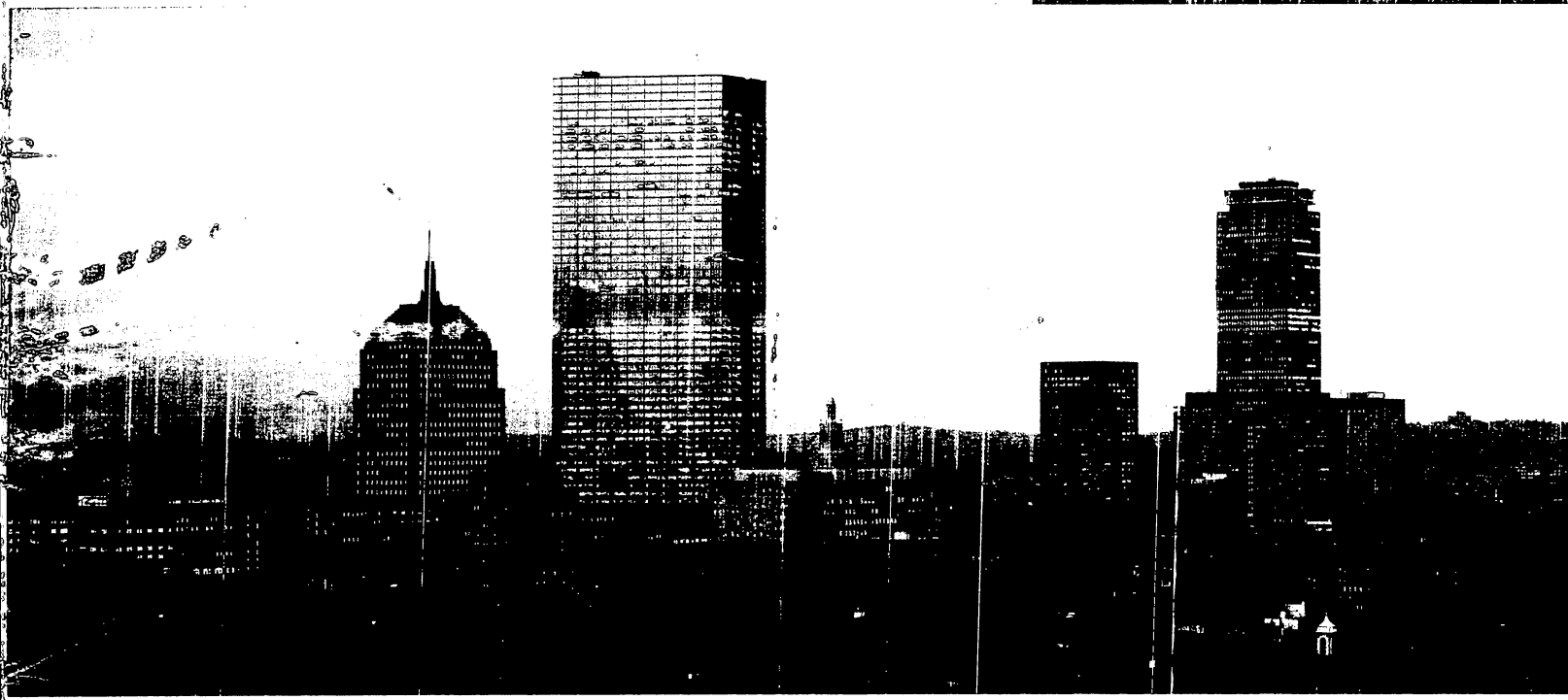




New England Telephone

A **NYNEX** Company



1985
Annual Report

Highlights Of 1985

	1985	% Change Over Prior Year
Operating Revenues	\$3,086,444,000	+ 8.5
Expenses	\$2,120,852,000	+ 9.0
Taxes	\$ 443,380,000	+ 7.1
Net Income	\$ 379,550,000	+16.8
Total Construction	\$ 843,361,000	+10.2
WATS Messages		
(IntraLATA)	311,287,000	+15.3
Toll Calls	2,807,400,000	+11.2
Local Calls	13,753,600,000	+ 3.1
Calls/Business Day	65,980,000	+ 4.8
Access Lines	4,804,000	+ 3.3
Employees	28,698	- 3.1

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President's Report

I'm pleased to report that 1985 was another excellent year for New England Telephone.

