SBC/Ameritech Merger Investigation
For the Illinois Commerce Commission

FINAL REPORT

January 8, 2001

SBC/Ameritech Merger Investigation For the Illinois Commerce Commission

FINAL REPORT

January 8, 2001

Primary Contact Person

John D. Heaton
Managing Director
Barrington-Wellesley Group, Inc.
5574 Brookline Drive
Orlando, FL 32819
Phone (407) 876-5825

SBC/Ameritech Merger Investigation

Table of Contents

I. Executive Summary

Background I-1

Summary of Results I-1

Quantified Results of Investigation I-8

Recommendations I-10

Acknowledgement I-14

II. Audit Scope and Approach

Introduction II-1

Audit Scope and Objectives II-1

Detailed Work Plan II-2

Organization of the Report II-5

Generally Accepted Government Auditing Standards II-6

Project Deliverables II-9

Project Schedule II-11

Glossary of Terms and Acronyms II-12

III. Regulatory Compliance

Introduction III-1

Illinois Commerce Commission Order III-1

Federal Communications Commission Order III-6

Audit Objectives III-7

Evaluative Criteria III-8

Summary of Audit Procedures III-8

Findings and Conclusions III-8

Quantified Results of Investigation III-12

Recommendations for the Company III-12

Policy Issues for the Commission III-12

Future Audit Issues III-12

IV. Internal Controls

Introduction IV-1

Objectives IV-1

Evaluative Criteria IV-2

Summary of Audit Procedures IV-2

Findings and Conclusions IV-4

Quantified Results of Investigation IV-13

Recommendations for the Company IV-13

Policy Issues for the Commission IV-13

Future Audit Issues IV-13

V. Affiliate Transactions

Background V-1

Objectives V-6

Evaluative Criteria V-6

Summary of Audit Procedures V-6

Findings and Conclusions V-7

Quantified Results of Investigation V-19

Recommendations for the Company V-19

Policy Issues for the Commission V-20

Future Audit Issues V-20

VI. Cost Allocation

Introduction VI-1

FCC Cost Allocation Guidelines VI-1

The Ameritech Cost Allocation Manual VI-3

Non-Regulated Activities VI-4

Incidental Activities VI-7
Cost Apportionment Methodologies VI-8
The Ameritech Part 64 Cost Allocation System VI-10
Audit Objectives VI-11
Evaluative Criteria VI-11
Summary of Audit Procedures VI-11
Findings and Conclusions VI-12
Quantified Results of Investigation VI-21
Recommendations for the Company VI-21
Policy Issues for the Commission VI-21
Future Audit Issues VI-21

VII. Reported Costs and Savings

Introduction and Summary VII-1
Savings and Recoverable Costs VII-1
Merger Transaction Costs VII-2
Procedural History VII-3
Employee-Related Transaction Costs VII-4
1999 Reported Costs and Savings VII-6
Employee-Related Costs VII-11
Employee Retention Payments VII-12
Change in Control and Severance Payments VII-14
Non-Change in Control Severance Plans VII-19
Stock Options VII-20
Audit Objectives VII-22
Evaluative Criteria VII-22
Summary of Audit Procedures VII-22
Questioned Costs VII-23

Findings and Conclusions VII-23
Quantified Results of Investigation VII-41
Recommendations for the Company VII-43
Policy Issues for the Commission VII-43
Future Audit Issues VII-43

VIII. Merger Integration Team Analysis

Introduction VIII-1
Merger Cost and Savings Planning Process VIII-1
Tracking and Reporting of SBC Merger Costs and Savings VIII-6
Allocation to Illinois VIII-12
Hypothetical Questions VIII-14
Objectives VIII-14
Evaluative Criteria VIII-15
Findings and Conclusions VIII-20
Quantified Results of Investigation VIII-44
Recommendations for the Company VIII-44
Policy Issues for the Commission VIII-44
Future Audit Issues VIII-45

