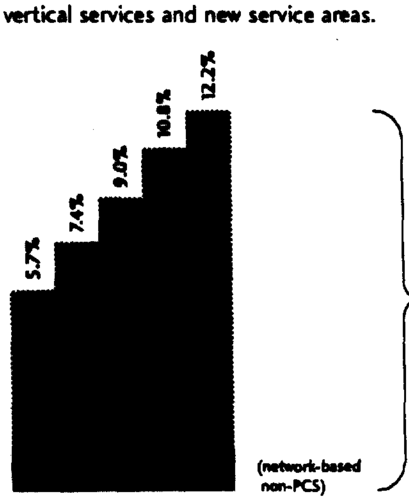
The CPUC authorized facilities-based local services competition effective January 1996 and resale competition effective March 1996. While the CPUC has established local competition rules and interim prices, several issues still remain to be resolved, including final rates for resale and LEC provisioning and pricing of certain network elements to competitors. In order to provide services to resellers, PacBell uses established operating support systems and has implemented electronic ordering systems and a customer care/billing center. Costs to implement local competition, especially number portability, are substantial. The CPUC has set a schedule to review PacBell's recovery of its local competition implementation costs incurred since January 1, 1996.

The CPUC has issued orders regarding the implementation of competition in 1997. Some of the key ones include permitting the resale of Centrex services to businesses only, prohibiting aggregation of customers to obtain toll discounts, enforcing optional calling plans retail tariff restrictions on resale, prohibiting sharing of certain Centrex features to route intraLATA calls, adopting no discount on private line resale, ordering resale of voice mail to competitors, and allowing collection of intrastate access charges on unbundled network elements. The CPUC order on resale of voice mail service was stayed and is being reviewed.

In December 1997, the TPUC set rates that SWBell may charge for access and interconnection to its telephone network. The TPUC decision sets pricing for dozens of network components and completes a consolidated arbitration between SWBell and six of its competitors, including AT&T and MCI. SWBell has TPUC-approved resale and interconnection agreements with approximately 80 local service providers, with approximately 15 pending approval.

In Missouri, the MPSC issued orders on a consolidated arbitration hearing with AT&T and MCI and on selected items with Metropolitan Fiber Systems (MFS). Among other terms, the orders established discount rates for resale of SWBell services and prices for unbundled network elements. SWBell appealed the interconnection agreement resulting from the first arbitration proceeding on November 5, 1997; a decision is still pending. A second arbitration process to address other interconnection issues with AT&T has concluded, and the MPSC ordered that an agreement be filed. SWBell has sought reconsideration of this order.

As a result of the Telecom Act and conforming interconnection agreements, the Telephone Companies expect increased competitive pressure in 1998 and beyond from multiple providers in various markets including facilities-based Competitive Local Exchange Carriers (CLECs), interexchange carriers (IXCs) and resellers. At this time, management is unable to assess the effect of competition on the industry as a whole, or financially on SBC, but expects both losses of market share in local service and gains resulting from new business initiatives, vertical services and new service areas.



Wireless Penetration
SBC's wireless penetration for its network-based non-PCS services is among the highest in the industry.

Wireless Local Service In 1993, the FCC adopted an order allocating radio spectrum and licenses for PCS. PCS utilizes wireless telecommunications digital technology at a higher frequency radio spectrum than cellular. Like cellular, it is designed to permit access to a variety of communications services regardless of subscriber location. In an FCC auction, which concluded in March 1995, PCS licenses were awarded in 51 major markets. SBC or affiliates acquired PCS licenses in the Major Trading Areas (MTAs) of Los Angeles-San Diego, California; San Francisco-Oakland-San Jose, California; Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma. The California licenses cover substantially all of California and Nevada. SBC is currently operational in all of its major California-Nevada markets and Tulsa, Oklahoma. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis, Tennessee and Little Rock, Arkansas and other consideration.

In November 1996, Pacific Bell Mobile Services (PBMS) conducted an extensive PCS trial in San Diego, California. Service was formally launched in San Diego, California in January 1997, in Las Vegas, Nevada in February 1997, in Sacramento, California in March 1997, in San Francisco in May 1997, in Los Angeles in July 1997 and in Bakersfield, California in October 1997. The network incorporates the Global System for Mobile Communications (GSM) standard which is widely used in Europe. PBMS is selling PCS as an off-the-shelf product in retail stores across California and Nevada. Significant competition exists, particularly from the two established cellular companies in each market.

