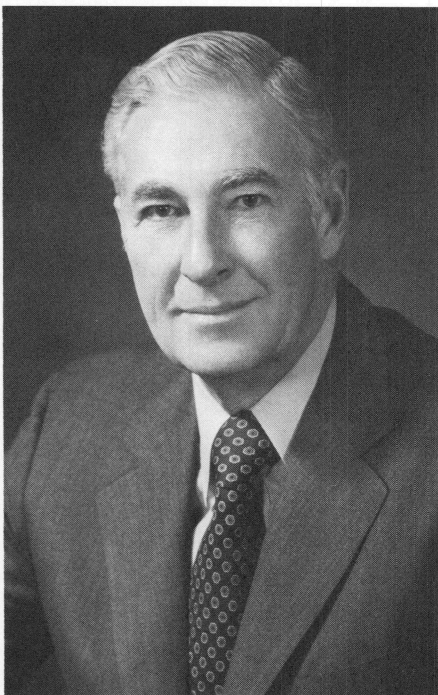

Annual Report
1981

New England Telephone is engaged in the business of furnishing communications services, mainly local and toll telephone service, in Maine, Massachusetts, New Hampshire, Rhode Island and Vermont. The Company is an associated company of the Bell System. The annual report for the System as a whole is issued by the American Telephone and Telegraph Company. We shall be happy to supply copies of that report, or additional copies of the New England Telephone report, upon request to any of our business offices. A copy of the Company's annual report on Form 10-K as filed with the Securities and Exchange Commission for the year 1981 will be furnished without charge, on request directed to the Secretary of the Company, Room 100, 185 Franklin Street, Boston, Mass. 02107.

New England Telephone and Telegraph Company

185 Franklin Street, Boston, Massachusetts 02107 • Telephone 617 743-9800

REPORT OF THE PRESIDENT



W. C. Mercer

1981 was a busy year, a good year in most ways. And it was a time of reorganizing the way we do business as we move into a dramatically different future.

As we entered the New Year of 1982, we also entered a period of profound change which may result in a new corporate structure for the Company, a change in ownership and a redefining of the telecommunications services New England Telephone Company supplies to the public.

These projected changes hinge on the approval by the federal court of a Consent Decree between the American Telephone & Telegraph Company (which owns 100 per cent of this Company's stock) and the Justice Department which had brought an antitrust suit against AT&T.

As part of the agreement ending the antitrust action, AT&T would divest the 22 local operating companies of the Bell

System, one of which is New England Telephone. Share-owners would continue to hold their ownership in AT&T and also would receive proportionate ownership in the divested local operating companies.

How New England Telephone and other divested companies would be organized is currently being studied. The agreement calls for a plan to be submitted by AT&T to the Justice Department within 6 months of the effective date of the Decree which is the date the Federal District Judge in Washington declares the agreement to be in the public interest. Full divestiture must be accomplished within 18 months of the Decree's effective date.

Under terms of the Consent Decree, AT&T must assure that local operating companies have sufficient personnel, facilities, technical information and financial resources to perform local service and local access functions. In addition, AT&T, Western Electric and Bell Labs must provide, until September 1,

1987, manufacturing and research and development to the local exchange companies on a priority basis for services needed to implement the Decree.

Our two primary services will be the provision of local exchange service to some 3.8 million customers in our five New England States, and the provision of access facilities to all competing inter-exchange carriers to enable their services to enter homes and businesses in our New England area. Beyond this, it appears that we will be marketing a variety of intra-exchange network services such as custom calling features and advanced mobile services.

Our ingenuity and efficiency in providing these services, supported by responsible regulation, will offer continued opportunities for service growth and financial soundness.

Our goal remains the same

Over the years our New England Telephone men and women have worked hard to build and operate the best

communications system for the general public at affordable rates. Service has always come first with us, and whatever the changes in corporate structure that lie ahead, these traditional objectives of outstanding service at fair rates will still be our goal.

In addition the Company remains committed to providing fulfilling careers and desirable benefits to its employees.

Volume of Business

Basic Telecommunication Services: For 1981, the increase in total leased Company-owned telephones in service amounted to 38,000 telephones compared to 142,000 in 1980. Several factors contributed to this slower growth. First was the effect of the recession; second was the sale, rather than lease, of our Design Line™ Telephones. And finally there was the effect of sales by competitors in the market.

Access lines – that is New England Telephone lines which

provide local central office dial tone to a customer – showed a gain of 104,000 lines or about the same as in 1980.

The growth in long distance calling ran below the percentage increases of recent years, while the WATS portion of toll calling held at the 1980 level.

Other Business Services: Sales of Company Dimension® and Horizon® PBX Systems were among the highest of Bell System companies.

Public services such as public and semi-public coin telephones, Charge-a-Call phones and Dial-It messages developed \$148 million in total revenues for a 17 per cent increase over 1980.

Increased sales of advertising in our Yellow Pages directories brought in \$108 million, an increase of 20 per cent over the previous year.

Rate Changes

In spite of improvements in the productivity of our work force

™Trademark of AT&T Co.

and tight management of controllable operating expense, it was necessary to seek regulatory approval for higher rates to cover increased labor and material costs of running the business due to inflation. More rapid depreciation of plant and equipment, ordered by the Federal Communications Commission, also increased operating expenses.

Additional annual revenues from rate increases in 1981 totalled \$137 million, with an additional \$60 million in repricings currently before regulatory commissions.

Earnings

The bottom line for all of our efforts resulted in a good earnings year in 1981. Revenues were \$2.7 billion or up 13 per cent while expenses and taxes were \$2.4 billion or up 12 per cent. Net income was \$296.1 million up \$48.5 million or 20 per cent over 1980.

A more detailed review, including factors contributing to these

improved earnings results, can be found on pages 10 and 11.

Capital Investment

During 1981 we invested more than \$728 million to expand, improve and rearrange the Company's communications systems serving our New England customers. We plan to spend another \$816 million in 1982 for the same purposes.

We installed 10 more Electronic Switching Systems in 1981, and almost 40 per cent of our customers are now being served by these modern systems which have programmed memories to perform individualized functions for specific customers.

Electronic monitoring and control systems are helping us to manage our local network facilities serving homes and businesses more efficiently and rapidly. They can test for possible troubles over large areas from one central location.

Starting with the Washington to New York leg, there is now

under construction a glass fiber optic system that will eventually extend 611 miles between Boston and Washington, D.C. The completed system can carry up to 80,000 simultaneous phone conversations over pulses of light traveling within glass fibers in a one-half inch cable. The lightwave equipment transmits phone conversations at digital speeds of 90 million bits per second.

We continued to convert coin telephones so that the public could reach an operator in an emergency without depositing a coin. Nearly one-fourth of our 86,000 coin phones had this feature at year's end.

A National Policy

Congressional action to establish a new national telecommunications policy resulted in the passage of Senate Bill 898 in October 1981 which defined the Senate's view of how the industry and the Bell System should be structured and operated. It will, however, need to be recon-

sidered in light of the terms of the agreement reached January 8, 1982 between AT&T and the Justice Department in the settlement of the Government's anti-trust suit. A proposed bill in the House needs to be reexamined for similar reasons.

Meanwhile, AT&T is continuing with the restructuring of the Bell System into regulated and unregulated subsidiaries as provided for in the Federal Communications Commission's Computer II decision. At the same time AT&T and the local operating companies are starting to plan the further restructuring called for under the agreement reached between AT&T and the Justice Department.

The Future

We face the future with the certainty that our product — telecommunications — will be

basic to almost every human endeavor. And, therefore, those who have the best telecommunications systems, whether they be nations, businesses or individuals, seem sure to surpass others.

Much of the potential in telecommunications has come from the merging of the science of communications and the science of computers. Computerized communications continues to accelerate in productive applications at a pace unparalleled in other fields.

So we in New England Telephone are in the right business at the right time.

Already we are able to transmit more information in an instant on almost any subject or situation than man ever dreamed possible.

As a result, we expect that the public will require the full development of such present capabilities as fingertip access to banking, shopping, education, entertainment and other kinds of information from their homes. Businesses will want sophisticated teleconferencing facilities, and streamlined systems that handle a growing volume of voice, data, video and facsimile information far more efficiently and in greater volumes.

These developments are opening totally new vistas in the human experience and at the same time totally new challenges to use these advances in the best interests of mankind.

As we move farther into the information age, these technological developments, and others we cannot now foresee, can improve the quality of life, increase

our productivity and contribute to the advancement and well-being of society as a whole.

Communications remains a very dynamic and vital business, and its future opportunities appear unlimited.

Under the new consensus that is developing in national telecommunications policy, there will be more freedom from regulation to innovate and manage. There will be an equal responsibility to serve the public well and to earn our way if we are to succeed.