By every major indicator we surpassed our 1984 performance which was one of the best in the company's history.

- Toll messages and WATS volumes grew for an overall increase of 11.7%.

- We added over 150,000 new access lines.

- Net income rose 16.8 per cent to \$380 million on revenues of \$3 billion.

- Return to Equity, a measurement of great importance to investors, reached 14.51 per cent in 1985, an increase of nearly a full percentage point over 1984.

- Our debt ratio was reduced to 41.9 per cent and our depreciation reserve grew 13.3 per cent over 1984.

- We achieved 100 per cent internal funding of our construction budget.

- Service continued to improve, as reflected by both internal and external measurements.

- Once again our team did a solid job of paring expenses through a most effective cost control campaign.

These fine results were brought about with a smaller number of employees even while our business was growing significantly. We reduced our work force by over 900 during 1985, bringing the total reduction to 3,000 since Divestiture.

And this streamlining of employee levels was achieved through sound force management, without the need for layoffs.

I am especially proud of our New England Telephone employee

team for the fine way they have so quickly adapted to the changes that have taken place in our industry. They have made this outstanding year possible.

It is gratifying to see that so many of them carry this same spirit of proprietorship and dedication into their communities where they volunteer their time and talents to enrich the lives of others.

Strong Economy

Another factor in our positive performance during 1985 was the strong New England economy.

Personal income growth in our company's operating area was greater than the nation's as a whole and employment continued to increase steadily.

"U.S. News and World Report" listed four of our major cities—Boston, MA, Burlington, VT, Manchester, NH, and Portland, ME—among the top ten in the nation "where business is best."

We operate today in a dynamic environment. We are in a transition from a predominantly regulated business to one which is increasingly competitive and driven by the marketplace.

Rapidly evolving technology is making it possible and profitable for others to enter the telecommunications market. Many regulators,

seeing competition as a means of expanding consumer choices and lowering prices, welcome the new entrepreneurs.

Despite these fundamental changes, we continue to retain our traditional values. We still believe our most important mission is to provide our customers an outstanding level of service, efficiently and courteously. By combining our heritage of public service with our technical and marketing skills, we intend to be a leader in the competitive information business.

Larger Markets

We expect that our revenues will grow as the rapidly expanding information industry creates increasingly larger markets for the kinds of services we provide.

The information industry is a multi-billion dollar business with high growth potential. Our state-of-the-art network, which reaches virtually every corner of our five-state area, gives us an opportunity to serve a major share of that expanding market.

We have invested heavily in the future of that information industry as evidenced by a construction budget of almost four billion dollars for the five year period ending 1985. And we plan to continue to invest at a rate of over \$800 million per year to insure that we remain

the leading-edge supplier of telecommunications services.

We will enhance our existing network with hardware and software to create a public switched *digital* network, evolving from a company providing universal *telephone* service to one providing universal *information* service.

Two-phase Plan

We have a two-phase plan to achieve this evolution.

First, we will continue to expand and enhance our present telecommunications services. We'll provide our customers with leading-edge technology, custom designed to meet their needs.

For example, computer-based switching systems will continue to replace electro-mechanical central offices at a rapid pace. By the end of 1985, 60 per cent of all main lines were served by computerized switches and we expect that figure to grow to 80 per cent by the end of 1988.

And, secondly, by aggressively deploying fiber optics and electronic switching facilities, we will continue the rapid expansion of our digital network that will ultimately give all our customers access to the Information Age services of the future.