In an FCC auction which concluded in January 1997, SBC acquired eight additional PCS licenses for Basic Trading Areas (BTAs) that are within the five-state area.

SBC also has state approved interconnection agreements to receive reciprocal compensation from interexchange carriers and other local service providers accessing its wireless networks in all states where it provides wireless services.

Companies granted licenses in MTAs and BTAs where SBC also provides service include subsidiaries and affiliates of AT&T, Sprint and other RHCs. Significant competition from PCS providers exists in SBC's major markets. Competition has been based upon both price and product packaging and has contributed to SBC's decline in average subscriber revenue per wireless customer.

Long-Distance Competition continues to intensify in the Telephone Companies' intraLATA long-distance markets. It is estimated that providers other than PacBell now serve more than half of the business intraLATA long-distance customers in PacBell's service areas.

The OCC recommended that SBC be allowed to offer interLATA long-distance in Oklahoma. Notwithstanding that recommendation, the FCC denied SBC such authority and SBC has appealed the decision in the D.C. Court of Appeals where the case is pending.

Since the Telecom Act, SBC has entered the wireless long-distance markets, and offers wireless long-distance service in all of its wireless service areas. In addition, through affiliates SBC also offers landline interLATA long-distance services to customers in selected areas outside the Telephone Companies' operating areas.

Other In the future, it is likely that additional competitors will emerge in the telecommunications industry. Cable television companies and electric utilities have expressed an interest in, or already are, providing telecommunications services. As a result of recent and prospective mergers and acquisitions within the industry, SBC may face competition from entities offering both cable TV and telephone services in the Telephone Companies' regulated operating areas. Interexchange carriers have been certified to provide local service, and a number of other major carriers have publicly announced their intent to provide local service in certain markets, some of which are in the Telephone Companies' regulated operating areas. Public communications services such as public payphone services will also face increased competition as a result of federal deregulation of the payphone industry.

Dollars in millions except per share amounts

SBC is aggressively representing its interests regarding competition before federal and state regulatory bodies, courts, Congress and state legislatures. SBC will continue to evaluate the increasingly competitive nature of its business, and develop appropriate competitive, legislative and regulatory strategies.

International Telmex was granted a concession in 1990, which expired in August 1996, as the sole provider of long-distance services in Mexico. In 1995, the Mexican Senate and Chamber of Deputies passed legislation providing for the introduction of competition into the Mexican long-distance market. This legislation specified that there would be an unlimited number of long-distance concessions and that Telmex was required to provide 60 interconnection points by January 1, 1997, and more than 200 interconnection points by the year 2000. Several large competitors have received licenses to compete with Telmex and begun operations, including a joint venture between AT&T and Alfa S.A. de C.V., a Mexican consortium, and Avantel, S.A., a joint venture between MCI and Grupo Financiero Banamex-Accival, Mexico's largest financial group. Balloting for presubscription of long-distance service is currently occurring among Telmex's customers in selected areas. At the end of 1997, Telmex had retained about 75% of its long-distance customers in areas that had completed balloting.

OTHER BUSINESS MATTERS

Merger Agreement On January 5, 1998, SBC and Southern New England Telecommunications Corporation (SNET) jointly announced a definitive agreement to merge an SBC subsidiary with SNET, in a transaction in which each share of SNET common stock will be exchanged for 1.7568 shares of SBC common stock (equivalent to approximately 120 million shares, or 6.5% of SBC's outstanding shares at December 31, 1997). After the merger, SNET will be a wholly-owned subsidiary of SBC. The transaction is intended to be accounted for as a pooling of interests and to be a tax-free reorganization. The merger is subject to certain regulatory approvals as well as approval by the shareowners of SNET at a special meeting expected to be held on March 27, 1998. If approvals are granted, the transaction is expected to close by the end of 1998.