IX. Additional Savings Possibilities

Introduction IX-1
Original SBC Savings Estimates IX-1
Investigation of Other Potential Savings IX-4
Pension Expense IX-6
Audit Objectives IX-10
Evaluative Criteria IX-10
Summary of Audit Procedures IX-10
Findings and Conclusions IX-10

Quantified Results of Investigation IX-21
Recommendations for the Company IX-21
Policy Issues for the Commission IX-21
Future Audit Issues IX-21

Chapter I

Executive Summary

Chapter I

Executive Summary

In this chapter of the report, we summarize the results of our investigation of the October 1999 merger between SBC Communications, Inc. (SBC) and Ameritech Corporation (Ameritech). Our audit was performed in accordance with Generally Accepted Auditing Standards and is referred to as the SBC/Ameritech Merger Investigation in this report.

Background

The Barrington-Wellesley Group, Inc. (BWG) performed the SBC/Ameritech Merger Investigation in accordance with the terms of a February 25, 2000 contract (Contract) with the Illinois Commerce Commission (ICC or Commission). In its Request for Proposals (RFP) relating to the audit and in the Contract, the Commission established broad objectives for the audit as follows:

1. Determine whether an updated Cost Allocation Manual (CAM) appropriately allocates costs between Ameritech Illinois (AI) and it affiliates and between regulated and non-regulated activities.

2. Develop accounting standards and assist the Commission in tracking merger-related costs and savings as determined by the Commission's Order approving the merger of SBC and Ameritech.

As more fully discussed in Chapter II, Audit Scope and Approach, the audit consumed 5,500 professional staff hours and was performed in four distinct phases from March 22, 2000 through January 8, 2001 when we delivered this Final Report. The Planning and Orientation phase of the audit was completed with the delivery of a Detailed Work Plan on May 19, 2000. We performed our Technical Review in the eight separate areas of investigation shown in Exhibit ES-1 below, and delivered Task Reports for review by the Commission Staff and verification by the Company from June 29, through November 22, 2000. We provided a Draft Report on December 20, 2000 and delivered a completely annotated copy of the Confidential Final Report and a second Final Report prepared for public distribution to the Commission Staff on January 8, 2001.

Exhibit ES-1
Outline of the Report

Cost Allocation Manual	Merger Costs and Savings
• Regulatory Compliance	• Recorded Cost and Savings
• Internal Controls	• Merger Integration Teams
• Affiliate Transactions	• Additional Savings Possibilities
• Cost Allocation	• Early Warning System (provided separately)

Summary of Results

Significant audit conclusions resulting from our investigation are listed below.

Regulatory Compliance

- AI has complied with the Commission's requirements relating to the filing of updated Cost Allocation Manuals, Affiliate Service Agreements and Compliance Reporting set forth in the Merger Order in Docket 98-0555.

- Although the Illinois Cost Allocation Manual (ICAM) and Ameritech Cost Allocation Manual (ACAM) should be essentially the same, there are several general ledger accounts referenced in the ACAM that are not included in the ICAM.

- SBC has complied with conditions set forth in the FCC Merger Order with respect to matters within the scope of this investigation.

Internal Controls

- In response to ICC and FCC requirements, SBC has established a high level Merger Compliance organization and is actively monitoring its performance against the compliance stipulations contained in the respective merger orders.

- Ameritech currently has an appropriate, experienced organization in place to control the cost allocation process and ensure CAM compliance. However, it is likely that the experience level in organizations responsible for CAM compliance will be affected by the reorganization and consolidation resulting from the merger.

- Ameritech has developed appropriate controls over the cost allocation process.

- Ameritech has developed and implemented an appropriate process to ensure compliance with FCC requirements regarding revisions to the Ameritech Cost Allocation Manual (ACAM). Merger-related changes to the ACAM were appropriately implemented using Ameritech's standard ACAM revision process.

- The Company has a well-documented Cost Allocation system called the Part 64 Cost Allocation System (PCAS). This system was created by Ameritech to properly allocate costs between regulated and non-regulated activities and to pass these costs to Ameritech's Separations System for use in preparing FCC Report 43-03, the Joint Cost Report or ARMIS Report.