Our employees' skills and dedication are largely responsible for accomplishing the results for this year, and their efforts are very much appreciated. I have no doubt that Telephone men and women will be as successful in answering the challenges of the future as they have been in meeting those of the past.

As long as we continue to pay attention to the three major deter-

minants of this business – provision of a needed service in a quality way, good earnings, good people – we'll have the keys to success no matter what our corporate configuration or our challenges.



W. C. Mercer
President

February 16, 1982

Report of Management

The financial statements on the following pages have been prepared in conformity with generally accepted accounting principles applicable to rate-regulated utilities. Such accounting principles are consistent in all material respects with accounting prescribed by the Federal Communications Commission for telephone companies, except as to revenue refunds and interest charged construction, as discussed in Notes to Financial Statements.

The integrity and objectivity of data in these financial statements, including estimates and judgments relating to matters not concluded by year end, are the responsibility of management as is all other information included in the Annual Report unless indicated otherwise. To this end, management maintains a system of internal accounting controls which, on an ongoing basis, is reviewed and evaluated. Our internal auditors monitor compliance with it in connection with their program of internal audits. However, there are inherent limitations that should be recognized in considering the assurances provided by any system of internal accounting controls. The concept of reasonable assurance recognizes that the costs of a system of internal accounting controls should not exceed, in management's judgment, the benefits to be derived. Management believes that the Company's system does provide reasonable assurance that transactions are executed in accordance with management's general or specific authorizations and are recorded properly to maintain accountability for assets and to permit the preparation of financial statements in conformity with generally accepted accounting principles applicable to rate-regulated utilities. Management also believes that this system provides reasonable assurance that access to assets is permitted only in accordance with management's authorizations, that the recorded accountability for assets is compared with the existing assets at reasonable intervals, and that appropriate action is taken with respect to any differences. Management also seeks to assure the objectivity and integrity of its financial data by the careful selection of its managers, by organizational arrangements that provide an appropriate division of responsibility, and by communications programs aimed at assuring that its policies, standards and managerial authorities are understood throughout the organization. These financial statements have been examined by Coopers & Lybrand, independent Certified Public Accountants.

The Audit Committee of the Board of Directors (see page 38), which is composed of Directors who are not employees, meets periodically with management, the internal auditors, and the independent auditors to review the manner in which they are performing their responsibilities and to discuss auditing, internal accounting controls, and financial reporting matters. Both the internal auditors and the independent auditors periodically meet alone with the Audit Committee and have free access to the Audit Committee at any time.



Vice President – Finance
and Comptroller

We hereby certify that the condensed return of its business and financial condition contained on pages 6 to 36 inclusive of this Annual Report is full, just and true.


Treasurer.



Vice President – Finance and Comptroller.

THE COMMONWEALTH OF MASSACHUSETTS
Suffolk s.s. Boston, March 1, 1982. Then personally
appeared the above-named J.F. Crain, Treasurer, and
H.H. Fellows, Jr., Vice President – Finance and Com-
ptroller, and severally made oath that the foregoing cer-
tificate by them subscribed is true to the best of their
knowledge, information and belief.

Before me,



Notary Public.

My Commission expires June 20, 1986

Report of Independent Certified Public Accountants

To the Shareowner of
New England Telephone and Telegraph Company

We have examined the balance sheets of New England Telephone and Telegraph Company as of December 31, 1981, 1980 and 1979, and the related statements of income and reinvested earnings and sources of funds supporting construction activity for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of New England Telephone and Telegraph Company at December 31, 1981, 1980 and 1979, and the results of its operations and sources of funds supporting its construction activity for the years then ended, in conformity with generally accepted accounting principles consistently applied, except for the change, with which we concur, in the method of computing interest charged construction as described in Note (a).

Boston, Massachusetts
February 3, 1982

Coopers & Lybrand

Selected Financial Data

	Dollars in Millions				
	1981	1980*	1979*	1978*	1977*
Revenues					
Local service.....	\$1,251	\$1,126	\$1,066	\$ 996	\$ 928
Toll service.....	1,362	1,195	1,073	977	888
Other (including other income).....	102	78	60	62	55
	<u>2,715</u>	<u>2,399</u>	<u>2,199</u>	<u>2,035</u>	<u>1,871</u>
Expenses					
Operating.....	1,825	1,615	1,454	1,311	1,183
Income taxes on operations.....	209	178	182	194	187
Other operating taxes.....	223	207	198	185	177
Interest.....	162	151	123	112	107
	<u>2,419</u>	<u>2,151</u>	<u>1,957</u>	<u>1,802</u>	<u>1,654</u>
Net Income.....	<u>\$ 296</u>	<u>\$ 248</u>	<u>\$ 242</u>	<u>\$ 233</u>	<u>\$ 217</u>
Total assets.....	<u>\$5,515</u>	<u>\$5,104</u>	<u>\$4,685</u>	<u>\$4,372</u>	<u>\$4,145</u>
Long and intermediate term debt.....	<u>\$1,713</u>	<u>\$1,604</u>	<u>\$1,405</u>	<u>\$1,403</u>	<u>\$1,401</u>
Ratio of earnings to fixed charges† (Securities and Exchange Commission basis).....	<u>3.79</u>	<u>3.53</u>	<u>4.06</u>	<u>4.47</u>	<u>4.43</u>

*Restated for compensated absences. See Note (d) to Financial Statements for explanation.

†For the purpose of this ratio: (i) Earnings have been calculated by adding to Income before Interest Expense the amount of related taxes on income and the portion of rentals representative of the interest factor; (ii) Fixed Charges comprise total Interest Expense and such portion of rentals.

Selected Operating Data

	Thousands				
	For the year ended December 31,				
	1981	1980	1979	1978	1977
Toll Messages.....	857,544	818,632	762,196	714,122	662,265
WATS Messages.....	380,854	333,395	290,355	252,354	215,108

Charges for toll messages and WATS messages for the year ended December 31, 1981 account for about 39% and 10%, respectively, of total billed operating revenues.

	Thousands				
	At December 31,				
	1981	1980	1979	1978	1977
Company-Owned Telephones in Service.....	7,110	7,072	6,930	6,781	6,527
Access Lines in Service.....	4,266	4,162	4,050	3,936	3,787

Recurring charges for company-owned telephones in service and access lines in service for the year ended December 31, 1981 account for about 26% of total billed operating revenues.

Management's Discussion and Analysis of Results of Operations

The Year 1981 Compared To The Year 1980

Revenues – Local and toll service revenues increased \$290.5 million due primarily to intra-state and interstate rate increase effects amounting to \$77.2 million and \$30.8 million, respectively. Other elements contributing to this increase were approximately as follows: \$84.1 million due to increased usage, \$41.4 million due to increased WATS revenues, \$31.5 million due to more telephones (see "Selected Operating Data") and \$25.5 million due to upgraded customer service features. Revenues from directory advertising increased \$10.5 million due to increased rates and \$7.2 million due to a higher volume of such sales.

Operating Expenses – increases are due to the following changes in:

	Dollars in Millions
Wages and salaries including cost of living adjustments	\$106.7
Provision for pensions and other employee benefits	6.0
Maintenance due to change in accounting for station connections (See Note (e) to Financial Statements)	24.4
Depreciation due to: Revised rates and practices (See Note (c) to Financial Statements)	44.0
Decrease due to change in accounting for station connections (See Note (e) to Financial Statements)	(21.3)
Increased plant investment	14.4
License Contract payments	1.4
Materials, supplies and other payments	33.9
Total operating expense increase	<u>\$209.5</u>

Income taxes – Total operating income taxes increased \$30.8 million reflecting higher income before such taxes.

Other taxes – Other operating taxes increased \$15.4 million. Principal reasons for such increases follow: State gross receipts taxes increased \$4.2 million primarily due to increased taxable revenues. Payroll-related and other operating taxes increased \$12.0 million due primarily to an increase in social security taxes caused principally by an increase in statutory rate and taxable wage base. The decrease of \$.8 million in property taxes was not significant.

Other income – Interest charged construction increased \$15.3 million due primarily to the change in recording of interest on intrastate investment for Massachusetts and Rhode Island construction projects expected to be completed in less than one year. See Note (a) to Financial Statements.

Interest – Total interest expense increased \$11.0 million of which \$18.4 million was due to increased average borrowings partially offset by a \$7.4 million decrease due to a lower average interest rate.

See Notes (a), (e), (f), (g) and (p) to Financial Statements for matters pertaining to Depreciation, ACCOUNTING FOR STATION CONNECTIONS COSTS, PROVISION FOR PENSIONS AND DEATH BENEFITS, INTERSTATE REVENUES TAX and DEPARTMENT OF JUSTICE ANTI-TRUST ACTION, respectively.