During 1985 we converted 29 of our switching offices from electro-mechanical to digital at a cost of \$121 million, and we plan to spend another \$130 million to convert 48 more during 1986.

And while we are setting the pace in technology, we also are working hard to encourage the kind of regulatory environment that will permit us to compete more freely in the marketplace.

Complex Times

These are complex times in our industry and both we and our regulators must resolve difficult issues and find innovative solutions to problems associated with the deregulation of the telecommunications business.

As an example, we have petitioned the Federal Communications Commission (FCC) for permission to bill our customers directly on a per-minute basis for connecting calls from their phone to their long distance company's call switching point.

This plan would enable us to offer lower rates to high volume users, thus reducing the incentive they now have to bypass our local network.

The Massachusetts Department of Public Utilities, meanwhile, issued an order authorizing intra-LATA competition in the state by

the end of 1986. This, in effect, opens up virtually all areas of our business to competition.

We anticipated this development and supported it. We recognize that competition in all phases of our business is inevitable and we ask only for the opportunity to be able to compete on an equal footing.

We are encouraged by the actions of our regulators and are confident that they will continue to allow us greater pricing and operating flexibility in the months ahead.

Increasing Confidence

We look to 1986 with an increasing level of confidence based on our excellent performance during the past year. But we also recognize challenges that remain to be met.

During the months ahead we plan to:

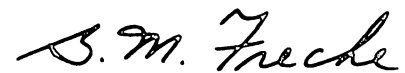
- Further improve our rate of return in all jurisdictions.
- Continue to work with our regulators to achieve a less regulated, more flexible operating and pricing environment.
- Position ourselves as the vendor of choice by providing responsive personal service and technology tailored to the needs of our customers.
- Continue to reduce our overhead and become even more cost-competitive. In fact, this year we

took a significant step in becoming joint owners of the NYNEX Service Company with New York Telephone to further improve operating efficiencies and reduce costs.

Help our customers better understand who we are and how we serve their communications needs in this new telecommunications environment.

Fully utilize the talents of our employees and create an environment in which they can work with pride and be recognized for their achievements.

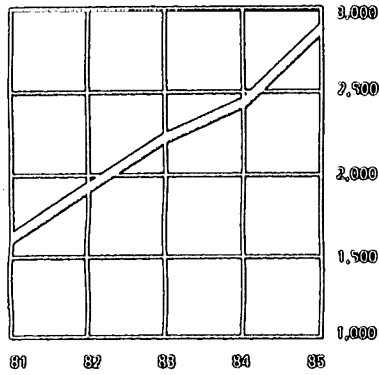
I am proud of our team's accomplishments in 1985 and I am confident in our ability to record even greater successes in the months and years ahead.



G. M. Freche
President and Chief
Executive Officer

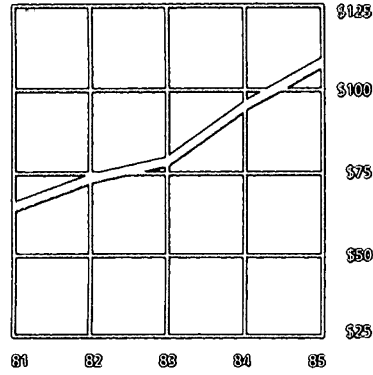
Access Lines Served by Electronic Switching

(in thousands)

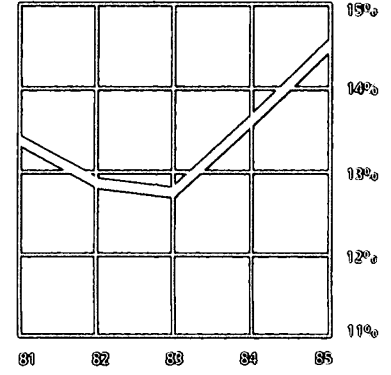


Operating Revenues per Employee

(in thousands)



Return to Equity





Tradition And The Future

From New England Telephone's inception more than a century ago, its mission has been to provide its customers with the best possible service at the lowest possible cost consistent with a sound financial policy.