- Although the SBC Executive Compensation and Management Incentive Plans do not specifically contain performance standards relating to service quality or the achievement of merger savings, existing performance standards are not in conflict with the Commission's requirements in these areas.

- Both the Ameritech and SBC Codes of Conduct provide adequate information and guidance to employees regarding legal and ethical behavior in a wide range of business situations. Merger related issues are adequately addressed in sections relating to Compliance with FCC Regulations for all employees and in supplements to the Codes of Conduct for others on a jobs related need to know basis.

- Both SBC and Ameritech have procedures relating to the investigation of violations to their Codes of Conduct and maintain reports to ensure that disciplinary action against violators is consistent and appropriate.

- The Ameritech internal audit organization is appropriately staffed and has developed an audit plan that adequately addresses the cost allocation process. The Company has taken appropriate corrective actions in response to audit findings.

- There are no readily accessible auditing tools available to test PCAS transactions. FCC reviews of PCAS external audits found compliance testing weaknesses.

Affiliate Transactions

- Ameritech has adequate internal controls to provide reasonable assurance that affiliate transactions are accounted for in accordance with FCC and Commission requirements.

- BWG's review of 1999 affiliate charges to AI indicates that transactions are priced in accordance with FCC regulations.

- The Company properly developed and applied loading rates in the determination of Fully Distributed Costs in 1999. Loading rates are added to direct charges to recoup indirect costs, overheads, and support costs that are not charged directly.

- The Company's independent auditor found no material exceptions relating to affiliate transactions in their audit of the 1999 ACAM.

- BWG's audit tests indicate that the Company has used an inappropriate method to calculate the 5 State Allocator which results in the over-charging of certain SBC and Ameritech Services, Inc. (ASI) costs to Ameritech Illinois.

- With the merger, there have been significant organizational and operational changes involving new corporate service affiliates, but allocation factors have not been adjusted to reflect these changes. It will be important to re-examine allocation factors once the full transition is complete.

- Billings to Ameritech Illinois from other Ameritech Operating Companies (AOCs) during the first quarter 2000 appear justified and are reasonable.

- Ameritech Illinois charges to affiliates in 1999 were adequately controlled and billed in accordance with FCC Rules.

- A comparison of AI charges to affiliates in 1999 and 2000 by pricing method reveals a projected reduction in affiliate billings in the year 2000.

- Although Ameritech is in the process of implementing SBC *Operating Practice 125 MP, Affiliate Transactions*, the Company has concluded that no compensation is due to

Ameritech Illinois relating to the exchange of Intellectual Property and Proprietary Information among companies involved in the merger.

- Although SBC and Ameritech adopted new procedures relating to the capitalization of computer software costs for financial reporting purposes in 1999, the change was not adopted for regulatory reporting purposes until 2000.

Cost Allocation

- Ameritech's cost allocation procedures and controls are adequate to prevent the occurrence of material misstatements. The Company has a well-documented Cost Allocation System and has implemented an appropriate process to ensure compliance with FCC requirements regarding revisions to the ACAM.

- The results of external audits indicate that the Ameritech cost allocation process, as documented in its CAM and executed in PCAS, properly allocates costs between regulated and non-regulated activities.

- The Company's current method of calculating the Marketing Allocator produces an inaccurate result. The Company was made aware of this in the 1999 independent audit and is planning to change its procedures to correct the problem. However, at the time of our audit tests, needed changes had not been implemented.

- There was an increase in non-regulated costs between the 1st Quarter of 1999 and the 1st Quarter of 2000 for most of the Part 32 accounts tested related to National Directory Assistance Service (NDA), which properly reflects the cost-allocation impact of the new non-regulated service.

- As compared to their peers, AI and Ameritech have high non-regulated to total cost ratios. This indicates a sufficiently aggressive approach to the allocation of costs to non-regulated activities.

- There are significant differences between the SBC CAM and the ACAM. Conversion by AI to the SBC CAM could produce significant shifts in costs from non-regulated to regulated services.