New England Telephone and Telegraph Company

Statements of Income and Reinvested Earnings

	Dollars in Millions		
	Year 1981	Year 1980(d)	Year 1979(d)
OPERATING REVENUES			
Local service			
Service and equipment charges.....	\$1,078.7	\$ 973.1	\$ 922.5
Message charges.....	116.3	104.3	97.7
Public telephones.....	39.7	35.3	33.6
Private lines and other services.....	15.9	13.5	11.6
Toll service			
Message charges.....	963.4	883.9	809.1
WATS.....	241.7	200.3	167.3
Private lines and other services.....	156.6	111.3	96.4
Directory advertising and miscellaneous.....	112.9	103.6	87.1
Provision for uncollectibles.....	(27.4)	(26.5)	(28.0)
Total operating revenues.....	<u>2,697.8</u>	<u>2,398.8</u>	<u>2,197.3</u>
OPERATING EXPENSES			
Maintenance.....	611.2	510.1	460.4
Depreciation.....	354.6	317.5	292.7
Network and operator services.....	166.6	158.7	150.2
Marketing and customer services.....	231.0	193.6	152.5
Financial operations.....	90.0	89.0	68.0
Directory.....	44.0	38.9	39.2
Provision for pensions and other employee benefits (f).....	242.1	236.1	222.4
Services received from parent under License Contract.....	52.6	51.2	44.4
Other operating expenses.....	33.1	20.6	24.1
Total operating expenses.....	<u>1,825.2</u>	<u>1,615.7</u>	<u>1,453.9</u>
Net operating revenues.....	<u>872.6</u>	<u>783.1</u>	<u>743.4</u>
OPERATING TAXES			
Federal income taxes (b).....	180.4	154.1	157.3
State income taxes (b).....	28.5	24.0	24.1
Property taxes.....	113.8	114.6	112.5
Gross receipts, payroll-related and other taxes (n).....	108.9	92.7	86.0
Total operating taxes.....	<u>431.6</u>	<u>385.4</u>	<u>379.9</u>
Operating income (carried forward).....	<u>\$ 441.0</u>	<u>\$ 397.7</u>	<u>\$ 363.5</u>

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

	Dollars in Millions		
	Year 1981	Year 1980(d)	Year 1979(d)
Operating income (brought forward).....	<u>\$ 441.0</u>	<u>\$ 397.7</u>	<u>\$ 363.5</u>
OTHER INCOME			
Interest charged construction.....	17.0(a)	1.7	1.8
Miscellaneous income and deductions – net (b) ..	<u>(.2)</u>	<u>(1.1)</u>	<u>(.8)</u>
Total other income.....	<u>16.8</u>	<u>.6</u>	<u>1.0</u>
Income before interest expense.....	457.8	398.3	364.5
INTEREST EXPENSE (n).....	<u>161.7</u>	<u>150.7</u>	<u>122.7</u>
NET INCOME.....	<u>\$ 296.1(c)</u>	<u>\$ 247.6</u>	<u>\$ 241.8</u>
REINVESTED EARNINGS			
At beginning of year.....	\$ 587.2	\$ 520.7	\$ 450.1
Add – Net Income.....	<u>296.1</u>	<u>247.6</u>	<u>241.8</u>
	883.3	768.3	691.9
Deduct – Dividends declared.....	<u>212.5</u>	<u>181.1</u>	<u>171.2</u>
At end of year.....	<u>\$ 670.8</u>	<u>\$ 587.2</u>	<u>\$ 520.7</u>

**New England Telephone and Telegraph Company
Balance Sheets**

Dollars in Millions
At December 31,
1981 1980(d) 1979(d)

ASSETS

TELEPHONE PLANT AND OTHER INVESTMENTS

– at cost

Telephone Plant

In service.....	\$6,405.7	\$5,897.8	\$5,472.4
Under construction.....	155.6	122.6	92.5
Held for future use.....	.7	4.3	–

	6,562.0	6,024.7	5,564.9
--	----------------	---------	---------

Less: Accumulated depreciation.....	1,631.7	1,451.3	1,348.8
-------------------------------------	----------------	---------	---------

	4,930.3	4,573.4	4,216.1
--	----------------	---------	---------

Other investments.....	3.9	4.0	5.9
------------------------	------------	-----	-----

	4,934.2	4,577.4	4,222.0
--	----------------	---------	---------

CURRENT ASSETS

Cash (h).....	10.4	9.0	10.5
---------------	-------------	-----	------

Receivables

Customers and agents (less allowance for uncollectibles: 1981, \$6.6; 1980, \$7.3; and 1979, \$7.2).....	442.7	382.5	344.6
--	--------------	-------	-------

Other	18.3	18.1	10.5
-------------	-------------	------	------

Material and supplies (principally at average cost).....	38.8	32.1	29.0
--	-------------	------	------

Prepaid expenses.....	3.6	5.8	4.3
-----------------------	------------	-----	-----

	513.8	447.5	398.9
--	--------------	-------	-------

DEFERRED CHARGES.....	67.0	79.3	63.6
-----------------------	-------------	------	------

TOTAL ASSETS.....	\$5,515.0	\$5,104.2	\$4,684.5
-------------------	------------------	-----------	-----------

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

	Dollars in Millions		
	At December 31,		
	1981	1980(d)	1979(d)
INVESTED CAPITAL, LIABILITIES, AND DEFERRED CREDITS			
COMMON SHARE OWNER'S EQUITY			
Common stock – one share, without par value (i)	\$1,774.9	\$1,469.5	\$1,465.1
Reinvested earnings – see page 13	670.8	587.2	520.7
	<u>2,445.7</u>	<u>2,056.7</u>	<u>1,985.8</u>
LONG AND INTERMEDIATE TERM DEBT (j)	<u>1,713.2</u>	<u>1,603.8</u>	<u>1,404.7</u>
CURRENT LIABILITIES			
Accounts payable (h)			
Western Electric Company, Inc., affiliate	53.0	42.2	38.7
American Telephone and Telegraph Company, parent	23.1	30.1	13.9
Payrolls	16.5	18.8	11.7
Other	86.6	66.1	61.8
Taxes accrued	57.9	54.8	49.1
Dividend payable	–	45.4	45.3
Interest accrued	25.8	25.4	22.4
Advance billing and customers' deposits	21.6	19.8	17.1
	<u>284.5</u>	<u>302.6</u>	<u>260.0</u>
Debt maturing within one year (k)	79.4	276.9	288.8
Income taxes deferred for one year	22.8	14.3	9.5
	<u>386.7</u>	<u>593.8</u>	<u>558.3</u>
DEFERRED CREDITS			
Accumulated deferred income taxes	701.5	620.5	543.0
Unamortized investment tax credits	260.4	223.0	187.9
Other	7.5	6.4	4.8
	<u>969.4</u>	<u>849.9</u>	<u>735.7</u>
LEASE COMMITMENTS (l)			
TOTAL INVESTED CAPITAL, LIABILITIES, AND DEFERRED CREDITS	<u><u>\$5,515.0</u></u>	<u><u>\$5,104.2</u></u>	<u><u>\$4,684.5</u></u>

New England Telephone and Telegraph Company
Statements of Sources of Funds Supporting Construction Activity

	Dollars in Millions		
	Year 1981	Year 1980(d)	Year 1979(d)
FUNDS FROM OPERATIONS			
Net income.....	\$296.1	\$247.6	\$241.8
Add – Expenses not requiring funds currently:			
Depreciation.....	354.6	317.5	292.7
Deferred income taxes – net.....	89.5	82.3	62.1
Investment tax credits – net.....	37.4	35.1	26.0
Deduct – Income not providing funds currently:			
Interest charged construction.....	17.0	1.7	1.8
Total funds from operations.....	760.6	680.8	620.8
Less – Dividends.....	212.5	181.1	171.2
	548.1	499.7	449.6
FUNDS FROM EXTERNAL FINANCING			
Additional equity investment by parent.....	305.4	4.4	3.5
Issuance of long term debt.....	150.0	300.0	–
Increase (decrease) in short term borrowings – net... ..	(137.5)	(111.9)	223.2
	317.9	192.5	226.7
Less – Retirement of intermediate term debt.....	100.0	–	100.0
	217.9	192.5	126.7

(continued next page)

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

	Dollars in Millions		
	Year 1981	Year 1980(d)	Year 1979(d)
CHANGES IN WORKING CAPITAL* (excluding debt maturing within one year and income taxes deferred for one year)			
Cash.....	\$ (1.4)	\$ 1.5	\$ (1.8)
Receivables.....	(60.4)	(45.5)	(29.4)
Material and supplies.....	(6.7)	(3.1)	(6.4)
Prepaid expenses.....	2.2	(1.5)	12.0
Accounts payable.....	22.0	31.1	15.2
Taxes accrued.....	3.1	5.7	3.9
Dividend payable.....	(45.4)	.1	3.3
Interest accrued.....	.4	3.0	—
Advance billing and customers' deposits.....	1.8	2.7	2.5
	<u>(84.4)</u>	<u>(6.0)</u>	<u>(.7)</u>
OTHER CHANGES*			
Other investments.....	.1	1.9	.6
Deferred charges.....	12.3	(15.7)	(23.6)
Other — net.....	17.3	7.9	7.8
	<u>29.7</u>	<u>(5.9)</u>	<u>(15.2)</u>
FUNDS SUPPORTING CONSTRUCTION ACTIVITY .	711.3	680.3	560.4
Add — Interest charged construction.....	17.0	1.7	1.8
TOTAL CONSTRUCTION.....	<u>\$728.3</u>	<u>\$682.0</u>	<u>\$562.2</u>

*()Denotes a change which results in a decrease in funds supporting construction activity.

