

testified before U.S. courts of law, regulatory commissions, and Congress on economic policy issues. I received Bachelors and Masters degrees in Electrical Engineering from Cornell University in 1966 and 1967, respectively. I received a Masters degree in Economics from Stanford University in 1975, and a Ph.D. in Engineering-Economic Systems from Stanford University in 1976.

I, Robert G. Harris, being duly sworn, depose and say:

I am a Principal at LECG, Inc. and Professor Emeritus of Business and Public Policy in the Haas School of Business, University of California at Berkeley. I earned Bachelor of Arts and Master of Arts degrees in Social Science from Michigan State University and Master of Arts and Doctor of Philosophy degrees in Economics from the University of California at Berkeley. My academic research has analyzed the effects of economic regulation and antitrust policy on industry performance, and the implication of changing economics and technology for public policies in transportation and telecommunications. Early in my career, I published extensively on competition, vertical relations and regulatory policies in the rail freight industry. More recently, I have published research on the reform of Japanese telecommunications policy; the strategic character of telecommunications services and its implications for public policies; the effects of regulation and the AT&T divestiture on technological innovation in telecommunications; the deployment and adoption of Integrated Services Digital Network; the development of competition in local access and exchange services; and the development of interconnection policies.

As an advisor to the U. S. Department of Transportation from 1976-79, I assisted in the drafting of legislation that was passed by Congress in 1980, reforming regulation of the motor carrier and railroad industries. While on leave from the University of California in 1980-81, I served as a Deputy Director for Cost, Economic and Financial

Analysis at the Interstate Commerce Commission. At the I.C.C., I was centrally involved in the major rule makings implementing the motor carrier and railroad regulatory reform acts of 1980 and directed the development of the Uniform Rail Costing System. I have also served as a consultant to the U.S. General Accounting Office, the U.S. Office of Technology Assessment, the U.S. Department of Justice, the California Attorney General and the California Department of Consumer Affairs. I have advised the Economic Planning Agency of Japan on the reform of Japanese telecommunications policies.

I have testified on telephone rate design, costing and pricing principles, competition policy and alternative regulation before the Federal Communications Commission and before the state commissions of 25 states plus the District of Columbia. I have testified before the United States Senate, the United States House of Representatives and the Joint Economic Committee of Congress on transportation, antitrust and telecommunications policy issues.

We have been asked by SBC Communications Inc. ("SBC") to evaluate the economic benefits of the proposed merger of SBC and Ameritech. Our analysis considers the impact of the merger for consumers in the rapidly changing telecommunications marketplace and summarizes the efficiencies that can be expected from the merger. We conclude that the merger is likely to provide substantial consumer benefits in the form of enhanced service alternatives, more rapid introduction of new services, and lower quality-adjusted prices.

The attached report contains the results of our analysis and the bases for our conclusions.

Richard J. Gilbert

Richard J. Gilbert

Robert G. Harris

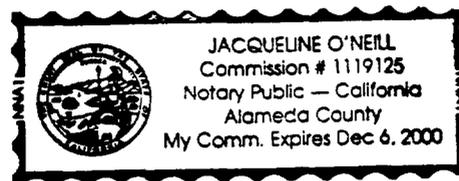
Robert G. Harris

Subscribed and sworn to before me

this day of July 21, 1998

Jacqueline O'Neill

Notary Public



**REPORT OF
RICHARD J. GILBERT
AND
ROBERT G. HARRIS**

July 21, 1998

Economic Benefits of the SBC-Ameritech Merger

I. Introduction

1. The purpose of this affidavit is to address the consumer impacts of the proposed SBC-Ameritech merger. Consumers benefit from new products and services and lower quality-adjusted prices than would occur without the merger. The merger presents significant opportunities to speed the development and introduction of new services and to reduce costs while improving service quality.

2. Section II summarizes the changes that are taking place in the local, national and global telecommunications industry and discusses how the merger fits in this dynamic marketplace. The telecommunications world of today is markedly different from that which existed in the past, and continues to change rapidly. The benefits that consumers receive from firms in the telecommunications marketplace will only come to pass if the firms who participate in the market are allowed to configure and transform themselves into entities that will succeed in this revolutionary period.

3. Section III describes the consumer benefits from the merger. The merger will enhance consumer welfare by accelerating the introduction of new services, increasing the utilization of existing services, and promoting competition in the supply of integrated services. SBC estimates the total cost savings from the merger to be around \$2.5 billion,¹ of which \$778 million is the result of increased utilization of existing products.² In addition to the increased consumer benefits from existing products, the merger will also allow the companies to develop and roll out new

¹ Kaplan Affidavit ¶ 2.

² Kaplan Affidavit ¶ 7.

technologies faster through sharing of research efforts, knowledge, and test markets, and because the merged company will have a larger base over which to spread costly and risky development and product introductions.

4. Section IV evaluates the efficiency estimates for the merger taking into account the results achieved in SBC's merger with Pacific Telesis. Experience shows that SBC's *ex-ante* estimates of the benefits of its merger with Pacific Telesis were on target. The benefits that can be expected from the SBC-Ameritech merger, supported by the results that have been achieved in the SBC-Pacific Telesis merger, lead to the overall conclusion that the merger of SBC and Ameritech is clearly in the public interest. The merger creates large efficiency gains and will have no anticompetitive effects. Indeed, the merger will enhance competition in those markets targeted by the merged company's national/local business plan and will likely stimulate new competition in integrated services to the benefit of consumers in the present SBC and Ameritech service areas.

II. The Merger Is Responsive to the Changing Dynamics of the Telecommunications Marketplace

5. The merger of SBC and Ameritech is an organizational response to the rapidly changing dynamics of the telecommunications industry. Chairman Kennard recently told a group of telecommunications investors and analysts: "the telecom industry is not just about to enter a revolution. It's in one."³ Technological change is affecting SBC and Ameritech in three critical respects:

- a) Consumers' growing appetite for voice, data, and video applications is influencing the

³ William E. Kennard, Chairman, FCC, Remarks to Legg Mason "Telecom Investment Precursors" Workshop, as prepared for delivery, Washington, DC, March 12, 1998.

competitive landscape by placing a premium on technologies that provide large amounts of bandwidth.