Restructuring Reserve In December 1993, PAC established a reserve to record the incremental cost of force reductions associated with restructuring PAC's business processes, of $1,431 in expenses, which impacted net income by $861. This restructuring was expected to allow PacBell to eliminate approximately 10,000 employee positions through 1997, net of approximately 4,000 new positions expected to be created. For the three-year period 1994 through 1996, net force reductions totalled 9,168.

This table sets forth the status and activity of this reserve during that three-year period:

	1996	1995	1994
Balance - beginning of year	$ 228	$ 819	$1,097
Charges: cash outlays	(195)	(372)	(216)
non-cash	64	(219)	(62)
Balance - end of year	$ 97	$ 228	$ 819

The remaining 1996 reserve of $97 was used during 1997. As a result of the new initiatives arising from the merger with PAC, net force changes during 1997 are not meaningful to the restructuring reserve.

Acquisitions and Dispositions In addition to the items discussed in Note 16 to the Financial Statements, SBC has made several acquisitions and dispositions since 1995.

In 1995, SBC made the following acquisitions: a wireless system serving Watertown, New York, and 100% of the stock of Cross Country Wireless (CCW), a wireless cable television operator providing service to 40,000 customers in Riverside, California and with licenses to provide service in Los Angeles, Orange County and San Diego. The CCW acquisition involved the issuance of stock valued at approximately $120 and assumption of $55 in debt. Additionally, SBC made the following equity investments in 1995: a $317 investment to acquire 40% of VTR S.A. (VTR), a privately owned Chilean telecommunications holding company which was 51% owned by Grupo Luksic (Luksic), a large Chilean conglomerate, and an investment in a South African wireless company.

In 1996, SBC made the following additional investments: an investment to maintain its indirect 10% ownership in a French cellular company to offset dilution of its interest resulting from other equity sales, and an increase in its holding in VTR to 49% through the purchase of shares from another minority shareholder. Also in 1996, SBC and the other RHCs reached an agreement to sell Bellcore. This sale was finalized in 1997.

During 1997, SBC contributed its French cellular holdings and an additional $240 to acquire a 15% interest in Cegetel, S.A, a newly formed company which is intended to provide a broad base of telecommunications services throughout France. Luksic exercised an option to purchase shares of VTR from SBC, reducing SBC's ownership to 44%; in December 1997, VTR sold its wireless services operations. SBC also sold its interests in an Australian directory publisher in 1997.

During the third quarter of 1997, SBC reached agreement to sell its cable television properties in Montgomery County, Maryland and Arlington, Virginia, as well as its purchase option to invest in cable television operations in Chicago, Illinois. These transactions are expected to close during 1998.

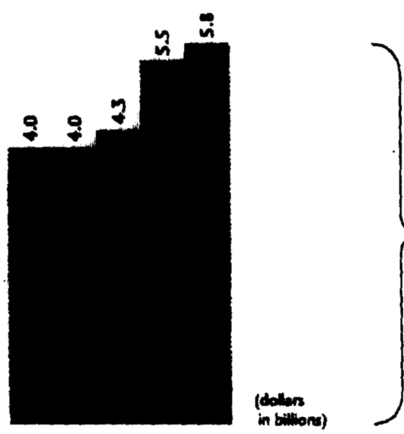
Throughout 1997 and in February 1998, SBC sold portions of its Telmex L shares so that SBC's total equity investment remained below 10% of Telmex's total equity capitalization.

None of these transactions had a material effect on SBC's financial results in 1997, 1996 or 1995, nor does management expect them to have a material effect on SBC's financial position or results of operations in 1998.

Strategic Realignment In July 1995, SBC announced a strategic realignment of functions, and recognized $139 in selling, general and administrative expenses. These expenses include postemployment benefits for approximately 2,400 employees arising from the future consolidation of operations, streamlining support and administrative functions and integrating financial systems. Full implementation of the realignment had been delayed due to the merger with PAC, and the realignment plans and all remaining liabilities were either integrated with or superseded by the post-merger initiatives. The charge reduced net income for 1995 by approximately $88.

LIQUIDITY AND CAPITAL RESOURCES

Capital Expenditures and Other Commitments To provide high-quality communications services to its customers, SBC, particularly its landline and wireless operations, must make significant investments in property, plant and equipment. The amount of capital investment is influenced by demand for services and products, continued growth and regulatory commitments.