The manner in which we have carried out this mission has been influenced through the decades by fundamental changes in society and technology.

The basic transformation now occurring in the telecommunications industry is yet another of those changes.

New technology is being developed at an unprecedented rate; our industry is moving swiftly from regulation to open competition; and the expectations of both our customers and our employees are being affected by the social forces of a world made smaller by the very communications industry of which we are a part.

This report describes our major accomplishments in 1985 as a member of the NYNEX family. But, more than that, it offers a sense of our corporate style and character as we lead the industry into a new era, managing toward the future while retaining the valued traditions of the past.

Earning Well In A Sound Economy

During 1985, the second year since Divestiture, we continued to demonstrate our ability to operate successfully in an increasingly competitive environment.

Net income increased 16.8 percent over 1984 and revenues were up 8.5 percent over the same period.

We accomplished this by stimulating greater use of our services; introducing new services designed to fill the needs of an expanding market; and keeping a tight rein on costs.

We expect to continue this successful performance, too.

The marketplace gives every indication of increasing the demand for our services.

The population of our five states is increasing steadily and sound economic growth is forecast into the 1990s.

Personal income growth in our company area was significantly greater than the nation as a whole in 1985 and is expected to continue leading the country through 1987.

Network Consultant Nancy Woodfork, left, confers with Karen Daidone, Senior Communications Coordinator for Goldman, Sachs & Co., at the investment firm's Boston office. As part of her marketing duties, Nancy analyzes customer needs and recommends services to meet those needs. Once a sale is made, she coordinates timely delivery of the new system and maintains close contact with the customer to answer questions, resolve problems and otherwise ensure total customer satisfaction.

The region's employment growth is rising steadily, also at a greater rate than the rest of the nation.

And the main drivers of the economy—business services, high tech products, education and defense business—are expected to remain strong.

We spent \$843 million in 1985 to build and modernize the switching, transmission and other facilities needed to make certain we are able to fill the needs of everyone—from the largest business demanding state-of-the-art communications capabilities to the residence customer who simply wants access to the network.

Reducing Costs Through Efficiency

Programs that reduce costs don't necessarily mean going without or doing less. We think it's better to control expenses by making the operation more efficient.

A good example of that is the deployment of digital technology in our network. This technology enables us to save significant amounts of money on operation and maintenance. Better still, it paves the way for new services which generate even more revenue.

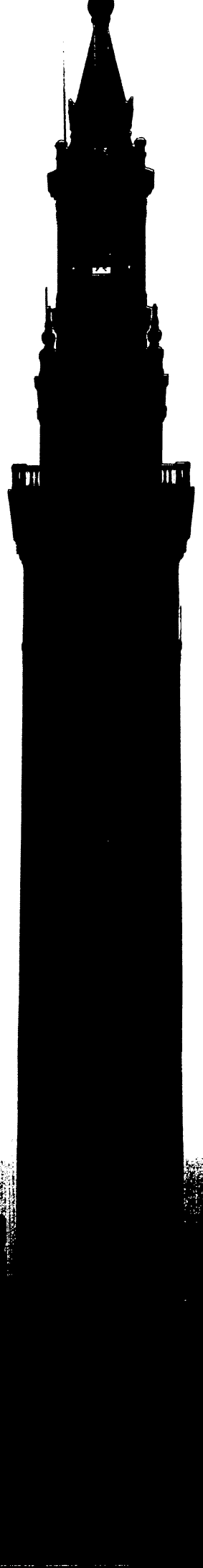
Right now we're introducing new systems whereby the digital capability of a large central switching machine can be routed to smaller satellite switches—making the technology available to more customers while reducing the cost of providing that service.