Notes to Financial Statements

(Dollars in Millions)

- (a) **ACCOUNTING POLICIES** – The financial statements of the New England Telephone and Telegraph Company ("Company"), which is a wholly-owned subsidiary of American Telephone and Telegraph Company ("AT&T"), reflect the application of the accounting policies described in this note and in Notes (d), (e), (f), (h) and (l). These statements have been prepared in conformity with generally accepted accounting principles applicable to rate-regulated utilities. Such accounting principles are consistent in all material respects with accounting prescribed by the Federal Communications Commission ("FCC"), except as to the accounting for revenue refunds and interest charged construction described in this note.

Revenue Refunds – The FCC's prescribed accounting provides that refunds of prior years' revenues, less related income tax effects, be charged against current income. However, in conformity with generally accepted accounting principles applicable to rate-regulated utilities, the Company in its financial statements treats material revenue refunds applicable to prior years as adjustments of the respective years' income and, within a year, as adjustments of the applicable interim periods' income.

Purchases From Western Electric – Western Electric Company, Incorporated ("Western Electric"), a wholly-owned subsidiary of AT&T has a substantial investment in manufacturing and other facilities which are devoted mainly to its business with affiliated telephone companies. Western Electric has a supply contract with the Company which provides that the prices it charges for the telephone equipment and materials it manufactures or procures for the Company shall be as low as the prices it charges its most favored customers for like materials and services under comparable conditions. The financial statements reflect items purchased from Western Electric at cost to the Company, which cost includes the return realized by Western Electric on its investment devoted to the communications business. (See "Telephone Plant" below.)

Telephone Plant – The investment in equipment and materials dedicated to providing communications services is stated at its original cost. The amounts shown do not purport to represent reproduction cost or current value. The original cost of telephone plant obtained from Western Electric includes a return on Western Electric's investment. (See "Purchases From Western Electric" above.) It is impossible to identify the particular purchases from Western Electric over a long period of years which were charged to the plant accounts and now remain therein, but the Company considers that such purchases represent about 39% to 42% of its total plant investment. Western Electric advises that its rate of profit before interest charges has varied by years and by classes of sales, but that such rate of profit before interest charges, included in prices for material sold and services furnished to affiliated telephone companies (including items chargeable to other than plant accounts), has been approximately 6% of such sales over the twenty year period ended December 31, 1981 and approximately 7% of such sales over the three year period then ended. Western Electric considers that its rate of profit before interest charges on those items which have been charged to the plant accounts is somewhat higher than its rate on total sales to affiliated companies.

Because AT&T and certain of its subsidiaries, including Western Electric and the Company, join in the filing of consolidated federal income tax returns, Western Electric's profits before income taxes included in the cost of those materials and services in the Company's plant accounts are excluded from consolidated taxable income in the year acquired from Western Electric. Instead, such profits

are recognized and taxed over the depreciable life of the related plant since, for tax purposes, the Company must exclude Western Electric profits in deriving the depreciable cost of its investment in telephone plant. Consequently, the Company's tax liability is higher than if it were permitted to depreciate the full amount it initially paid to Western Electric. Western Electric provides the Company with the funds necessary to pay the tax liability on these deferred profits in the year in which the Company first acquires the related telephone plant. These payments are treated as reductions of the investment in telephone plant which results in a reduction in depreciation expense over the life of the related plant. However, there is no material effect on Net Income because the decrease in depreciation expense is offset by the aforementioned increase in the income tax provision. See also Note (p).

Material and Supplies – New material and reusable material are carried in inventory at average original cost, except that specific costs are used in the case of large individual items. Nonreusable material is carried at estimated salvage value.

Depreciation – Provision in the accounts for depreciation is based on straight-line composite rates, prescribed by the FCC, determined on the basis of the average expected lives of categories of plant acquired in a given year. The Company had expected to determine such straight-line composite rates in 1981 on the basis of equal life groups ("ELG") of certain categories of telephone plant acquired in a given year which would result in a higher provision for depreciation than that based on average expected lives. Although the FCC had approved the ELG concept in November 1980, it did not authorize implementation in 1981. The Company's current expectation is that the FCC will authorize the implementation of ELG beginning in 1982. Effective January 1, 1981, the FCC authorized shorter lives for customer terminal equipment and other telephone plant. The use of the "remaining life" method of depreciation will be discussed at a meeting in 1982 with the New England Conference of Public Utility Commissioners, the FCC staff and the Company. The "remaining life" method provides for the full recovery of the investment in telephone plant. The increases in depreciation expense resulting from these FCC actions should be allowable in determining revenue requirements in rate-making proceedings. See also Notes (c) and (n).

When depreciable plant, other than minor items thereof which are replaced, is retired, the amount at which such plant has been carried in telephone plant in service is charged to accumulated depreciation.

Maintenance and Repairs – The cost of maintenance and repairs of plant, including the cost of replacing minor items not effecting substantial betterments, is, with minor exceptions, charged to operating expenses.

Interest Charged Construction – Regulatory authorities allow the Company to accrue interest as a cost of constructing certain plant and as an item of income, i.e., interest charged construction. Such income is not realized in cash currently but will be realized over the service life of the plant as the resulting higher depreciation expense is recovered in the form of increased revenues.

The FCC's prescribed accounting, effective January 1, 1979, did not provide for a return on telephone construction projects expected to be completed in less than one year through the accrual of interest

(Dollars in Millions)

charged construction; instead these projects are included in the rate base upon which interstate revenue requirements are determined. State regulatory accounting which differs from this FCC treatment was recently approved by commissions in Massachusetts and Rhode Island and provides for a return on the intrastate portion of short term construction projects through the accrual of interest charged construction and these financial statements reflect such accruals which caused a \$14.9 increase in Interest charged construction of which \$5.0 and \$3.1 were applicable to years 1980 and 1979, respectively.

Income Taxes:

- (1) AT&T and its subsidiaries file a consolidated federal income tax return. The consolidated income tax currently payable is allocated in accordance with each company's contribution to consolidated taxable income.
- (2) Income tax regulations allow recognition of certain transactions for tax purposes in time periods other than the period during which the transaction will be recognized in the determination of net income for financial reporting purposes. Appropriate income charges and their subsequent reversal, reflected as deferred income taxes – net, prevent the tax effect of these timing differences from distorting net income. The Company recognizes the tax effects of timing differences on the following transactions:
 - a. When vacation pay and certain property taxes are deductible for income tax purposes in the year prior to being accounted for in these financial statements, the tax effects of these timing differences are included in Current Liabilities–Income taxes deferred for one year in the accompanying balance sheets. For regulatory accounting and rate-making purposes these expenses are accounted for when paid.
 - b. Expenses associated with the Company's purchase and retirement in February 1977 of \$120.0 of its \$175.0 thirty-five year 9.5% debentures due June 1, 2010, which were deductible for 1977 income tax purposes, are being written off over a ten year period. Tax effects of these timing differences are included in Deferred Credits– Accumulated deferred income taxes in the accompanying balance sheets.
 - c. Depreciation for income tax purposes uses accelerated methods and shortened lives causing such depreciation to be higher during the early years of plant life and lower in later years than the depreciation charges for such plant reflected in these financial statements. The accumulated tax effects of these timing differences are shown in the accompanying balance sheets as Deferred Credits– Accumulated deferred income taxes. See also Note (e).
- (3) Investment tax credits result from provisions of the federal tax law which allow for a reduction in tax liability based on certain construction expenditures. Corresponding reductions in tax expense are deferred and, except for the additional one per cent credit available under the Tax Reduction Act of 1975 which must be contributed currently to the Bell System Employee Stock Ownership Plan, are amortized as reductions in tax expense over the life of the plant which gave rise to the credits.