Reported Costs and Savings

- As required by the Commission's Amended Order, the Company filed its 1999 Cost and Savings Report for the period ended December 31, 1999 in April 2000. While the Company has complied with the Commission's reporting requirements, the use of Uniform System of Accounts (USOA) accounts alone does not allow for specific identification of areas of potential interest to the Commission.

- In the 1999 Cost and Savings Report, the Company netted $1.6 million of costs against reported savings of $0.4 million for a negative net savings of $1.2 million.

- The Company did not have sufficient procedures or training programs in place to ensure that merger transaction costs were not charged to merger implementation tracking codes, and as a result had to rely on an after-the-fact review of charges by SBC personnel to ensure transaction costs were not netted against savings in the 1999 Report.

- SBC's treatment of certain non-Executive Committee employee severance and relocation costs may be inconsistent with the Commission's Order and Amended Order.

- The 1999 Costs and Savings Report includes approximately $463,000 of merger costs associated with compliance activities. $90,000 of these costs are allocated to AI. The inclusion of these costs in the 1999 Costs and Savings Report is not clearly supported by the Merger Order or Amended Order.

- The 1999 Costs and Savings Report includes $2.7 million associated with the cost of conversion to a common SBC/Ameritech e-mail system $0.5 million of this cost is allocated to the Illinois regulated jurisdiction. The inclusion of e-mail costs in the 1999 Costs and Savings Report is not clearly supported by the Merger Order or Amended Order since the Company has identified no savings directly related to these costs.

- While Ameritech used appropriate methodologies to allocate costs and savings incurred by other entities to AI, accounting cut-offs and timing differences resulted in a number of mismatches of cost and savings.

- The SBC Parent Allocation factors were appropriately applied. Revised allocation factors will be calculated for the Year 2000 and should be reviewed to determine their consistency with the 1999 factors.

- Although the Merger Investigation RFP requires a review of merger transaction costs, the Company is not required to separately report such costs to the Commission. The Commission has only required that these costs not be netted against merger savings or otherwise recovered from ratepayers.

- SBC has identified about $156.0 million in 1998 and 1999 one-time merger costs that were appropriately classified as merger related transaction costs. However, the $156.0 million may not represent the total transaction costs since the Company is not required to separately report such costs.

- In addition to the $156.0 million of merger transaction costs identified by the Company, the Company has also incurred $21.9 million in Executive Committee Change in Control and retention payments that are being tracked independently from the $156.0 million, but are considered "below-the-line" and will not be charged to AI regulated operations.

- With the exception of employee-related costs, SBC's treatment of one-time merger transaction costs is consistent with the requirements of the Amended Order.

- As a result of the merger with SBC, substantially all stock options granted prior to May 11, 1998 pursuant to Ameritech Compensation and Benefit Plans became fully vested.

Although there are no accounting costs to be recognized relating to this transaction, there may be significant economic costs.

- Tier B and below management employees received higher severance benefits under the change in control agreement than were available to them without a change in control.

- A precise quantification of severance benefits that would have been paid to employees under the Corporate Resource Severance Pay Plan (CRSPP) absent a change in control cannot be made.

Merger Integration Team Analysis

- The documentation developed by the merger integration teams (MIT) provides sufficient information to enable the Commission to assess the reasonableness of planned merger-related costs and savings.

- The merger teams adequately identified and quantified planned merger-related costs and savings.

- While the Oracle merger tracking database is an effective tool for summarizing and reporting information regarding the status of merger costs and savings, it currently contains only preliminary data for the Year 2000 on a year-to-date basis.

- The principal means for verification of merger costs and savings data is the review of results by the team's finance contact and the team lead prior to inputting data into the Oracle model. MIT analysts review the results on a monthly basis; however they may not identify all necessary adjustments until a more thorough initiative review involving Transition Planning management personnel is completed.

- SBC has a formal process in place to track and review the merger team implementation costs.

- While the use of a decision tree approach to allocate identified merger costs and savings to Illinois is appropriate, we are unable to verify SBC's process to determine AI regulated/intrastate savings as SBC has not yet performed the required analysis.