- b) Consumers are also eager for packages that integrate voice, data, Internet, and other services, making it advantageous for business arrangements that can provide service packages at low cost.
- c) The rapid change in wireline, wireless, and cable-based telecommunications technologies means that companies such as SBC and Ameritech must maintain a broad portfolio of technological assets to ensure their ability to remain competitive as the telecommunications industry continues to evolve.

6. The simple fact is SBC and Ameritech no longer enjoy the certainty of being a regulated, franchised supplier of access and switching services for voice telephony. As discussed below, traditional voice telephony occupies a shrinking share of the total demand for communications services. Business and residential consumers have an increasing demand for data, and the distinction between voice telephony and data is becoming blurred.⁴ Multi-location business

⁴ For example, "Bell Atlantic will begin building a long distance data network next month to tap the multibillion-dollar market for high speed services within its East Coast region... Bell Atlantic said it hopes the packet-switched network will generate \$3 billion a year in revenue by 2003 through high speed services such as Internet access, data transport and video conferencing... [The network] will incorporate asynchronous transfer mode (ATM), synchronous optical network (SONET) and wave division multiplexing (WDM) technologies." From "Bell Atlantic to Build Long Distance Data Network," *Telecom A.M.*, June 9, 1998. Also, a study by SRI consulting finds that "business fax transmissions, voicemail messages and pages - - not real-time voice conversations - will drive most of the growth in the use of internet telephony in the next five years." From "IP Telephony to Capture Five Percent of LD Traffic by 2002, Study Says," *Telecom A.M.*, April 16, 1998. Furthermore, Alan Cane of the *Financial Times*, asserted that, "...high bandwidth, or broadband, systems are necessary to transmit multimedia: the moving video images, high fidelity sound and top-quality graphics that will characterize tomorrow's communications... When you say multimedia, are you talking about Internet and such like? The transmission of data - Internet traffic is one example - is growing fast and should exceed the volume of voice traffic early next century." From "Telecom A.M. Guide: The New Telephony," *Telecom A.M.*, October 7, 1997.

customers in particular have a demand for a bundle of local, long distance and data services from a single supplier to simplify billing and obtain economies of “one-stop shopping.”⁵ These customers are a key marketing target for the merged SBC-Ameritech national/local business plan.

7. Firms that can provide telecommunication services, including data services, cheaper and more effectively will take market share from the landline local exchange carriers. Firms that can provide integrated packages of data , voice and other services will be especially effective competitors in the telecommunications industry of the future.

8. These changes in technology and demand make it crucial that public policy makers consider the dynamics of the telecommunications marketplace when evaluating the SBC-Ameritech merger. The merger in no way gives the combined SBC-Ameritech leverage to delay these emerging technologies. Instead, the combined company provides a better organizational platform to develop and introduce new technologies and services that respond to consumer demands. A primary benefit of the merger is the ability to develop and roll out competing technologies and services faster than would be possible for the companies individually.

9. The public interest benefits of the merger necessarily must consider the likely economic consequences to the merger parties and their customers if they fail to complete the intended transaction. The experience of industries that are in the process of de-regulation, or have already witnessed de-regulation, is that market forces disregard the geographic and product boundaries that have been imposed by regulators. Competition from suppliers in related industries or from the same industry in different geographic locations tend to unravel the structure of service tariffs designed by the regulators. Competitors target and win the more profitable customers, which in the case of telecommunications are the high volume users that account for a very large share of total revenues. Firms that remain under the “protection” of regulation face a dwindling customer base which is

⁵ “On the Value of Being Integrated,” Yankee Group, July 1997.

increasingly expensive to serve. The consequence of the erosion of market share is an eventual need to re-structure regulated rates to recover the increasing per-capita revenue requirements of the remaining customers.

10. The merger of SBC and Ameritech can mitigate the adverse effects of increasing competition on formerly captive customers, such as residential and small business consumers, by making the merged company better able to compete for market share. These customers can benefit from this enhanced competition for two reasons. First, by retaining profitable customers, the merged company retains a source of earnings that contributes to the fixed costs of serving all customers. Second, the competition for customers will take place with new and improved technologies that will produce benefits for all customers in the form of enhanced choices and lower costs.

11. Technological change is dramatically altering the competitive landscape in the telecommunications industry. Significant technological developments in radio communications, including microwave, satellite, terrestrial broadcast radio and television and cellular telephone, have dramatically lowered the cost, improved the quality and proliferated a wide range of wireless communications services. It is also increasingly clear that the coaxial wireline cable TV network will be upgraded technologically to provide point-to-point telecommunications services. Competition for incumbent telephone companies coming from new data services is rapidly expanding as they provide head-to-head competition with SBC and Ameritech's existing telecommunications services. Voice service delivered over the public switched network is facing increasing competition from data services, such as faxes and e-mails. The number of e-mails sent per day, for example, is growing at 55 percent annually and at that rate would reach 5 billion messages per day by the year 2005 in the U.S. alone.⁶ Moreover, many data services, such as faxes

⁶ "Telecom Restructured," *Forrester Research*, September 1997, p. 5. Also, George Gilder predicts that if growth in Internet usage continues at current rates, voice services will fall to less

and e-mails, are rapidly moving off the public switched network and onto the Internet and wireless networks.⁷ Dataquest predicts that the number of fax pages sent over the Internet rather than the public network will increase over one hundred fold from 44 million in 1997 to 5.6 billion in just three years.⁸

12. Data communications services are the fastest growing services in telecommunications, and none of this traffic is reflected in the standard measures of competition based on access lines. For example, Forrester research estimates that, by 2004, Internet telephony will divert \$3 billion of normal telco traffic.⁹ While these services are not perfect substitutes for voice services, it is clear that the degree of substitutability is increasing over time. According to a report by the International Engineering Consortium, traditional wireline voice service, which today generates more than 80 percent of total RBOC and IXC revenue, will amount to less than 50 percent by 2010.¹⁰

13. Not only are consumers using the Internet to send e-mail and files rather than dialing up their colleagues and sending faxes, but now the Internet can handle voice traffic (albeit voice broken into packets). With cheap transport, cost-effective packet-switches, and metro area SONET fiber rings, CLECs are bypassing much of the local exchange network. Commenting on the Sprint announcement of ION (a new broadband local telecommunications offering currently in

than 1 percent of telecom traffic by 2004. See "The Fiber Baron," *The Wall Street Journal*, October 6, 1997, p. A22.