(b) INCOME TAXES

The components of operating income tax expense were as follows:

	<u>1981</u>	<u>1980*</u>	<u>1979*</u>
Federal:			
Current	\$ 58.4	\$ 41.1	\$ 72.5
Deferred – net	78.6	72.5	54.6
Investment tax credits – net	43.4	40.5	30.2
	<u>180.4</u>	<u>154.1</u>	<u>157.3</u>
State:			
Current	17.6	14.2	16.6
Deferred – net	10.9	9.8	7.5
	<u>28.5</u>	<u>24.0</u>	<u>24.1</u>
Total	<u><u>\$208.9</u></u>	<u><u>\$178.1</u></u>	<u><u>\$181.4</u></u>

*See Note (d).

Current income tax benefits related to non-operating deductions included in Miscellaneous income and deductions – net were:

	<u>1981</u>	<u>1980</u>	<u>1979</u>
Federal	\$.2	\$.5	\$.7
State	–	.1	.1
Total	<u><u>\$.2</u></u>	<u><u>\$.6</u></u>	<u><u>\$.8</u></u>

Total deferred income tax expense – net results principally from timing differences between depreciation expense for income tax purposes and depreciation expense reflected in these financial statements.

(Dollars in Millions)

The Company's effective federal income tax rate, as determined by dividing Federal income taxes (see page 21) by the sum of Federal income taxes and Net Income was 37.8% in 1981, 38.3% in 1980 and 39.3% in 1979. The differences of 8.2% in 1981, 7.7% in 1980 and 6.7% in 1979 between the effective rate and the federal income tax statutory rate of 46% are attributable to the following factors:

	<u>1981</u>	<u>1980</u>	<u>1979</u>
a. Certain taxes and payroll-related construction costs capitalized for financial statement purposes, but deducted currently for income tax purposes, net of applicable depreciation	2.7%	3.9%	3.4%
b. Interest charged construction, which is excluded from taxable income, net of applicable depreciation	1.1	(.3)	(.3)
c. Amortization of investment tax credits over the life of the plant which gave rise to the credits. Such amortization reduced income tax expense for the years 1981 through 1979 by the amounts shown in Note (n)	4.6	4.4	3.6
d. Other differences	<u>(.2)</u>	<u>(.3)</u>	<u>-</u>
Total	<u><u>8.2%</u></u>	<u><u>7.7%</u></u>	<u><u>6.7%</u></u>

- (c) REVISED DEPRECIATION RATES AND PRACTICES – Results reflect revised depreciation rates and practices prescribed by the FCC effective January 1, 1981. The resulting change in Depreciation expense decreased Net Income in 1981 by approximately \$22.3. See also Note (a), "Depreciation".
- (d) ACCOUNTING FOR COMPENSATED ABSENCES – Net Income for 1981, 1980 and 1979 has been reduced by \$.6, \$.6 and \$.7, respectively, and Reinvested Earnings as of January 1, 1979 have been reduced by \$3.1 to reflect accrual of the liability for vacations and other compensated absences of certain employees. This accrual, which is a change in accounting implemented during 1981 to comply with Financial Accounting Standards Board Statement No. 43, recognizes that this liability for employees expected to be associated with detariffed service offerings must be accrued when earned, rather than when paid which is the accounting method used in the rate-making process.

- (e) ACCOUNTING FOR STATION CONNECTIONS COSTS – During 1981 the FCC directed that certain costs of installing telephone service on a customer's premises be expensed as of January 1, 1981 instead of capitalized and that the investment in installation costs be amortized. This change increased Maintenance and Other operating expenses by \$24.4 and \$5.5, respectively, and decreased Depreciation expense by \$21.3. This change will increase operating expenses in future years; such increases have been allowed in New Hampshire and Vermont in determining revenue requirements in rate-making proceedings. Approval of similar treatment is pending in Maine, Massachusetts and Rhode Island.

Pending Internal Revenue Service ("IRS") action on the Company's request to make a comparable accounting change, installation costs continue to be capitalized for tax purposes and the tax effects of the timing differences are included in Deferred Credits - Accumulated deferred income taxes.

- (f) PROVISION FOR PENSIONS AND DEATH BENEFITS – Prior to October 1, 1980, the Company sponsored a noncontributory plan which covered all of its employees for service pensions and certain death benefits. Since October 1, 1980, the employees of the Company have been covered by two national Bell System noncontributory pension and death benefit plans sponsored by AT&T and the Bell System companies, including the Company, one for management employees and another for non-management employees. The IRS has approved these two newly designed plans. Contributions to such plans are made to irrevocable trust funds. It has been, and continues to be, the policy of the Company to make contributions which are equal to the current year cost of the plans determined on a going concern basis by actuarial methods specified by the Employee Retirement Income Security Act of 1974 ("ERISA"). The following data relate to plan costs:

	<u>1981</u>	<u>1980</u>	<u>1979</u>
Current year cost	<u>\$129.4</u>	<u>\$146.9</u>	<u>\$140.1</u>
Current year cost as a percent of salaries and wages	12.4%	15.6%	16.7%

(Dollars in Millions)

Amendments to the plans during 1981 had the effect of increasing 1981 pension cost by approximately \$5.5. The changes in plan design effective October 1, 1980, together with changes in actuarial assumptions and 1980 experience reduced 1981 pension cost by approximately \$55.9. Changes in actuarial assumptions, an amendment to the plans prior to October 1, 1980, and changes in plan design effective October 1, 1980 decreased pension cost for 1980 by approximately \$7.7.

Statement of Financial Accounting Standards No. 36 ("Statement No. 36") requires that certain disclosures be made of the actuarial present value of accumulated plan benefits and the fair value of net assets available for plan benefits ("fair value" essentially is current market value). But, with the October 1, 1980 merger of the individual Bell System companies' plans, including the Company's plans, into the two national Bell System plans, such disclosures are not presented for the Company because the structure of the new plans does not permit the plans' assets and the accumulated benefits data to be disaggregated. However, based on the latest actuarial valuations of the two national plans, utilizing assumed rates of return of 8.9% and 8.0% for 1980 and 1979, respectively, the fair value of net assets available for plan benefits exceeds the actuarial present value of vested and non-vested accumulated plan benefits at December 31, 1980 and 1979.

The Company believes that misleading inferences concerning the plans' funding status may result from a comparison of the actuarial present value of accumulated plan benefits with the fair value of net assets available for plan benefits. This is because plan assets have been accumulated by making contributions equal to current year costs determined on a going concern basis as required by ERISA, while the determination of the actuarial present value of accumulated plan benefits required by Statement No. 36 is essentially a "plan termination" type calculation, which uses methods and assumptions which are not the same as those used to determine current year pension costs. The required method for determining the actuarial present value of accumulated plan benefits fails to take into consideration probable future events such as future wage and salary increases and future employee service which have been taken into consideration in determining costs for the plans. Furthermore, the fair value of net assets available for plan benefits will fluctuate which also may create erroneous impressions with respect to long term progress on funding the pension plans.

- (g) INTERSTATE REVENUES TAX – In August 1979 a county court in Illinois ruled that interstate telephone revenues earned in Illinois are subject to a messages tax. This court decision was appealed and, in March 1981, was reversed by an intermediate appellate court; however, the Illinois Department of Revenue is seeking further review of this issue before the Supreme Court of Illinois. Amounts involved relate to 1967 and subsequent years and will continue to grow. The Company's interstate earnings include a reimbursement of its own interstate expenses (including taxes) plus its share of the Bell System's interstate revenues remaining after other Bell System telephone companies have been reimbursed for their interstate expenses; consequently, should it ultimately be determined that these amounts are payable, Net Income would be decreased in a future period. If such determination had been made as of December 31, 1981, the decrease in Net Income could have been as much as \$6.0.
- (h) CASH – The Company follows the practice of making certain payments by draft and recording such drafts as accounts payable until such time as the banks honoring the drafts have presented them for payment. AT&T maintains cash and temporary cash investments upon which the Company may draw on a day-to-day basis to meet its obligations, including coverage for outstanding drafts. Outstanding drafts included in Accounts payable amounted to \$33.3 at December 31, 1981, \$16.1 at December 31, 1980 and \$18.4 at December 31, 1979.
- (i) COMMON STOCK – The equity capital of the Company was increased by \$300.0 in 1981 through additional equity investment made by AT&T and by \$5.4, \$4.4 and \$3.5 in 1981, 1980 and 1979, respectively, in connection with the Bell System Employee Stock Ownership Plan. Under a merger transaction which became effective on December 22, 1980, AT&T common shares were exchanged for the Company's 7,440,213 publicly held outstanding common shares. All shares were recapitalized to one share – no par.
- (j) LONG AND INTERMEDIATE TERM DEBT – Interest rates and maturities on long and intermediate term debt outstanding at December 31, 1981 were as follows:

Maturities	3% to 4 $\frac{5}{8}$ %	6 $\frac{1}{8}$ % to 7 $\frac{3}{8}$ %	8% to 9 $\frac{1}{2}$ %	12 $\frac{1}{5}$ % to 15 $\frac{1}{4}$ %	Total
1987-1996	\$105.0	\$ –	\$ –	\$ –	\$ 105.0
1997-2006	155.0	100.0	370.0	–	625.0
2007-2016	–	325.0	230.0	–	555.0
2017-2018	–	–	–	450.0	450.0
	<u>\$260.0</u>	<u>\$425.0</u>	<u>\$600.0</u>	<u>\$450.0</u>	<u>1,735.0</u>
Unamortized discount – net					(21.8)
Total					<u>\$1,713.2</u>

(Dollars in Millions)

(k) DEBT MATURING WITHIN ONE YEAR – The Company follows the practice of financing construction of telephone plant partially through advances from AT&T, bank loans, commercial paper, commercial notes and other notes, all of which are payable in twelve months or less after issuance, pending long term financing.