- An overview of planned savings in the years 2000 to 2004 indicates that SBC expects to achieve approximately (redacted) percent of its run-rate savings by 2002, the end of the three-year Illinois savings recovery period. SBC planned savings increase from approximately (redacted) in 2000 to (redacted) in 2002.

- The merger teams evaluated savings initiatives based on a five year payback period, raising the possibility that SBC might not realize savings associated with a number of initiatives until after the three-year period for the sharing of savings in Illinois is scheduled to end. There is at least one merger initiative for which savings are not expected until 2003.

- Only 13 of the 168 merger initiatives are solely related to the export of best practices from Ameritech to the other SBC companies, indicating that ratepayers in Illinois will benefit from the merger.

- Although SBC developed its merger savings recommendations based on the assumption that service levels would be maintained, certain merger team recommendations have a potential effect on service quality.

- SBC has established formal, well-documented methodologies for the calculation of merger cost and savings associated with each sub-initiative. However, the process is inherently complex and sometimes relies upon assumptions that are not subject to verification.

- The verification of the Company's cost and savings calculation methodology for the 35 sub-initiatives selected for testing indicates that the Company has made significant progress. However, at the time of our review, the effort was a work in progress and the Company has an appreciable distance to go.

- Confidence in the accuracy of the calculated cost and savings amounts varies considerably depending upon the sources of data elements used in the equations and the application of estimates and assumptions.

- During the review of the 35 sub-initiatives selected for testing, the Company proposed adjustments or alternative treatment of savings that bear directly on allocations to Illinois.

- Planned savings associated with five of the 35 sub-initiatives selected for testing proved to be spurious and estimates for the year 2000 are overstated by (redacted).

- SBC uses a variety of methods for calculating merger team labor-related savings. With minor modifications, most of the approaches used are reasonable and, where practical, are consistent in similar situations.

Additional Savings Possibilities

- Although the MIT process is designed to address cost and savings relating to depreciation expense, quantification has not yet been completed by the Company.

- Although the Finance Team 26 and SBC's tax management team reviewed opportunities for merger related tax savings, none have been determined.

- While it is likely the merger will result in improved cash flow and a commensurate reduction in interest expense, SBC has yet to identify any merger related interest savings.

- The Company has made an appropriate determination of the out of scope merger teams.

- The Company has identified merger related employee terminations in a manner that may understate the amount of merger related pension plan settlement gains.

- The Company is correct in its assertion that settlement gains recorded in 1999 represent an accelerated recognition of gains that occurred in previous periods but were deferred in accordance with FAS 87 accounting requirements. However, the recognition of the gains resulting in credits to expense for accounting purposes in 1999 is in part attributable to the merger.

- Although the SBC and Ameritech pension plans are not scheduled for integration until 2003, Ameritech adopted amendments to the Ameritech Pension Plan (APP) and the Ameritech Management Pension Plan (AMPP) as of July 1, 1999 to conform certain actuarial assumptions with those of SBC. One of these changes had a significant impact on pension expense.

- Although there is a significant decrease in Ameritech Illinois operating expenses in the 1st Quarter 2000 when compared to the 1st Quarter 1999, our analysis identified only the pension expense reduction as a potential merger related savings not reported by the merger teams or that had not come to our attention through other procedures in the audit.

- The decrease in operating expenses exceeds the amount of savings reported in the Merger Tracking database for the first quarter of 2000.

Quantified Results of Investigation

In some areas of the audit, our work resulted in possible adjustments to cost and savings amounts reported by the Company to date, and other adjustments relating to cost allocation and savings amounts not reported by the Company. Some categories of cost and savings included in the Company's 1999 Costs and Savings Report are based upon the Company's interpretation of applicable regulatory principles. In some cases we believe there are appropriate alternatives, and use the term "questioned costs" to bring to the Commission's attention those matters requiring its interpretation and approval or which lack adequate support. In this manner, our work can be used by the Commission to narrow the scope of items requiring additional review.