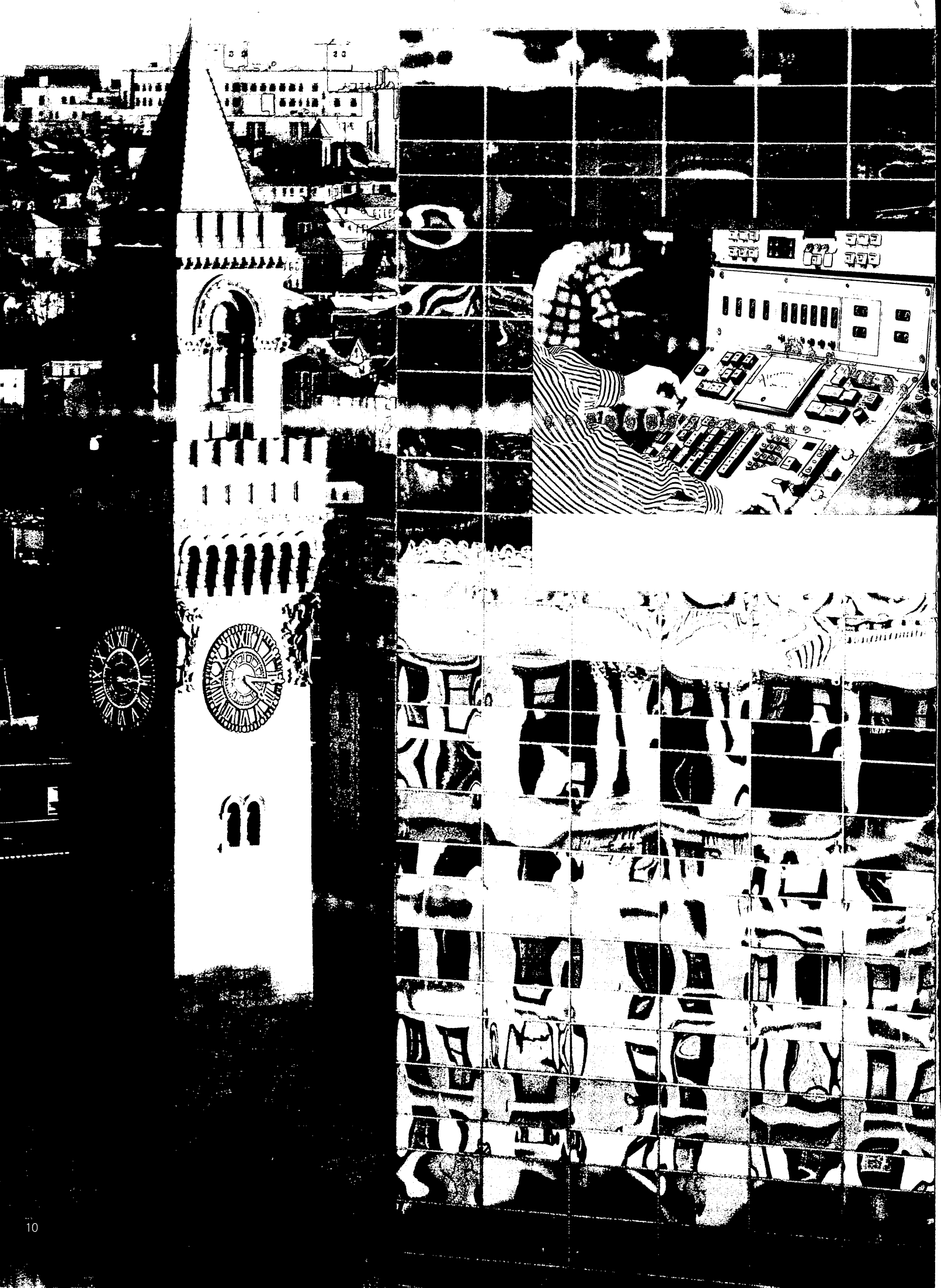
We're also working with NYNEX and Bellcore—which provides engineering and other services to the regional companies—to develop new mechanized and automated maintenance systems for our digital environment. We expect these systems will result in substantial savings as they become fully functional.