Capital Expenditures
Continued growth and the build-out of PCS networks led to increases in capital expenditures.

SBC's capital expenditures totaled $5,766, $5,481 and $4,338 for 1997, 1996 and 1995. The Telephone Companies' capital expenditures increased 7% in 1997 and 26% in 1996 due primarily to demand-related growth, network upgrades, customer-contracted requirements, ISDN projects, PCS build-out and SWBell's regulatory commitments.

In 1998, management expects total capital spending to decrease slightly from 1997, to between $5,500 and $5,700. Capital expenditures in 1998 will relate primarily to the continued evolution of the Telephone Companies' networks, including amounts agreed to under regulation plans at SWBell, and continued build-out of Mobile Systems' markets and PBMS. SBC expects to fund ongoing capital expenditures with cash provided by operations.

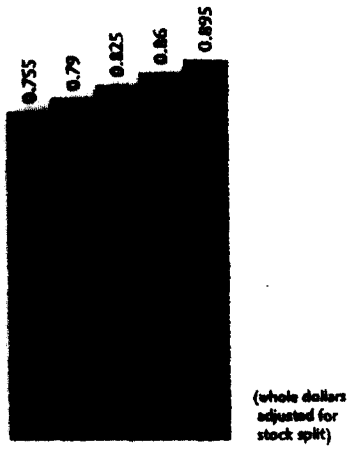
SWBell continues to make additional network and infrastructure improvements over periods ranging through 2001 to satisfy regulatory commitments. Total capital expenditures under these commitments will vary based on actual demand of potential end users. SWBell anticipates spending approximately $100 in 1998 associated with these commitments.

PacBell has purchase commitments of approximately $190 remaining in connection with its previously announced program for deploying an all-digital switching platform with ISDN and SS-7 capabilities.

Over the next few years, SBC expects to incur significant capital and software expenditures for customer number portability, which allows customers to switch to new local competitors and keep the same phone number, and interconnection. SBC expects capital costs and expenses associated with customer number portability to total up to $1.2 billion on a pre-tax basis over the next four years. Full recovery of customer number portability costs is required under the Telecom Act; however, the FCC has not yet determined when or how those significant costs will be recovered. SBC has filed a tariff for recovery of these costs. No action has been taken by the FCC on this tariff, pending the issuance of its order on customer number portability. SBC is unable to predict the likelihood of the FCC permitting the tariffs to become effective. Capital costs and expenses associated with interconnection will vary based on the number of competitors seeking interconnection, the particular markets entered and the number of customers served by those competitors. Accordingly, SBC is currently unable to reasonably estimate the future costs that will be incurred associated with interconnection.

SBC currently operates numerous date-sensitive computer applications and systems throughout its business. As the century change approaches, it will be essential for SBC to ensure that these systems properly recognize the year 2000 and continue to process critical operational and financial information. SBC has established processes for evaluating and managing the risks and costs associated with preparing its systems and applications for the year 2000 change. Total expenses for this project have been estimated to be less than $250 over the next three years. SBC expects to substantially complete modifications and incur most of these costs during 1998 to allow for thorough testing before the year 2000.

Dividends Declared Dividends declared by the Board of Directors of SBC (Board) were $0.895 per share in 1997, $0.86 per share in 1996, and $0.825 per share in 1995. These per share amounts do not include dividends declared and paid by PAC prior to the merger. The total dividends paid by SBC and PAC were $1,638 in 1997, $1,680 in 1996 and $1,933 in 1995. Pursuant to the terms of the merger agreement, PAC reduced its dividend beginning in the second quarter of 1996. The lower second and third quarter dividends paid in 1996 improved 1996 cash flow by approximately $195. SBC's dividend policy considers both the expectations and requirements of shareowners, internal requirements of SBC and long-term growth opportunities. On January 30, 1998, the Board declared a first quarter 1998 dividend of $0.23375 per share.



Dividends
SBC has increased its dividend every year since divestiture.

Cash, Lines of Credit and Cash Flows SBC had $398 of cash and cash equivalents available at December 31, 1997. Commercial paper borrowings as of December 31, 1997, totaled $1,268. SBC has entered into agreements with several banks for lines of credit totaling $2,475, all of which may be used to support commercial paper borrowings (see Note 9 to the Financial Statements). SBC had no borrowings outstanding under these lines of credit as of December 31, 1997.