A summary of possible adjustments to 1999 reported cost and savings is provided in Exhibit ES-2 below, with a reference to the appropriate section of the report where the bases for our proposed adjustments are explained. There are $1.3 million in questioned costs due to the possibility that the Company's regulatory interpretation may differ from that of the Commission. The quantification of questioned costs and savings results in an adjusted net savings total of $0.1 million, in comparison to negative net savings of $1.2 million originally reported by the Company.

Exhibit ES-2
1999 Questioned Costs
(Dollars in Thousands)

Category	Amount Allocated to AI	Reason Questioned	Report Reference
Severance Costs	$651	Possible Transaction Cost	Chapter VII, Conclusion 4
Relocation Costs	19	Possible Transaction Cost	Chapter VII, Conclusion 4
Compliance Costs	90	Possible Transaction Cost	Chapter VII, Conclusion 5
Pre-Merger Costs	4	Incurred pre-merger	Chapter VII, Conclusion 6
E-mail Costs	548	Not tied to future savings	Chapter VII, Conclusion 7
Total	$1,312		

Note: The pre-merger costs identified in the audit include $21,000 of compliance costs. To avoid double counting, only $4,000 pre-merger costs are listed in this Exhibit.

Quantified results from our review of Additional Savings Possibilities are shown in Exhibit ES-3. In addition, our test of affiliate transactions disclosed a possible adjustment to inter-company charges to AI during the first quarter of 2000 in the amount of $1.3 million due to the use of an inappropriate calculation of the 5 State Allocator.

Exhibit ES-3
Other Quantified Results
(Dollars in Thousands)

Description	Savings Amount	Period Affected	Reason Questioned	Report Reference
Depreciation Expense Savings (Note 2)	41,400	2000	Not yet determined in Company savings process	Chapter IX Exhibit ASP-4
Illinois State Income Tax Expense (Note 1)	1,600	Total Expenses	Will be reported in 2000 Report	Chapter IX Page IX-12
Pension Cost Savings (Note 1)	6,800	1999	Settlement Gains not Reported by Company	Chapter IX Exhibit ASP-7
Pension Cost Savings (Note 2)	46,824	1999	Change in Ameritech actuarial assumptions to conform to SBC	Chapter IX Exhibit ASP-8

Note 1: Amount is after allocation to AI

Note 2: Amount is before allocation to AI.

Recommendations

To the extent applicable, at the end of each chapter of the report, we have developed three types of recommendations: 1) Recommendations for the Company addressing accounting and administrative matters that we believe require improvement; 2) Policy Issues for the Commission summarizing regulatory issues that should be considered and resolved as soon as possible to provide the Company with guidance relating to the filing of subsequent years' annual Merger Cost and Savings Reports; and 3) Future Audit Issues that we have identified to provide guidance for the Commission Staff in the design of the scope of subsequent audits. A complete summary of these recommendations by type is provided below with a reference to the chapter in the report where the related findings are discussed:

Recommendations for the Company

- To ensure compliance with Commission requirements, file affiliate service agreements required to be filed and retain date-stamped copies of transmittal letters to document the filings. (Chapter III – Regulatory Compliance)

- Update the ICAM to include all accounts reflected in the ACAM. (Chapter III)

- Document the reasons for differences between the ICAM and Part 711, and request Commission approval for any deviations from the prescribed rules. Alternatively, petition the Commission for changes to Part 711. (Chapter III)

- Update the PCAS binder to reflect all changes made since the last revision in 1995. (Chapter III)

- Monitor timely receipt of employee Code of Conduct Acknowledgement Forms more closely. This can be accomplished by requiring supervisors responsible for obtaining Acknowledgement Forms from employees in their areas of responsibility to submit summary schedules of forms received annually to the Director of Compliance in the Human Resources Department. (Chapter IV – Internal Control)

- Develop mechanized tools to facilitate testing of PCAS to ensure the proper allocation of costs between regulated and non-regulated accounts (similar to that available for the Separations System). This would provide employees as well as internal and external auditors a readily accessible testing mechanism and audit trail to validate compliance with FCC and ICC cost allocation rules. (Chapter IV)