⁷ E-mail and Internet faxes not only substitute for the local provider's retail services, in terms of intraLATA toll traffic, they also result in a loss of wholesale revenue through reduced switched access traffic.

⁸ "Dataquest Says Internet Faxing is on the Way to Provide Low-Cost Alternatives to Traditional Faxing," *Dataquest Press Release*, November 10, 1997.
<<<http://gartner3.gartner.com/dq/static/about/press/pr-b9757.html>>>.

⁹ "Telecom Restructured," *Forrester Research*, September 1997.

¹⁰ Robert M. Janowiak, Massoud Saghafi, and Jagdish N. Sheth, "Communications Outlook: Competition, Growth, and Consolidation," *Annual Review of Communications*, International Engineering Consortium, Volume 50, 1997.

development), Wall Street Journal analysts summarized the BOCs' situation in these terms:

“With data rapidly overtaking voice calls as the primary traffic on phone networks world-wide, the big phone companies need to retool their systems, lest rivals such as Sprint, IXC and even tiny Frontier Corp. move in quickly and lure away their high-spending business and residential customers. The newcomers can provide a full suite of voice and data services to business customers simply by leasing a pipeline from local carriers, relegating the Bells to the role of a wholesaler of dumb wires.”¹¹

14. Americans' increasing appetite for bandwidth is substantially impacting local competition by reshaping many competitors' strategies and destroying old paradigms such as local service. The most sought after access to the customers' premises may not be the two wire copper loop but the next generation “access” technology or the protocol that will “soup up” the loop.

15. An important point to note with respect to many of these new technologies is that they do not require access via the local loop provided by the incumbent LEC. For instance, Internet access is available both via fixed wireless facilities and cable modems. VSAT provides another important and evolving technology that bypasses LEC local loops VSAT networks compete directly with Ameritech, SBC and other exchange carriers by using satellite links in place of local loops. VSAT technology also offers higher reliability and increased adaptability by allowing a gradual increase in bandwidth without having to replace equipment.¹²

16. Besides VSAT technology, satellites are playing a very large role in other competitive aspects of telecommunications. Many of the world's largest firms are investing heavily in satellites for providing access. With their large geographic coverage, satellites offer the possibility of new and improved services such as global phone service, video, data broadcasting, and direct-to-car

¹¹ Stephanie N. Mehta and John J. Keller, “Sprint Plans to Integrate Voice, Data,” *Wall Street Journal*, June 3, 1998, p. A3.

¹² Robin Gareiss, “Satellite Services: Down to Earth and Ready for Business,” *Data Communications Magazine*, see <<<http://www.data.com/roundups/earth.html>>>, December, 1997, p. 4; Simon Bull, “Asia-Pacific VSAT Who Owns the Sky?,” *Data Communications Magazine*, see <<http://www.data.com/global_networks/sky.html>>, March, 1997, p. 2.

audio services.

17. A significant change growing out of the availability of many new technologies is the shift from modal to intermodal competition. Where technologies were once designed for a specific purpose (e.g. cable for television, wireless for mobile services), these technologies are now jumping across multiple applications. Cable modems are used for data traffic and wireless services supplement local wireline telephone services.

18. A variety of technologies are being used to either supply services traditionally offered by local telephone companies or to supply advanced services such as high speed data. Among these alternatives are PBX systems used by large customers or for virtual private networks from firms such as AT&T, MCI, or Sprint.

19. Yet another aspect of this technological revolution is fixed wireless. Fixed wireless applications are competing directly with services traditionally provided over the ILEC network such as access, high speed access, and call handling capabilities. The advantage of fixed wireless is cost-effective high bandwidth. In a proceeding on LEC provision of CMRS services, the Commission noted that "fixed wireless technology has developed to the point where it has the potential to provide a competitive alternative to the incumbent LEC network" and that "[i]n the wake of the development of fixed wireless services, incumbent LECs and CMRS operators are increasingly likely to be direct competitors, and wireless carriers can no longer appropriately be regarded as merely providers of adjunct services."¹³

20. It has long been recognized that cable holds a tremendous potential in offering direct competition to local telecommunications providers. That potential is now being reinvigorated. Whereas the cable companies' digital dreams of interactive video and voice in the early 1990s were

¹³ Report and Order, In the Matter of Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services, FCC WT Docket No. 96-162, rel. October 3, 1997, ¶ 54.

largely unrealized, they have found new life in the Internet era and the demand for high speed access. The nation's largest cable companies have started Internet access service via cable modems. Buoyed by the success of cable modems and the interest of Silicon Valley, the cable industry has also revived the strategy of converging entertainment and communications around TVs hooked into a cable connection with a small set-top box.

21. The merger of Ameritech and SBC must be viewed in the complex and evolving marketplace with its many players and technologies. It is insufficient to confine an analysis to "direct" sources of competition, examining only how many entrants are competing for local exchange service using their own facilities, unbundled network elements (UNEs), or resale. The competition from alternative services underscores the need for SBC and Ameritech to properly position themselves in the telecommunication industry. These alternative modes of communication services are increasingly becoming direct sources of competition as technology advances and consumer tastes evolve. Excluding these sources from an analysis of the merger leads to an underestimation of current competition and ignores highly significant market trends that are key strategic drivers for the transaction.

22. No one, of course, can know with certainty the contours of the telecommunications industry of the 21st century. Major telecommunications firms have been responding to these uncertainties in different ways. Many of the largest IXCs have been adding new services to their offerings by pursuing a strategy of acquisition. WorldCom, for example, has entered local exchange markets and has become the largest provider of Internet services by acquiring MFS, Brooks Fiber, UUNet, and if the merger is approved, MCI, to gain a total of 129 local networks across the country.¹⁴ AT&T, similarly, has acquired TCG, the largest CLEC in the U.S., and has announced plans to acquire TCI, the second largest U.S. cable provider.