During 1997, as in 1996 and 1995, SBC's primary source of funds continued to be cash generated from operations, as shown in the Consolidated Statements of Cash Flows. Net cash provided by operating activities exceeded SBC's construction and capital expenditures during 1997, as in 1996 and 1995; this excess is referred to as free cash flow, a supplemental measure of liquidity. SBC generated free cash flow of $1,204, $1,935 and $2,452 in 1997, 1996 and 1995.

During 1996 PAC issued $1,000 of TOPrS, $500 at 7.56% in January 1996 and $500 at 8.5% in June 1996 (see Note 10 to the Financial Statements). The proceeds were used to retire outstanding short-term debt, primarily commercial paper that had increased significantly during 1995.

During 1997, 1996 and 1995, the Telephone Companies refinanced long-term debt with an aggregate principal amount of $964.

Total Capital SBC's total capital consists of debt (long-term debt and debt maturing within one year), TOPrS and shareowners' equity. Total capital increased $958 in 1997 and $1,844 in 1996. The increase in 1997 was due to higher debt levels and 1997 earnings. The increase in 1996 was due to PAC's increased financing requirements and the reinvestment of earnings, partially offset by the acquisition of treasury shares.

Debt Ratio SBC's debt ratio was 56.2%, 55.5% and 61.7% at December 31, 1997, 1996 and 1995. The debt ratio is affected by the same factors that affect total capital. For 1995, the decrease in equity caused by the discontinuance of regulatory accounting increased the debt ratio by 13.2 percentage points.

Employee Stock Ownership Plans See Note 13 to the Financial Statements.

CONSOLIDATED STATEMENTS OF INCOME

Dollars in millions except per share amounts

	1997	1996	1995
Operating Revenues			
Local service	**$ 12,602**	$ 11,389	$ 10,365
Network access	**5,815**	5,831	5,514
Long-distance service	**2,115**	2,240	2,072
Directory advertising	**2,111**	1,985	1,984
Other	**2,213**	2,000	1,777
Total operating revenues	**24,856**	23,445	21,712
Operating Expenses			
Cost of services and products	**9,488**	8,250	7,864
Selling, general and administrative	**7,276**	5,250	4,694
Depreciation and amortization	**4,922**	4,109	4,034
Total operating expenses	**21,686**	17,609	16,592
Operating Income	**3,170**	5,836	5,120
Other Income (Expense)			
Interest expense	**(947)**	(812)	(957)
Equity in net income of affiliates	**201**	207	120
Other income (expense) – net	**(87)**	(82)	194
Total other income (expense)	**(833)**	(687)	(643)
Income Before Income Taxes, Extraordinary Loss and Cumulative Effect of Accounting Change	**2,337**	5,149	4,477
Income taxes	**863**	1,960	1,519
Income Before Extraordinary Loss and Cumulative Effect of Accounting Change	**1,474**	3,189	2,958
Extraordinary Loss from Discontinuance of Regulatory Accounting, net of tax	**–**	–	(6,022)
Cumulative Effect of Accounting Change, net of tax	**–**	90	–
Net Income (Loss)	**$ 1,474**	$ 3,279	$ (3,064)
Earnings Per Common Share:*			
Income Before Extraordinary Loss and Cumulative Effect of Accounting Change	**$ 0.81**	$ 1.73	$ 1.61
Net Income (Loss)	**$ 0.81**	$ 1.78	$ (1.66)
Earnings Per Common Share-Assuming Dilution:*			
Income Before Extraordinary Loss and Cumulative Effect of Accounting Change	**$ 0.80**	$ 1.72	$ 1.60
Net Income (Loss)	**$ 0.80**	$ 1.77	$ (1.66)

*Restated to reflect two-for-one stock split declared January 30, 1998.