- Revise the method used to calculate the 5 State Allocator to more accurately determine the amount of affiliate billings. Allocation factors currently in use should be reviewed semi-annually to determine if adjustments are needed to reflect cost shifting attributable to the merger. (Chapter V – Cost Allocation)

- To minimize the possibility of incorrect billings to affiliates, update AM 237, *Outline of Procedures for Interentity and Other Miscellaneous Billing*, to reflect current information. (Chapter V)

- Complete the implementation of SBC OP 125 relating to Intellectual Property and Proprietary Information (IP/PI) and develop a complete log of IP/PI exchanged in the merger. A complete analysis of this issue should be provided to the ICC when completed. (Chapter V)

- To improve the accuracy of cost allocations, calculate the Marketing Allocator based upon the latest three months of experience, similar to the General Allocator, and take steps to normalize anomalies in any of the cost pools used in developing the ratio. (Chapter VI – Cost Allocation)

- To improve system documentation and to facilitate testing and verification of results by internal staff and auditors, develop additional reports in the PCAS Part 64 system. Standard reports similar to those available from the Separations System should be produced to improve PCAS documentation. (Chapter VI)

- Keep the Commission fully informed of plans to adopt the SBC CAM. Before adopting the SBC CAM, perform an appropriate analysis of the impact of the proposed changes and provide this information to the Commission. Obtaining information regarding the change in regulated and non-regulated cost allocation of PacBell might be of benefit in the analysis. (Chapter VI)

- Submit a revised 1999 Cost and Savings Report to the Commission incorporating the agreed-upon adjustments identified in this report. Explain reasons for disagreement with any of the adjustments proposed. Alternatively, to correct the cut-off problems noted as of December 31, 1999, request permission from the Commission to combine 1999 cost and savings information with year 2000 information in the Year 2000 Report. In this way, the Year 2000 Report will include costs and savings information in the for the year and 84 day period from the date of the merger (October 8, 1999) through December 31, 2000. (Chapter VII – Reported Costs and Savings)

- Before issuing the Year 2000 Merger Costs and Savings Report, develop a systematic process for review of input to the Oracle database for all sub-initiatives. The review process should be documented with formal written procedures and should be supported by checklists to demonstrate that established procedures were followed. Transition Planning management personnel should sign off on the checklist for each sub-initiative to indicate their review and approval of the cost and savings calculations. (Chapter VIII – Merger Integration Teams)

- Review sub-initiatives that contain data elements that are currently not subject to verification to determine if an alternative calculation of savings would reduce reliance on undocumented estimates and assumptions. Alternatively, perform the additional analysis needed to document the assumptions used. (Chapter VIII)

Policy Issues for the Commission

- In the proceedings relating to the review of merger cost and savings, determine whether or not AI is entitled to compensation relating to the exchange of Intellectual Property and Proprietary Information (IP/PI) and develop appropriate guidelines and reporting requirements for the Company to follow. Alternatively, confirm the Company's contention that the transfer of IP/PI between companies in the merger is a "like-for-like" exchange of property. (Chapter V – Affiliate Transactions)

- Develop guidelines for the Company to follow in reporting costs for sub-initiatives that have not produced savings in excess of costs at the date reports are filed. This issue involves the question of the time period and level of detail for which the Company must demonstrate that the costs of its merger initiatives are producing savings. In addition, consider extending the three-year period for sharing of net merger savings to ensure an equitable apportionment to the Company and its ratepayers. (Chapter VIII – Merger Integration Teams)

- Review the Company's stated position regarding the proposed treatment of costs and savings in selected sub-initiatives identified in the report to determine if the proposed treatment is acceptable. (Chapter VIII)

- Determine whether or not pension plan settlement gains and expense reductions attributable to changes in actuarial assumptions to conform the SBC and Ameritech pension plans are merger-related and develop appropriate guidelines and reporting requirements for the Company to follow. (Chapter IX – Additional Savings Possibilities)