Debt maturing within one year is included as debt in the Company's computation of debt ratios and consists of the following:

	Amounts			Weighted Average Interest Rate		
	1981	1980	1979	1981	1980	1979
Advances from AT&T, parent	\$ 9.0	\$ 27.8	\$ 38.0	12.25%*	15.00%*	12.00%*
Notes Payable:						
Banks loans	–	11.2	13.2	–	21.50%	15.25%
Commercial paper	20.4	68.7	152.6	12.57%	18.76%	12.81%
Commercial notes	5.0	64.2	30.0	12.68%	19.13%	13.96%
Other notes	5.0	5.0	55.0	11.92%	15.63%	10.79%
Three Year 8¾% Notes due June, 1981	–	100.0	–			
Thirty Five Year 3% Debentures due October, 1982	40.0	–	–			
Total	\$79.4	\$276.9	\$288.8			

	Amounts			Weighted Average Interest Rate#		
	1981	1980	1979	1981	1980	1979
Average amounts of notes payable outstanding during the year	\$ 72.8	\$162.1	\$153.0	16.43%	13.94%	11.07%
Average amounts of advances from AT&T outstanding during the year	\$ 12.8	\$ 25.3	\$ 7.3	14.35%	11.99%	11.85%
Maximum amounts of notes payable at any month end during the year	\$186.1	\$295.6	\$250.8	–	–	–

#Computed by dividing the average daily face amount of notes and advances payable into the aggregate related interest expense.

*Advances, which are evidenced by notes, are not in practice required to be settled currently, although the Company may elect to repay them in whole or in part prior to demand. Interest on advances is at a daily rate equal to the lower of either the rate of high-quality commercial paper as determined by AT&T or the lowest prime rate on new borrowings being charged by three designated New York City banks.

- (l) LEASE COMMITMENTS – The Company leases certain facilities and equipment used in its operations and reflects lease payments as rental expense of the periods to which they relate. See Note (n). At December 31, 1981 the aggregate minimum rental commitments under noncancellable leases for the periods shown were approximately as follows:

<u>Years</u>	<u>Amounts</u>
1982	\$ 36.7
1983	33.5
1984	30.4
1985	25.3
1986	22.2
Thereafter	<u>145.1</u>
Total	<u><u>\$293.2</u></u>

These leases include some which would be classified as "capital leases" under criteria established by the Financial Accounting Standards Board. However, for regulatory accounting and rate-making purposes, such leases are not capitalized. Had such leases been capitalized, the following amounts would have been included in the Balance Sheets:

	At December 31,		
	<u>1981</u>	<u>1980</u>	<u>1979</u>
Assets	<u>\$ 90.6</u>	<u>\$ 91.3</u>	<u>\$ 93.3</u>
Less: Accumulated amortization	<u>35.0</u>	<u>34.5</u>	<u>32.5</u>
	<u><u>\$ 55.6</u></u>	<u><u>\$ 56.8</u></u>	<u><u>\$ 60.8</u></u>
Lease commitments	<u><u>\$ 69.5</u></u>	<u><u>\$ 67.5</u></u>	<u><u>\$ 64.7</u></u>

The effect on Net Income, however, would have been insignificant.

(Dollars in Millions)

(m) QUARTERLY FINANCIAL INFORMATION (UNAUDITED) – All adjustments necessary for a fair statement of income for each period have been included.

Calendar Quarter	Amounts		
	Total Operating Revenues	Operating Income	Net Income
<u>1979</u>			
1st	\$ 530.3	\$ 84.5	\$ 55.5
2nd	543.9	90.9	60.9
3rd	557.2	93.1	62.9
4th	565.9	95.0	62.5
Total	<u>\$2,197.3</u>	<u>\$363.5</u>	<u>\$241.8</u>
<u>1980</u>			
1st	\$ 571.8	\$ 89.5	\$ 54.0
2nd	588.5	96.3	58.4
3rd	615.4	102.5	65.6
4th	623.1	109.4	69.6
Total	<u>\$2,398.8</u>	<u>\$397.7</u>	<u>\$247.6</u>
<u>1981</u>			
1st	\$ 624.3	\$ 95.3	\$ 61.6
2nd	663.4	108.2	71.2
3rd	702.3	122.1	84.0
4th	707.8	115.4	79.3
Total	<u>\$2,697.8</u>	<u>\$441.0</u>	<u>\$296.1</u>

Results for the first two quarters of 1981 have been restated to reflect the use of revised depreciation rates and practices prescribed by the FCC on a retroactive basis in 1981. The resulting changes in Depreciation expense reduced Net Income for the first two quarters of 1981 by \$5.5 and \$5.5, respectively. See Note (c).

Results for the first and second quarters of 1981 and for all four quarters of 1980 and 1979 have been restated to reflect the effect of the change in accounting for compensated absences implemented in the third quarter of 1981. See Note (d).

Results for the first three quarters of 1981 have been restated to reflect the effect of intrastate interest charged construction on short term projects in Massachusetts and Rhode Island. The resulting increases to Net Income were \$1.3 and \$1.7 in the second and third quarters, respectively, and \$9.0 in the first quarter which includes \$7.8 related to 1979 and 1980. See Note (a).

(n) ADDITIONAL FINANCIAL INFORMATION -

	<u>1981</u>	<u>1980</u>	<u>1979</u>
Depreciation - Percentage of average depreciable telephone plant	<u>6.00%</u>	<u>5.81%</u>	<u>5.75%</u>
Amortization of investment tax credits	<u>\$ 21.7</u>	<u>\$ 17.9</u>	<u>\$ 14.5</u>
Gross receipts, payroll-related and other taxes:			
Gross receipts	\$ 49.0	\$ 44.8	\$ 40.4
Payroll-related	59.5	47.6	45.3
Other4	.3	.3
Total	<u>\$108.9</u>	<u>\$ 92.7</u>	<u>\$ 86.0</u>
Interest expense:			
Interest on long and intermediate term debt ..	\$146.2	\$123.6	\$103.4
Interest on advances from AT&T	1.8	3.0	.9
Interest on notes payable	12.0	22.6	16.7
Other	1.7	1.5	1.7
Total	<u>\$161.7</u>	<u>\$150.7</u>	<u>\$122.7</u>
Rental expense	<u>\$ 57.8</u>	<u>\$ 54.4</u>	<u>\$ 46.6</u>

-
- (o) MCI AND LITTON ANTITRUST LITIGATION – In June 1980, MCI Communications Corporation was awarded \$1.8 billion in treble damages in a civil antitrust suit against AT&T. In June 1981, in another antitrust suit against AT&T and certain other Bell System companies, Litton Industries, Inc. was awarded \$276.8 million in treble damages. While the Company is not a defendant in these cases, it could experience financial impacts from such awards through contracts providing for the allocation of expenses among Bell System telephone companies. The Company has been advised that AT&T is seeking to have both these awards set aside and that it is the opinion of AT&T's legal counsel that any monetary liability or financial impact to which AT&T and the Bell System companies might be subject after final adjudication would not be material in amount.
- (p) DEPARTMENT OF JUSTICE ANTITRUST ACTION – On January 8, 1982, AT&T announced it had agreed to a proposal by the Department of Justice which modified the existing 1956 Consent Decree. As a result, both the Department of Justice and AT&T have stipulated dismissal of the Department of Justice's 1974 Civil Antitrust Action involving AT&T and its subsidiaries, including the Company. The New Consent Decree is subject to further court proceedings. The terms of the New Consent Decree require that AT&T divest those parts of Bell System operating telephone companies that provide local exchange and exchange access service and also require termination of the License Contracts between AT&T and the operating telephone companies and the Standard Supply Contract between Western Electric and the operating telephone companies. Interexchange facilities, including those currently owned by the operating telephone companies, would remain a part of AT&T, which would continue to own Western Electric and Bell Telephone Laboratories, Incorporated. AT&T's access to the services of the divested local exchange companies would be on terms and conditions equal to other interexchange carriers. Ownership of customer premises equipment would remain with AT&T. The separated local exchange companies would be divested by a spin-off to AT&T's share owners or by other disposition.