¹⁴ *Inside the Competitive Local Exchange*, Third Edition, Telecom Publishing Group, 1997, pp. 93-97. See also, <<<http://www.brooks-fiber.com>>> and <<<http://www.mci.com>>>.

23. Other entrants are positioning themselves to serve customers through strategic alliances and partnerships in order to expand into new product and geographic markets. Several IXC's, including AT&T and MCI, have expanded into local markets by forming alliances with CLECs already operating in these markets. For example, MCI has signed preferred provider agreements with three CLECs covering 79 markets whereby MCI uses the networks of these CLECs to offer local service to customers, bypassing the networks of the incumbent LEC.¹⁵ AT&T has signed several similar agreements for the same purpose. Electric utilities are also entering new markets by leveraging their existing fiber assets into telecommunications through partnerships with CLECs and other telecommunications providers. ICG, for example, has partnered with several electric utilities throughout the country, gaining it access to over 2,000 miles of fiber, including 1,200 miles leased from Southern California Edison.¹⁶

24. Still other entrants are pursuing resale strategies to enter new markets and offer one-stop shopping. MCI, for example, has added paging to its offerings by purchasing wholesale services from PageNet and SkyTel, and has a resale agreement with Nextwave to purchase at least 10 billion minutes of PCS capacity over the next ten years.¹⁷ Of course, many entrants are entering local

¹⁵ The agreement with Brooks accounts for 37 of the markets, ACSI accounts for 21, and Hyperion for 21. See "Brooks Expands Preferred Provider Agreement with MCI," Brooks Press Release, July 10, 1997. See also, "MCI Selects ACSI As Preferred Provider in 21 Markets," *Telecom A.M.*, Telecom Publishing Group, Vol. 3, No. 20, January 31, 1997. Also, "Hyperion Named as MCI Preferred Provider of Dedicated Access Circuits," Adelphia Press Release, July 9, 1997.

¹⁶ "ICG Communications Announces Fiber Network Project in Atlanta," *ICG Press Release*, June 11, 1997; "ICG Telecom Group Enters Agreement To Lease 105-Mile Fiber Network From The L.A. Department of Water," *ICG Press Release*, September 25, 1996; "ICG Communications, Inc. And American Electric Power Enter Agreement To Add 45-Mile Fiber Optic Network In Columbus Metropolitan Area Plus 138-Mile Link To Canton," *ICG Press Release*, August 6, 1996; "IntelCom Group announces agreement with Southern California Edison to lease in excess of 1,200 fiber-optic route miles, a three-fold expansion of network," *ICG Press Release*, March 27, 1996; "Landmark Venture Joins Major Utility With Competitive Phone Carrier," *ICG Press Release*, January 14, 1997.

¹⁷ John Zahurancik and Elliot Hamilton, "Trends in World Paging and U.S. Paging," *MTA-EMCI Review*, 1996 as seen in *StrataViews* at <<<http://www.strategisgroup.com>>>. "MCI Enters

exchange markets around the country by offering resold services of incumbent local exchange carriers. USN Communications is packaging a comprehensive product offering through resale agreements with various facilities-based telecommunications providers.

25. As these examples illustrate, telecommunications firms are pursuing a wide range of strategies to prepare for the uncertain future of the industry. Some firms are integrating by acquiring firms that supply complementary products or similar products in different geographic markets. This strategy exploits economies of scope and scale in production and allows these firms to supply products that better satisfy consumer demands. The restructuring and redefining of the market, characterized by a constantly changing cast of niche players, mom and pop outfits, small entrepreneurial firms, and large fully integrated ones, is in response to the regulatory, technological, and market changes that have been taking place since divestiture and before.

26. The global telecommunications market and its occupants are undergoing profound change. "I think you're beginning to see a lot of positioning, getting ready for the new world order in telecommunications," said Dave Otto, a telecommunications industry analyst at Edward Jones, in St. Louis.¹⁸ Similarly, François Fillon, France's telecommunications minister, expects that many national markets will give way to one worldwide market. "The world telecom market will be organized around three or four or five big global operators," Fillon said.¹⁹ Firms like AT&T, the United Kingdom's BT and Japan's NTT are all attempting to compete by increasing and maintaining a large scale. The merger of SBC and Ameritech will create a company with the resources and technological assets to compete with these industry giants. In the dynamic and increasingly competitive environment that characterizes the evolving telecommunications marketplace, the merged SBC-Ameritech will be under intense pressure to offer consumers

Wireless Agreement With Nextwave," at <<<http://www.qualcomm.com>>>, August 26, 1996.

¹⁸ InfoWorld, July 21, 1997, Telcos go after international market.

¹⁹ infoWorld, 1/13/97.

attractive quality-adjusted prices to retain and win customers and to re-invest productivity gains from the merger to remain competitive.

III. Consumer Benefits from the SBC-Ameritech Merger

27. The merger of SBC and Ameritech will benefit consumers in five respects:

- a) By combining the resources of SBC and Ameritech, the merger will enhance investment opportunities and speed the introduction of new services and technologies.
- b) The merger will facilitate diffusion of best practices between SBC and Ameritech, thereby lowering costs and facilitating the deployment of new services.
- c) The merger will make possible other cost reductions by exploiting economies of scale and scope and by enabling purchasing economies.
- d) Consumers will benefit from market responses to the announced national/local business strategy of the merged firm.
- e) The merger will reduce the risk that ratepayers will be left responsible for the stranded assets of a company that is not competitive in the global telecommunications market.