- Consider whether or not an imputed reduction in interest expense relating to revenue enhancement initiatives within the regulated telephone operating companies is a merger related expense savings to be shared with ratepayers in Illinois. (Chapter IX)

- Consider whether or not an imputed savings in the cost of capital related to improved cash flow from reduced capital expenditures constitutes savings to be shared with ratepayers in Illinois. (Chapter IX)

Future Audit Issues

- Test the Company's compliance with Commission requirements relating to the filing of affiliate service agreements. (Chapter III – Regulatory Compliance)

- Include the examination of affiliate company allocation factors and billings in the scope of the Year 2000 CAM audit to ensure that they properly reflect organizational and operational changes following the merger. (Chapter V – Affiliate Transactions)

- Expand the scope of the annual CAM audit to include an assessment of the Company's decision-making process relating to affiliate transactions. Documentation showing that the services needed are either not available or would be more costly if obtained from third party providers should support decisions in this area. (Chapter V)

- Obtain merger costs and savings information at a level of detail greater than that which is available from AI by Uniform System of Accounts (USOA) account. Reference to the Company's tracking codes is needed for a complete understanding of the nature of specific costs and savings. (Chapter VII – Reported Costs and Savings).

- Unless the Company re-files 1999 Cost and Savings Information in combination with information provided in the Year 2000 Report, perform extensive cut-off tests as of December 31, 1999 to ensure that there is an appropriate matching of costs and savings and that costs are not double counted. (Chapter VII)

- In establishing the scope of the audit of the Year 2000 Cost and Savings Report, design the audit to focus on five principal areas: 1) Merger Cost and Savings Calculations, 2) Merger Cost and Savings Tracking, 3) Illinois Savings Allocations, 4) Assignment of Costs to USOA Accounts, and 5) Part 32 and 64 Allocation Factors. (Chapter VIII – Merger Integration Teams)

  ⇒ Because there are more than 400 sub-initiatives with planned savings in the year 2000, we recommend that the audit of reported costs and savings be performed on a statistical or judgmental sampling basis.

  ⇒ The verification of Part 32 and Part 64 allocation factors should be performed for all USOA accounts with significant Illinois merger costs or savings. Tests should be made to ensure that allocations are based upon the most recent reliable data.

- A summary of audit areas to be addressed in the audit of 2000 reported costs and savings is shown in Exhibit ES-4.

Exhibit ES-4
Audit of 2000 Reported Costs and Savings
Recommended Audit Areas

Audit Area	Issues	Scope
Saving Calculation Methodology	• Is the overall savings calculation methodology appropriate? • Is the data used in the savings calculations from a reliable source and is the data appropriately used? • Does the Oracle merger database contain correct cost and savings information?	Selected sub-initiatives
Merger Cost Tracking	• Are the costs properly associated with the merger sub-initiative? • Does the Oracle merger database contain correct savings information?	Selected sub-initiatives
Illinois Cost Allocation (Illinois Allocation Decision Trees)	• Has SBC identified and applied reasonable cost allocation methodologies?	Selected sub-initiatives
Assignment to USOA Accounts	• Are sub-initiative costs and savings assigned to proper USOA accounts?	Selected sub-initiatives
Part 32 and 64 Allocation Factors	• Are Part 32 and 64 allocation factors calculated correctly?	All USOA accounts

- After the Company files its Year 2000 Merger Cost and Savings Report, review USOA accounts used to record depreciation expense to determine whether or not costs and savings are included. Obtain information from the Company needed to compare Ameritech Illinois pre and post-merger depreciation rates and amounts as a percent of plant in service to determine whether adjustments to savings amounts reported by the Company are required. (Chapter IX – Additional Savings Possibilities)

- Determine the number of employees who left the Company in 1999 in anticipation of the merger and recompute merger related pension plan settlement gains. (Chapter IX)

Acknowledgement

We wish to acknowledge and express our appreciation for the cooperation and support we received from SBC/Ameritech personnel during the course of the audit and for the guidance of the Commission staff.