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

Dollars in millions except per share amounts

	December 31, 1997	1996
Assets		
Current Assets		
Cash and cash equivalents	$ 398	$ 314
Short-term cash investments	320	432
Accounts receivable – net of allowances for uncollectibles of $395 and $311	5,015	4,684
Prepaid expenses	349	287
Deferred income taxes	622	201
Deferred charges	82	102
Other current assets	276	251
Total current assets	7,062	6,271
Property, Plant and Equipment – Net	27,339	26,080
Intangible Assets – Net of Accumulated Amortization of $1,002 and $611	3,269	3,589
Investments in Equity Affiliates	2,740	1,964
Other Assets	1,722	1,581
Total Assets	$42,132	$39,485
Liabilities and Shareowners' Equity		
Current Liabilities		
Debt maturing within one year	$ 1,953	$ 2,335
Accounts payable and accrued liabilities	7,888	6,584
Dividends payable	411	393
Total current liabilities	10,252	9,312
Long-Term Debt	12,019	10,930
Deferred Credits and Other Noncurrent Liabilities		
Deferred income taxes	1,639	853
Postemployment benefit obligation	4,929	5,070
Unamortized investment tax credits	417	498
Other noncurrent liabilities	1,984	2,181
Total deferred credits and other noncurrent liabilities	8,969	8,602
Corporation-obligated mandatorily redeemable preferred securities of subsidiary trusts"	1,000	1,000
Shareowners' Equity		
Preferred shares ($1 par value, 10,000,000 authorized: none issued)	–	–
Common shares ($1 par value, 2,200,000,000 authorized: issued 1,867,022,568* at December 31, 1997 and 1,867,545,248* at December 31, 1996)	934	934
Capital in excess of par value	9,418	9,422
Retained earnings	1,146	1,297
Guaranteed obligations of employee stock ownership plans	(183)	(229)
Deferred Compensation – LESOP trust	(119)	(161)
Foreign currency translation adjustment	(574)	(637)
Treasury shares (29,741,356* at December 31, 1997 and 41,233,878* at December 31, 1996, at cost)	(730)	(985)
Total shareowners' equity	9,892	9,641
Total Liabilities and Shareowners' Equity	$42,132	$39,485

*Restated to reflect two-for-one stock split declared January 30, 1998.
"The trusts contain assets of $1,030 in principal amount of the Subordinated Debentures of Pacific Telesis Group.
The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Dollars in millions, increase (decrease) in cash and cash equivalents

	1997	1996	1995
Operating Activities			
Net income (loss)	$ 1,474	$ 3,279	$ (3,064)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	4,922	4,109	4,034
Undistributed earnings from investments in equity affiliates	(100)	(138)	(58)
Provision for uncollectible accounts	523	395	346
Amortization of investment tax credits	(81)	(80)	(95)
Deferred income tax expense	215	626	609
Extraordinary loss, net of tax	–	–	6,022
Cumulative effect of accounting change, net of tax	–	(90)	–
Changes in operating assets and liabilities:			
Accounts receivable	(854)	(765)	(463)
Other current assets	(69)	(50)	77
Accounts payable and accrued liabilities	1,400	632	(76)
Other – net	(460)	(502)	(542)
Total adjustments	5,496	4,137	9,854
Net Cash Provided by Operating Activities	6,970	7,416	6,790
Investing Activities			
Construction and capital expenditures	(5,766)	(5,481)	(4,338)
Investments in affiliates	(26)	(74)	(54)
Purchase of short-term investments	(916)	(1,005)	(704)
Proceeds from short-term investments	1,029	816	587
Dispositions	578	96	14
Acquisitions	(1,115)	(442)	(1,186)
Net Cash Used in Investing Activities	(6,216)	(6,090)	(5,681)
Financing Activities			
Net change in short-term borrowings with original maturities of three months or less	(505)	(977)	1,402
Issuance of other short-term borrowings	1,079	209	91
Repayment of other short-term borrowings	(805)	(134)	(91)
Issuance of long-term debt	1,498	989	981
Repayment of long-term debt	(506)	(408)	(1,086)
Early extinguishment of debt and related call premiums	–	–	(465)
Issuance of trust originated preferred securities	–	1,000	–
Purchase of fractional shares	(15)	–	–
Issuance of common shares	–	111	74
Purchase of treasury shares	(80)	(650)	(216)
Issuance of treasury shares	293	52	82
Dividends paid	(1,622)	(1,664)	(1,814)
Other	(7)	(106)	–
Net Cash Used in Financing Activities	(670)	(1,578)	(1,042)
Net increase (decrease) in cash and cash equivalents	84	(252)	67
Cash and cash equivalents beginning of year	314	566	499
Cash and Cash Equivalents End of Year	$ 398	$ 314	$ 566