28. The merger will generate the consumer benefits listed above in three different ways. The first is from improvements in the internal operations of the merged firm, which result in faster deployment of existing services, new services that are introduced more rapidly as a result of more effective research and development, and lower production costs that are passed on to consumers in competitive telecommunications markets. The second general source of consumer benefits is from market responses to the merged firm's operations. Entry into out-of-region markets, a key element of the merger's business plan, likely will cause other telecommunications firms to enter the merged firm's territory with their own integrated services. This competition will bring lower prices and

more choices to consumers. Finally, by making the combined firm a more effective competitor, the merger will mitigate losses of profitable customers to rival telecommunications suppliers, and thereby reduce the risk of stranded assets. We have addressed in Section II the impacts of the merger on market participants and on the ability of the merged firm to retain customers in the new telecommunications industry. This section focuses on the likely effects of the merger on the internal operations of the merged firm. Although efficiency gains cannot be predicted with certainty, the estimates summarized in this section were prepared with due diligence and with the benefit of experience from the SBC-Pacific Telesis merger.

A. Accelerate the Delivery of New Services

29. The merger of SBC and Ameritech will benefit consumers by facilitating the development and introduction of new services and packages of services. The merged company will be able to develop and introduce these new services and packages of services at lower cost and more rapidly than SBC and Ameritech could achieve without the merger. Consumers will benefit directly from these new service offerings.

30. The conclusion that consumers will benefit from the merger of SBC and Ameritech is supported by economic theory and by the experience of the merger of SBC and Pacific Telesis. Research and development has the characteristic of a public good, which means that, as a matter of economic theory, the results of an R&D program can be applied to almost any scale of operations without diluting its value. Thus, R&D performed by SBC can be used to benefit the operations of the merged company, as can R&D performed by Ameritech. Redundant R&D expenditures can be avoided and the remaining R&D delivers more “bang for the buck” because it benefits the total operations of the merged company. Similarly, the merger reduces the cost of research and development by permitting R&D expenditures to be amortized over a larger customer base.

31. A merger would raise economic concerns about effects on research and development only if the merger would substantially concentrate markets in which the parties are actual or potential

competitors. SBC and Ameritech presently do not compete in the provision of wireline services. We understand that SBC and Ameritech may be required to sell any overlapping cellular systems as part of the completion of the merger. Thus there is no risk that the merger would result in higher concentration in markets for existing wireline or wireless access or exchange services. For most other telecommunications services, such as Internet access, competition exists from a wide range of sources. These include, as discussed in Section II above, various forms of wireless technologies including satellite and microwave systems, and cable-based systems. These services can be provided by a large number of actual and potential competitors, ranging from small, specialized providers of dedicated access services to large IXCs that can provide a full range of access and switching services. Given the diversity of competition that can exist for these services, there is no reason to believe that the merger of SBC and Ameritech could have any adverse consequences for the rate of investment in research and development for new telecommunications services.

32. The benefits of the merger for research and development are not merely theoretical. The experience of the SBC merger with Pacific Telesis demonstrates that these economies are real. SBC and PacTel represented that their merger would deliver substantial efficiency gains as the merged company could exploit the knowledge base of each of the merger parties to improve the quality of existing services, introduce new services, and raise productivity. Experience since the merger indicates that these representations were accurate estimates of the merger benefits.

33. The merger will accelerate the introduction of new products and services to consumers by exploiting complementary research and testing activities and by allowing the merged firm to spread the risks and costs of R&D and product introduction over a larger customer base. In addition to the cost savings from the combination of R&D, there are synergies to be obtained by having experienced and talented researchers exchanging new ideas and approaches to technological problems. The combination of research talent allows the organization to tap the collective expertise and experience of the two companies, and thus encourages the development and adoption of new technologies. Furthermore, the larger market area enhances market experimentation and new

service introduction by providing more numerous and more diverse test markets.

34. As with the cost savings described above, the benefits of combining R&D and marketing to speed the development and introduction of new products are not likely to occur without the merger. The advantage of an integrated firm is that technical standards can be agreed upon quickly and enforced hierarchically. In a joint venture arrangement, rivalry, opportunism, and genuine disputes over the best standards could needlessly delay the development and introduction of new services.

35. An example of the likely benefits of the merger is the expected effect on the employment of Digital Subscriber Loop (DSL). DSL exploits unused bandwidth on standard phone lines without interfering with voice transmissions. DSL can be considered the second wave of products (the first wave being ISDN) targeted to the remote access market. Asymmetric DSL implies that transmission speed depends on the direction of data transmission.²⁰ Some of the advantages of DSL connections over ISDN and analog modems include (1) no need for call setup since the connection is always on, (2) no busy signals, and (3) the local loop bandwidth is not shared with other residential subscribers.

36. Both Ameritech and SBC have experience in developing DSL service. SBC is using its R&D subsidiary, Technology Resources, Inc. (TRI) to assist in the deployment of DSL technology.²¹ In late 1997, SBC began offering FasTrak DSL services under the Pacific Bell brand in San Francisco and under the Southwestern Bell brand in Austin, Texas. The first service offers 384 Kbps to and from a carrier central office. The second service works at 1.5 Mbps downstream and 384 Kbps upstream.²² SBC plans to make asymmetric DSL services available to approximately 4.4 million households and 650,000 business customers by the end of 1998. The cost of the

²⁰ For a more detailed discussion on the operation of DSL and its current impediments, see Joanna Makris, "DSL Services," *DATA COMMUNICATIONS*, April 21, 1998 at 38.

²¹ Kaplan Affidavit ¶ 20(c).

²² "SBC unveils two new DSL test markets," *ISDN NEWS*, Dec. 12, 1997.

services (including unlimited Internet access) will range from \$199 to \$339 per month.²³

37. Ameritech is also introducing DSL. In June 1998, Ameritech accelerated the deployment and enhanced the scalability of its newly announced DSL service. The new Subscriber Management System (SMS) will allow a broader population of business and consumer subscribers to enjoy the benefits of high-speed Internet access.²⁴ The SMS 1000 can aggregate as many as 4000 DSL virtual circuits or Frame Relay logical connections over high-speed links generating from multiple central offices (COs). Using a unique capability known as "multiple contexts", Ameritech can enable a single DSL connection to support multiple types of subscriber services such as multiple Internet Service Providers (ISPs).²⁵ This service provides only one example of the many that will likely surface in the near future.