As a result of such divestiture, the local exchange companies could be required to make an immediate payment of federal income taxes previously deferred on intercompany profits (See Note (a), "Telephone Plant"). The amount of the payment applicable to local exchange plant owned by the Company is approximately \$31.2 million. While payment of these deferred taxes should have no direct effect on Net Income, an immediate payment would increase the local exchange companies needs for cash. However, AT&T believes that, pursuant to tax regulations, a closing agreement is likely to be entered into with the IRS which would result in only a moderate acceleration of the present time period over which these intercompany profits become taxable.

Supplementary Data Accounting for the Effects of Inflation (Unaudited)

Continued high rates of inflation have drawn increased attention to the need to assess both the impact of inflation on business and the results of management's efforts in coping with it. No consensus has been reached either on the preferability of any one reporting method or on the practical usefulness of the resulting data. The Financial Accounting Standards Board ("FASB"), believing that additional experience should be gained and experimentation undertaken with respect to reporting the effects of inflation, issued Statement of Financial Accounting Standards No. 33 ("Statement No. 33") which requires disclosure of supplementary data to reflect the effects of general inflation (constant dollar) and the effects of changes in specific prices (current cost). The following data have been prepared to comply with Statement No. 33; however, the Company believes that it should be used with care because the data neither completely nor accurately portray inflation's effects.

Traditionally, financial statements have been prepared on the basis of historical costs, i.e., the actual number of dollars exchanged at the time each transaction took place. However, it is recognized that general inflation has caused the purchasing power of dollars to decline, the result of which is the presentation of financial statement elements in dollars of varying purchasing power. To eliminate this disparity, such elements may be restated in "constant" dollars, each of which then has equal purchasing power. To reflect the effects of inflation and thus express operating results in dollars of comparable purchasing power, Statement No. 33 requires the Company to show what the FASB characterizes as "income from continuing operations" as if depreciation of plant assets had been based on asset amounts expressed in dollars of constant purchasing power. (This is shown in column (b) of Table A, stated in average 1981 dollars). This adjustment is derived from the application of the Consumer Price Index for All Urban Consumers ("CPI-U"), a measure of inflation based on changes in the costs to consumers of a wide range of commodities and services. (The 1981 average CPI-U has been estimated based on actual statistics through November 1981.)

Technological improvements, changes in supply and demand, and productivity gains cause the specific prices of goods and services purchased by a particular business to fluctuate differently from price changes that would be caused solely by general inflation. To reflect the effects of such specific price changes on operating results, Statement No. 33 requires that the Company also show "income from continuing operations" as if depreciation of plant assets had been based on the "current cost" of these or comparable assets, rather than on historical cost. (This calculation is shown in column (c) of Table A, stated in average 1981 dollars.) Because current cost data are unique to each company, the current cost of telephone plant has been calculated by applying internally-generated indexes to investments in each of the major telephone plant accounts.

(Dollars in Millions)

In computing "income from continuing operations," only depreciation expense has been adjusted to show the effects of inflation. Because most other operating expense items are current year transactions, they already are recorded in dollars of approximately current purchasing power.

In accordance with requirements of Statement No. 33, no adjustments have been made to reflect any effects of inflation on provisions for federal income taxes. The effective federal income tax rate (operating federal income taxes divided by the sum of operating federal income taxes and "income from continuing operations") for the historical data in column (a) of Table A would be 37.9%. The rate reflecting adjustments for inflation would be 115.4% for column (b) and 76.3% for column (c) of Table A. While the federal income taxes used in these computations include Investment Tax Credits and tax deferrals relating to accelerated depreciation, the effects of inflation on effective tax rates also would be dramatically increased, even though in lower percentages, if these tax benefits were excluded. These tax benefits were intended by Congress to provide funds for investment in other capital assets in order to increase productivity and employment.

Amounts shown as "net assets at year end" in Table B are common share owner's equity as shown in the historical cost financial statements, adjusted for general inflation by the difference between telephone plant at historical cost and telephone plant in constant dollars and adjusted for changes in specific prices by the difference between telephone plant at historical cost and telephone plant at current cost.

It is essential that regulatory authorities allow telephone services to be priced at levels that will preserve the Company's ability to attract the continuing additional amounts of capital necessary to meet the public's demand for telephone services. Such price levels need to provide rates of return which, giving recognition to the effects of inflation, adequately will compensate purchasers of securities for funds provided for telephone plant construction. This inflation-affected compensation would acknowledge higher interest rates for debt securities in anticipation that such debt will be repaid in dollars having less purchasing power; it would acknowledge that returns on equity securities must be comparable with returns available on alternative equity investment opportunities. Because of this comparable return requirement for equity securities, any reflection of "constant dollar" or "current cost" depreciation in the returns on equity of non-regulated companies should result in regulatory recognition of the need for increased returns on equity for the Bell System and thus give recognition to similar inflation effects on its depreciation. Accordingly, the Company has no reason to expect that increases in operating revenues will not keep pace with the effects of inflation on depreciation; the constant dollar and current cost amounts shown for telephone plant investment in the accompanying schedule reflect this premise. Should regulatory authorities not give recognition to the need for such higher equity returns, then the recoverable amount of the Company's plant, when adjusted for inflation's effects, could be reduced. The amount of such reductions applicable to constant dollar results in 1981 (Table A column (b)) could have been as much as \$146.4, the cumulative amount of such reductions at December 31, 1981, could have reduced "net assets," as defined herein, by as much as \$3,941.6. No reduction applicable to current cost results in 1981 (Table A column (c)) is necessary; current cost depreciation provided for any 1981 reduction that otherwise might have been necessary. However, the cumulative amount of current cost reductions applicable to all years through December 31, 1981, had they been required, could have reduced net assets at December 31, 1981 by as much as \$3,141.0.

The reader should note the item identified in the supplementary schedule as "benefits from decline in purchasing power of net amounts owed." During periods of inflation lenders of money experience a loss due to the fact that amounts owed to them will be repaid in dollars having less purchasing power than the dollars originally lent; it is in anticipation of such loss that interest rates are so high during inflationary times. Conversely, to the extent that lenders are losing purchasing power, borrowers are benefitting. In assessing the impact of inflation on business, the Company believes that the benefits from inflation's effects on money that is borrowed should be viewed as an offset to interest expense. The benefit, however, does not provide funds to the Company or increase the amount of cash available for dividends.

The disclosure called for by Statement No. 33 is misleading by its incorrect inference that the Company ought not to have paid out more in dividends than its inflation-adjusted income from continuing operations. Statement No. 33 is based on the incorrect premise that depreciation expense, rather than being a means of allocating asset costs to accounting periods, provides funds to be set aside and used for the replacement of those assets being depreciated. Statement No. 33 also assumes that the cost of new assets acquired to replace retired assets will equal the original cost of the retired assets adjusted for either inflation or specific price increases; obviously such is not the case for a high technology industry such as ours. Technological advances hold down price increases for new communications equipment and also increase significantly the productive capacity of both new and existing equipment. As shown in the accompanying Analysis of Construction Program and Cash Utilization (Table C), internally-generated funds, after paying dividends, were sufficient not only to provide all the funds needed for plant replacement, modernization and customer movement, but also to provide \$124.6, \$104.7 and \$89.3 in 1981, 1980 and 1979, respectively, for financing new telephone growth and other corporate investments.

Readers also should note that the increase in the specific prices of telephone plant actually has been less than the general increase in the rate of inflation. This difference primarily is attributable to "benefits of technological improvements in constructing telephone plant." These technological improvements, combined with the resulting improvements in productivity, have been responsible for the Company's success in keeping the rate of growth in the prices of its services below the rate of growth in the general level of prices.

Statement No. 33 also requires that the data shown in Table B be presented in a five year summary, restated into the average purchasing power of the dollar during 1981. The calculations for these restatements have been made by applying the average CPI-U for 1981 to the data for the years 1977 through 1980. No adjustments have been made to the historical cost information, which is presented for comparison purposes only.