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREOWNERS' EQUITY

Dollars in millions except per share amounts

	Common Shares		Capital in Excess of Par Value	Retained Earnings (Deficit)	Guaranteed Obligations of Employee Stock Ownership Plans	Deferred Compensation Leveraged Employee Stock Ownership Trust	Foreign Currency Translation Adjustment	Treasury Shares	
	Shares	Amount						Shares	Amount
Balance, December 31, 1994	930,665,766	$931	$9,258	$4,665	$(315)	$(306)	$(363)	(11,401,628)	$(463)
Net income (loss) for the year ($(1.66) per share*)	–	–	–	(3,064)	–	–	–	–	–
Dividends to shareowners ($0.825 per share*)	–	–	–	(1,933)	–	–	–	–	–
Reduction of debt associated with Employee Stock Ownership Plans	–	–	–	–	43	–	–	–	–
Cost of LESOP trust shares allocated to employee accounts	–	–	–	–	–	64	–	–	–
Foreign currency translation adjustment, net of income tax benefit of $116	–	–	–	–	–	–	(215)	–	–
Issuance of common shares	3,196,076	3	129	–	–	–	–	–	–
Purchase of treasury shares	–	–	–	–	–	–	–	(4,610,713)	(216)
Issuance of treasury shares:									
Dividend Reinvestment Plan	–	–	19	–	–	–	–	2,730,666	111
Other issuances	–	–	(8)	–	–	–	–	2,158,694	87
Other	–	–	–	16	–	–	–	–	–
Balance, December 31, 1995	933,861,842	934	9,398	(316)	(272)	(242)	(578)	(11,122,981)	(481)
Net income for the year ($1.78 per share*)	–	–	–	3,279	–	–	–	–	–
Dividends to shareowners ($0.86 per share*)	–	–	–	(1,680)	–	–	–	–	–
Reduction of debt associated with Employee Stock Ownership Plans	–	–	–	–	43	–	–	–	–
Cost of LESOP trust shares allocated to employee accounts	–	–	–	–	–	81	–	–	–
Foreign currency translation adjustment, net of income tax benefit of $28	–	–	–	–	–	–	(59)	–	–
Purchase of common shares	(89,218)	–	–	–	–	–	–	–	–
Purchase of treasury shares	–	–	–	–	–	–	–	(13,099,709)	(650)
Issuance of treasury shares:									
Dividend Reinvestment Plan	–	–	26	–	–	–	–	2,667,752	109
Other issuances	–	–	(5)	–	–	–	–	937,999	37
Other	–	–	3	14	–	–	–	–	–
Balance, December 31, 1996	933,772,624	934	9,422	1,297	(229)	(161)	(637)	(20,616,939)	(985)
Net income for the year ($0.81 per share*)	–	–	–	1,474	–	–	–	–	–
Dividends to shareowners ($0.895 per share*)	–	–	–	(1,638)	–	–	–	–	–
Reduction of debt associated with Employee Stock Ownership Plans	–	–	–	–	46	–	–	–	–
Cost of LESOP trust shares allocated to employee accounts	–	–	–	–	–	42	–	–	–
Foreign currency translation adjustment, net of income tax expense of $38	–	–	–	–	–	–	63	–	–
Purchase of common shares	(261,340)	–	–	–	–	–	–	–	–
Purchase of treasury shares	–	–	–	–	–	–	–	(1,547,110)	(80)
Issuance of treasury shares	–	–	(38)	–	–	–	–	7,293,371	335
Other	–	–	34	13	–	–	–	–	–
Balance, December 31, 1997	**933,511,284**	**$934**	**$9,418**	**$1,146**	**$(183)**	**$(119)**	**$(574)**	**(14,870,678)**	**$(730)**

*Restated to reflect two-for-one stock split declared January 30, 1998.

The accompanying notes are an integral part of the consolidated financial statements.