38. As noted by Martin Kaplan, the combined company would realize efficiencies in the deployment of DSL services by consolidating testing, technical consulting, and the preparation of engineering design specifications using SBC's Technology Resources, Inc. subsidiary. These benefits can be obtained with little or no incremental cost because of the public good characteristic of the R&D already being performed at TRI. While the companies have not yet planned how to merge their R&D operations, it is virtually certain that there will be numerous other situations in which the combination of SBC and Ameritech will accelerate the pace of both introduction and commercialization.

B. The Merger Will Generate Significant Additional Efficiency Gains That Cannot Be Realized Otherwise

39. The merger of SBC and Ameritech will generate additional efficiency gains by exploiting

²³ "Bell Atlantic, SBC to toll out ADSL," *ISDN NEWS*, June 16, 1998.

²⁴ "DSL: Ameritech selects RedBack SMS 1000 for scalable support of broadband access service," *EDGE, ON & ABOUT AT&T*, June 15, 1998.

²⁵ *Id.*

economies of scale and scope. SBC estimates the total efficiency gains to be \$2.5 billion, of which \$778 million is from expected revenue synergies. Cost savings amount to \$1.43 billion, and the remainder arises from increased revenue (from increased penetration of value-added services) and cost savings in in-region long distance.²⁶ The increases in competition from alternative technologies ensure that a large share of the efficiencies generated by the merger will accrue to consumers.

40. The merger of SBC and Ameritech provides opportunities for the merging firms to reallocate and reorganize resources in ways that reduce costs while increasing or maintaining the quality of the services provided. The potential for more efficient resource utilization exists in a wide variety of areas. Among them are rationalizing repair and maintenance facilities over a combined firm, lower cost purchasing and the attainment of scale economies in administrative functions. In addition to efficiency improvements, quality improvements can be expected in many areas such as repair and maintenance and the more rapid introduction of new technologies and products, discussed above. These cost reductions and quality improvements either would not occur in the absence of the merger, or would occur more slowly and at higher cost. Experience with the SBC-Pacific Telesis merger reveals that these efficiencies are real and substantial.

41. The merger will benefit customers through a reduction in repair times, installation times, and increased efficiency in customer service. SBC estimates that the reduction in trouble reports and field dispatches alone will reduce costs by \$250 million, and will result in improved technician productivity and better customer service. Much of this improvement will result from combining the operations and facilities of the two separate firms, and from the application of best practices. As noted above, SBC has considerable experience bringing together the best practices of different companies to improve these areas to the benefit of consumers, while reducing costs.

42. The merger will also generate technical efficiencies in other operational areas. One area is

²⁶ Kaplan Affidavit ¶ 2,7,17,23, 27.

in provisioning and maintenance. The merger can bring about a reduction in trouble reports and field dispatches in Ameritech's territory, as well as improved technician productivity, through the adoption of best practices. In addition to better service, SBC estimates the resultant cost savings to be \$115 million.²⁷

43. SBC and Ameritech have over 3100 combined switches and 120 tandems.²⁸ The companies currently use two different methods of acquiring and maintaining switches, with Ameritech outsourcing its switch engineering functions and SBC performing these functions in-house. The merger would allow the combined entity to take advantage of scale economies in performing these functions, and to generate substantial cost savings in switch procurement because of its larger size. SBC estimates cost savings of \$45 million annually from combining these operations.²⁹ These savings would also carry over to the design and purchase of software upgrades for the switches to allow for new and improved services to be delivered by existing switching equipment.

44. As with switching, Ameritech also outsources billing and OSS while SBC companies maintain their own data systems. These functions are subject to large economies of scale, and the merger allows the parties to reduce costs by combining and standardizing these operations. SBC estimates these savings at \$227 million.³⁰

45. One of the biggest areas where economies of scale may result is in the area of purchasing. The combined entity will be a larger customer for vendors and will be better able to exploit economies of scale in the production of telecommunications equipment. One of the many examples available is the price that the combined entity would pay for cellular and PCS handsets. The

²⁷ Kaplan Affidavit ¶ 21(a).

²⁸ Kaplan Affidavit ¶ 21(b).

²⁹ Kaplan Affidavit ¶ 21(b).

³⁰ Kaplan Affidavit ¶ 20(b).

combined firm's larger scale would allow the combined entity to negotiate better contracts for these and other essential components. Given the competitive nature of the cellular business and the increasingly competitive nature of all telecommunications services, these savings would be expected to flow substantially to consumers. The scale economies in procurement would apply to many other areas as well. SBC estimates that the total procurement savings will amount to \$381 million.³¹ Another area where scale affects purchasing is in long distance, where the increased volume after the merger will allow the company to receive larger volume discounts for wholesale interexchange services.

46. Still another area where efficiencies can be expected is in the elimination of duplicative administrative functions, including headquarters functions (accounting, HR, etc.), reduction in the number of operations, repair, telemarketing, and collection centers, and the combination of marketing and product development functions. Savings in these areas are a result of scale economies in these operations. For instance, the two companies face many of the same legal issues and circumstances so that the increase in size due to the merger does not require an equivalent increase in the size of the legal department. The efficiencies resulting from this combination of factors show up as both lower costs and increased ability to quickly develop and introduce new products and technologies.

47. In addition to the benefits described earlier, the application of best practices allows for other operational savings as well in areas such as network design, operator services, etc. SBC estimates these savings to be \$153 million.³²

D. Consumer Benefits from Organizational Efficiencies and Synergies

48. In addition to the technical efficiencies and cost savings enumerated above, the merger

³¹ Kaplan Affidavit ¶ 20(a).

³² Kaplan Affidavit ¶ 23.

allows the combined firms to exploit certain synergies in their operations. These synergistic effects include the ability to develop and roll out new technologies faster and to more consumers.

49. Combining Ameritech and SBC will have a variety of synergistic effects that are separate from and in addition to the cost savings above. They arise from the overall benefits stemming from a larger entity that has the benefit of the combined expertise of the two companies encompassing a larger geographic area. Information or experience gained in one firm can be transferred or shared with the other. These kinds of benefits directly result from a merger of the units and incentives of the two firms.