Supplementary Financial Data Adjusted for the Effects of Inflation and Changing Prices – December 31, 1981

(Dollars in Millions)

Table A

	As Reported in the Historical Cost Financial Statements (a)	Adjusted for General Inflation (Constant Dollars) (b)	Adjusted for Changes in Specific Prices (Current Costs) (c)
Operating revenues	\$2,697.8	\$2,697.8	\$2,697.8
Depreciation	354.6	674.8	594.7
Other operating expenses	1,470.6	1,470.6	1,470.6
Operating federal income taxes	180.4	180.4	180.4
Other operating taxes	251.2	251.2	251.2
Other income	(16.8)	(16.8)	(16.8)
Interest expense	161.7	161.7	161.7
	<u>2,401.7</u>	<u>2,721.9</u>	<u>2,641.8</u>
Income (loss) from continuing operations	<u>\$ 296.1</u>	<u>\$ (24.1)</u>	<u>\$ 56.0</u>
Benefits from decline in purchasing power of net amounts owed		<u>\$ 233.7</u>	<u>\$ 233.7</u>
Amount by which current cost of telephone plant would have increased if computed by reference to changes in general price levels			\$ 782.4
Increase in current cost of telephone plant			<u>395.8</u>
Difference, primarily due to benefits of technological improvements in constructing telephone plant			<u>\$ 386.6</u>
Telephone plant, net of accumulated depreciation (year end 1981 dollars) ..	<u>\$4,930.3</u>	<u>\$9,057.0</u>	<u>\$8,218.8</u>

Supplementary Five-Year Comparison of Selected Financial Data

Table B

	<u>1981</u>	<u>1980*</u>	<u>1979*</u>	<u>1978</u>	<u>1977</u>
Operating revenues in average 1981 dollars	\$2,697.8	\$2,649.5	\$2,754.9	\$2,832.4	\$2,803.3
Historical cost information					
Income from continuing operations	\$ 296.1	\$ 247.6	\$ 241.8		
Net assets at year end	2,445.7	2,056.7	1,985.8		
Historical cost information adjusted for general inflation (average 1981 dollars): ¹					
Income (loss) from continuing operations \$	(24.1)	\$ (8.8)	\$ 45.0		
Net assets at year end	6,277.7	6,027.2	5,955.4		
Historical cost information adjusted for changes in specific prices (average 1981 dollars): ¹					
Income from continuing operations	\$ 56.0	\$ 46.3	\$ 71.8		
Difference between the amount by which current cost of telephone plant would have increased if computed by reference to changes in general price levels and increase in current cost of telephone plant	386.6	173.7	556.6		
Net assets at year end	5,477.1	5,468.2	5,492.2		
Other Information: ¹					
Benefits from decline in purchasing power of net amounts owed in average 1981 dollars	\$ 233.7	\$ 286.1	\$ 332.5		
Average CPI-U (1981 estimated)	272.7	246.8	217.4	195.4	181.5

¹Certain information for the years prior to 1979 is not disclosed since it is impractical to obtain.

*See Note (d).

Analysis of Construction Program and Cash Utilization

Table C

Construction program components (approximate):

	In Millions of Historical Dollars		
	1981	1980	1979
Plant replacement	\$ 47.6	\$ 41.5	\$ 46.5
Plant modernization	175.6	175.3	135.4
Customer movement	145.5	164.4	161.9
Growth	342.6	299.1	216.6
	711.3	680.3	560.4
Add-Interest charged construction	17.0	1.7	1.8
Total construction program	\$728.3	\$682.0	\$562.2
Retirements of telephone plant at historical cost	\$194.5	\$219.8	\$191.3

Internally-generated funds available for investments (see pages 16 and 17):

	In Millions of Historical Dollars		
	1981	1980*	1979*
Funds from operations	\$760.6	\$680.8	\$620.8
(Increase) in working capital	(84.4)	(6.0)	(.7)
Decrease (increase) in deferred charges and other-net ..	29.6	(7.8)	(15.8)
	705.8	667.0	604.3
Less – Dividends	212.5	181.1	171.2
Funds available for investments	493.3	485.9	433.1
Less – Amount spent on plant replacement, plant modernization, and customer movement	368.7	381.2	343.8
Funds available for growth and other investments	\$124.6	\$104.7	\$ 89.3

*See Note (d).

1981-82 Director and Officer Changes

Randolph W. Bromery, a member of the Board of Directors for more than 4 years, resigned to pursue other business activities. His service on the Company's Board was a valuable and productive one, and his contributions to our business are greatly appreciated.

Robert J. Casale, Vice President-Business Marketing, accepted a position with AT&T as National Director of Business Sales.

Richard W. Blackburn, General Attorney, was elected Vice President and General Counsel succeeding C. Duane Aldrich who retired.

Peter W. Bertschmann, Vice President-External Affairs, was named Vice President-Personnel succeeding Harold R. Dann who will retire effective March 31, 1982.

Walter E. Bartlett, Vice President-Public Relations, was named Vice President-External Affairs, and Rodney M. Torres, Vice President-Business, was appointed Vice President-Marketing.

Richard A. Jalkut became Vice President-Maine replacing Perry M. Hudson who retired; and Rita A. O'Brien became Vice President-Rhode Island replacing Bruce W. Baldwin who had transferred to the Revenue Matters Department at Corporate Headquarters in Boston.

Officers and Board Committees

Officers

PRESIDENT
WILLIAM C. MERCER

EXECUTIVE VICE PRESIDENT
JOHN S. NORTH

VICE PRESIDENTS
WALTER E. BARTLETT
PETER W. BERTSCHMANN
RICHARD W. BLACKBURN
General Counsel
HAROLD R. DANN
LINCOLN A. DIVOLL
DELBERT L. EMERY
HAYNES H. FELLOWS, JR.
Finance and Comptroller
PETER L. HAYNES
PETER C. MANUS
GEORGE D. NOBLE, JR.
THOMAS J. NORRIS
JOHN F. PRENDIVILLE
RODNEY M. TORRES

TREASURER
JAMES F. CRAIN

SECRETARY
WILLIAM H. P. SMITH

State Vice Presidents

RICHARD A. JALKUT
Maine

LINCOLN A. DIVOLL
Massachusetts

JOHN J. COLEMAN
New Hampshire

RITA A. O'BRIEN
Rhode Island

DEIGHTON K. EMMONS
Vermont

Executive Committee

WILLIAM C. MERCER
Chairman

RICHARD D. HILL

MAURICE LAZARUS

JOHN S. NORTH

DONALD A. ROACH

HUGH C. SAUNDERS

Audit Committee

LOUIS W. CABOT
Chairman

LUTHER F. HACKETT

MRS. GEORGE L. SARGENT

Corporate Public Policy Committee

MAURICE LAZARUS
Chairman

EDWARD E. PHILLIPS

ADELE S. SIMMONS

KIMON S. ZACHOS

Board of Directors

LOUIS W. CABOT
Chairman of the Board, Cabot
Corporation, Boston, Mass.

HAYNES H. FELLOWS, JR.
Vice President, New England
Telephone and Telegraph
Company

LUTHER F. HACKETT
President, Hackett, Valine &
MacDonald, Inc., Burlington,
Vermont

RICHARD D. HILL
Chairman of the Board and
Chief Executive Officer, First
National Boston Corporation,
Boston, Mass.

WALTER B. KELLEY
Vice President-Tariffs and Costs,
American Telephone and
Telegraph Company, New York,
N.Y.

MAURICE LAZARUS
Chairman of the Finance
Committee, Federated
Department Stores, Inc., Boston,
Mass.

WILLIAM C. MERCER
President, New England
Telephone and Telegraph
Company

JOHN S. NORTH
Executive Vice President,
New England Telephone
and Telegraph Company

EDWARD E. PHILLIPS
Chairman and Chief Executive
Officer, New England Mutual
Life Insurance Company,
Boston, Mass.

DONALD A. ROACH
President and Chief Executive
Officer, Brown & Sharpe
Manufacturing Company, North
Kingstown, Rhode Island

MRS. GEORGE L. SARGENT
Vice Chairman of the Board
of Trustees, New England
Medical Center Hospital, Inc.,
Boston, Mass.

HUGH C. SAUNDERS
Chairman of the Board and
Chief Executive Officer,
Saunders Brothers, Inc.,
Westbrook, Maine

ADELE S. SIMMONS
President, Hampshire College,
Amherst, Mass.

KIMON S. ZACHOS
Partner, Sheehan, Phinney,
Bass & Green, Manchester,
New Hampshire



New England Telephone

 New England Telephone

RECEIVED BY
OFFICE OF CITY CLERK

MAR 25 4 48 PM '82

CAMBRIDGE, MASS.



**New England
Telephone**

185 Franklin Street
Boston, Mass. 02107
Phone (617) 743-4207

Joseph R. Plati
Division Staff Manager-Taxes

March 31, 1982

Dear Sir:

Enclosed is a copy of Annual Report of New England Telephone
and Telegraph Company for the year 1981 filed in accordance with
Massachusetts General Laws (Ter. Ed.), Chapter 166, Section 12A.

Very truly yours,

Attachment

Comm. from Paul E. Healy, City Clerk, transmitting comm. from Joseph R. Plati, Div. Staff Mgr. of Taxes, New England Telephone & Telegraph Company enclosing the 1981 Annual Report of said company.

In City Council,

March 29, 1982

3/29/82
Placed
on
File