50. A number of benefits accrue immediately upon merging. Products or services "owned" by one company can be introduced to customers of the other. Test marketing that is conducted in one area can now be spread over a larger roll out area, benefiting customers of both companies. However, this is more than just spreading the costs over a larger base. The availability of more test market areas and the larger market over which product costs can be recouped can help to make economical the introduction of services that otherwise would not be brought to market. It may also permit the introduction of services that have higher risk associated with them since they would have a greater likelihood of cost recovery.

E. Expanding the Adoption of Existing Services

51. Consumer access to existing services will be expanded by allowing the combined entity to use the best marketing practices of each merging partner and by the synergistic effects of combining their expertise in marketing. Combining market research and development efforts across firms allows better customer focus, lowers market research costs and allows the more effective use of its results.

52. SBC has had particular success in some areas and would be expected to transfer that success to Ameritech upon completion of the merger. Ameritech, also brings to the table specialized expertise and experience that will synergistically enhance the marketing and packaging of services.

One area the people at SBC point to where Ameritech is successful is Centrex. According to SBC, Ameritech is an industry leader in Centrex. SBC estimates that improved marketing and Ameritech's Centrex experience could increase sales by \$120 million.³³ It is important to note that these increased Centrex revenues come from making SBC and PacTel more competitive marketers of Centrex technology, which is in direct competition with other technologies such as PBX. Thus, applying Ameritech's know-how and best practices to SBC's Centrex business is strongly procompetitive. Further study may reveal other areas where application of Ameritech's best practices and know-how can be beneficially transferred to SBC and its customers.

53. SBC has extensively studied how it can apply its strengths and knowledge to Ameritech's product offerings. According to data supplied by SBC, in addition to the Centrex example above, the company can be expected to expand customer purchases in a number of areas, including the following.

- SBC has had particular success in the services covered by what are known as vertical features, such as call waiting, return call service, and voice mail. For example, vertical service revenues for SBC increased by approximately 20% in 1997 and 29% in 1996.³⁴
- Caller ID is another vertical service where SBC's marketing prowess may well yield increased market penetration. In its five-state territory, SBC's marketing efforts resulted in half of its residential customers subscribing to caller ID.³⁵ In Pacific Bell's territory, caller ID penetration has increased from 1% to 9% since the merger. SBC estimates that application of best practices and individual firm know-how across the broader organization will increase sales of vertical

³³ Kaplan Affidavit ¶ 14.

³⁴ SBC 10-K Filing Submitted to SEC, March 11, 1998.

³⁵ Anita Raghavan, Steven Lipin, and John J. Keller, "Growing Up: SBC Communications to Acquire Ameritech in a \$55 Billion Deal," *WALL STREET JOURNAL*, May 11, 1998, at A1.

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

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

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

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
<i>Financial Data</i>					
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%
<i>Operating Data⁸</i>					
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.

⁸ 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

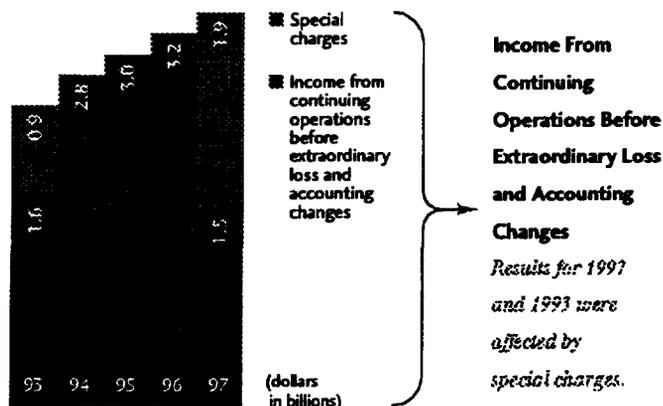
Financial results, including percentage changes from the prior year, are summarized as follows:

	1997	1996	1995	Percent Change	
				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.



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

MANAGEMENT'S DISCUSSION AND ANALYSIS, continued

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:

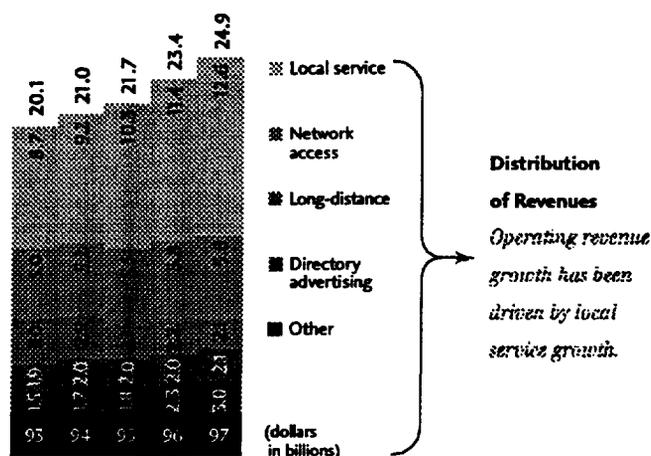
	1997	1996	1995	Percent Change	
				1997 vs. 1996	1996 vs. 1995
Local service					
Landline	\$ 9,568	\$ 8,754	\$ 8,118	9.3%	7.8%
Wireless	3,034	2,635	2,247	15.1	17.3
Network access					
Interstate	3,946	4,008	3,770	(1.5)	6.3
Intrastate	1,869	1,823	1,744	2.5	4.5
Long-distance service	2,115	2,240	2,072	(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

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.

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.



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

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:

	1997	1996	1995	Percent Change	
				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

MANAGEMENT'S DISCUSSION AND ANALYSIS, continued

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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.

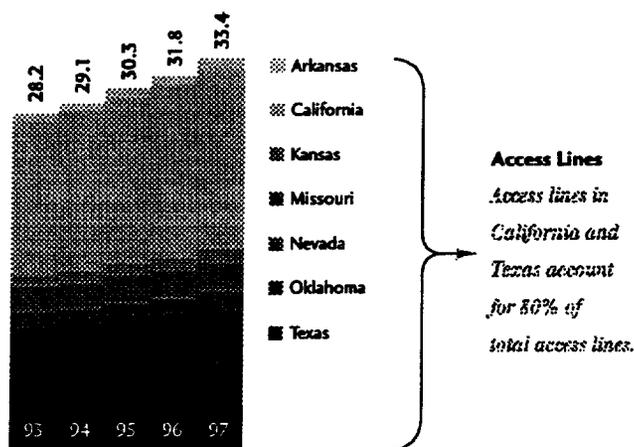
Federal Regulation During 1997, the FCC issued an Access Reform Order restructuring access charges paid for interexchange carrier access to the Telephone Companies' networks. The order raises the flat monthly end user charge for primary business lines, and additional residence and business lines, and 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.



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

MANAGEMENT'S DISCUSSION AND ANALYSIS, continued

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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

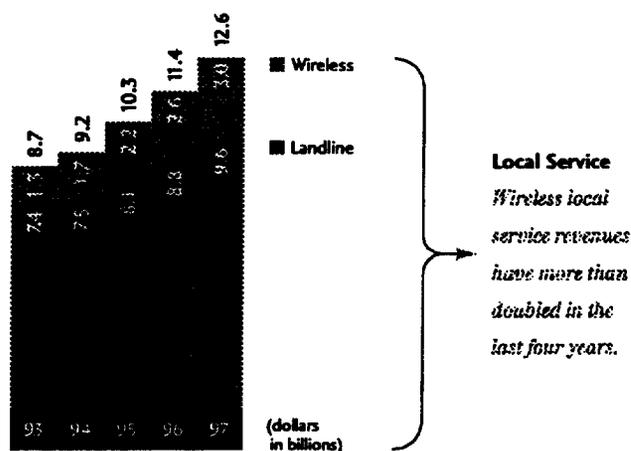
various aspects of competition within, and regulation of, the telecommunications industry. The Telecom Act provides that all post-enactment conduct or activities which were subject to the consent decree issued at the time of AT&T divestiture of the Regional Holding Companies (RHCs), referred to as the 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS, continued

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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.

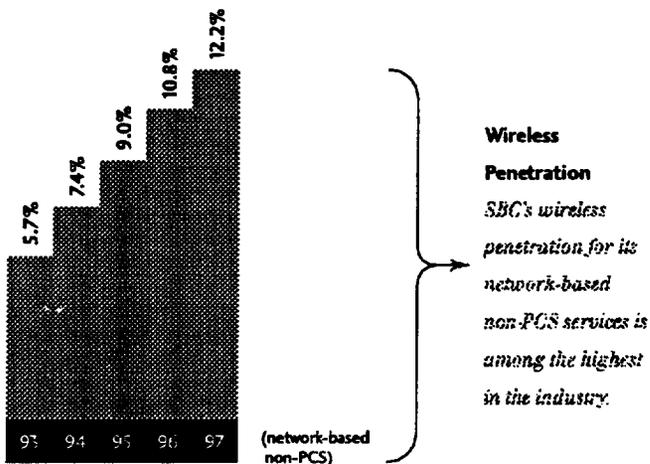
The CPUC has issued orders regarding the implementation of competition in 1997. Some of the key ones include permitting the resale of Centrex services to businesses only, prohibiting aggregation of customers to obtain toll discounts, enforcing optional calling plans retail tariff restrictions on resale, 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 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

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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.

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.

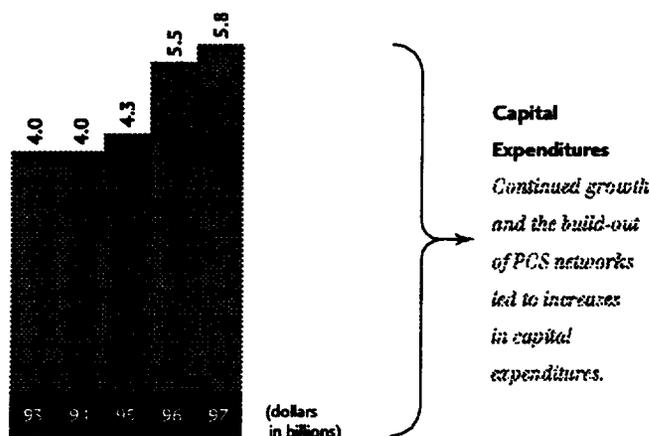
Throughout 1997 and in February 1998, SBC sold portions of its Telmex L shares so that SBC's total equity investment remained below 10% of Telmex's total equity capitalization.

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.



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.

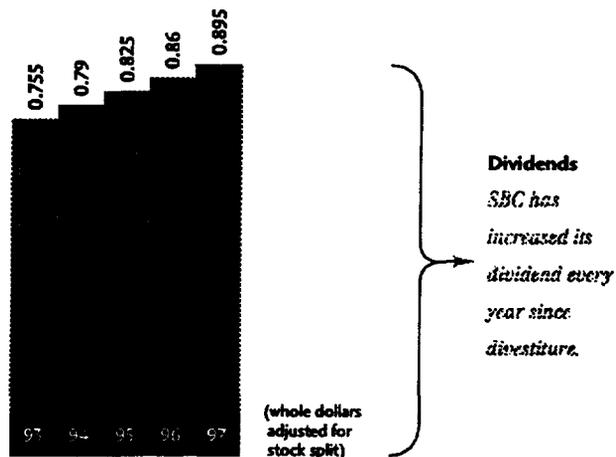
Over the next few years, SBC expects to incur significant capital and software expenditures for customer number portability, which allows customers to switch to new local competitors and keep the same phone number, and interconnection. SBC expects capital costs and expenses associated with customer number 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS, continued

Dollars in millions except per share amounts



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
<i>Operating Revenues</i>			
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
<i>Operating Expenses</i>			
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
<i>Other Income (Expense)</i>			
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
<i>Assets</i>		
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
<i>Liabilities and Shareowners' Equity</i>		
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
<i>Operating Activities</i>			
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
<i>Investing Activities</i>			
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)
<i>Financing Activities</i>			
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.