Our own Cost Competitiveness Campaign, which rewards employees for identifying and suggesting methods of eliminating unnecessary expense, has saved the company hundreds of thousands of dollars.

And, by enlarging spans of supervision and taking advantage of normal attrition, we further lowered our cost of doing business in 1985 by adjusting the work force downward by more than 900.

When a customer transmits digital data, that stream of information flows into one of our switching centers where sophisticated electronic equipment interprets the routing instructions and directs the data instantly along the appropriate network path to its destination. The digital cross-connect equipment which performs this function in our Springfield, MA, central office is being monitored here by Technician Chip Brodeur. This new technology enables us to route digital traffic more efficiently and with less equipment than was once possible.





In independently conducted surveys, residence customers reported strong satisfaction with both the technical and personal quality of service that we provide.

Ninety-seven percent of our top 100 business customers rated our service satisfactory to excellent during 1985. And a survey of 8,500 other business customers showed that 89 percent of them rated our service satisfactory to excellent.

We are gratified by these results but we are working hard to make them even better in 1986.

Our Employees Are The Key To Our Success

Our employees are our most important asset.

As we face the challenges of competition, it is they who will determine the degree of our success. Thus, we encourage them to assume greater levels of responsibility, to improve their skills and to recognize their changing role in the business.

We have programs in place to help them accomplish this.

They range from analytical, leadership and financial courses for first and second level managers to seminars in strategic thinking and planning for senior management.

These programs are designed to help the leaders of our business make the transition from traditional styles of management to a more participatory one involving risk-taking and independent action.

The object is to develop the "manager of the future" and change the company's personality and management style at all levels.

And much the same philosophy that shaped the new management development program is being employed in a corresponding program for non-management employees.

We're making a special effort to provide our employees with training in the technical skills for which there will be increasing demand in the workplace of the future. This training will be augmented by other programs such as job rotation and alternative reward systems.

These efforts are intended both to fill the growing needs of the business and to broaden the career potential of our employees.

In Newport, RI, Technician Tom Cook tests lines, trunks and other components of the DMS-100 switching system which brings the speed and versatility of digital communications to local residence and business customers. Technicians use this specially designed diagnostic equipment to ensure that the system operates at peak efficiency. During 1985 we converted 29 of our switching offices from electro-mechanical to digital at a cost of \$121 million, and we plan to spend another \$130 million in 1986 to convert 48 more.

Installation-Maintenance Manager Chet Harriman, left, Outside Plant Engineer Joe Raynes, and Outside Plant Supervisor Doug Swasey discuss plans for providing telecommunications services to this 13-story office building being erected in downtown Portland, ME. The tenants, including a bank and an insurance company, will require a full range of our network services—from voice grade telephone lines to special circuits designed to carry digital data. Projects such as this require extensive planning to ensure that all facilities are in place when the customer needs them.

The ultimate goal is deregulation. While that may not be realized in the immediate future, regulators are showing signs of better understanding and appreciating the needs of our industry.

For example, the Massachusetts Department of Public Utilities, as part of an order establishing intraLATA competition in late 1986, is granting us pricing flexibility for those services found to be fully competitive.

The commissions in Maine and Vermont have approved rate filings that include provisions for discounts for high volume users of our intrastate long distance network. These orders give us increased flexibility to price our services competitively so that we can retain these valued customers.

And the chairman of the Vermont commission has suggested the deregulation of all services with the exception of residence and small business exchange service.

We intend to continue working with our regulators on these and other initiatives as our business moves confidently into the competitive marketplace.

Service Is Still The First Priority

High quality service is our heritage.

Whether it meant wading through snowdrifts to keep the lines open, restoring facilities after natural disasters, or simply providing dial tone when a customer wanted it—our commitment has always been to provide the best possible service.

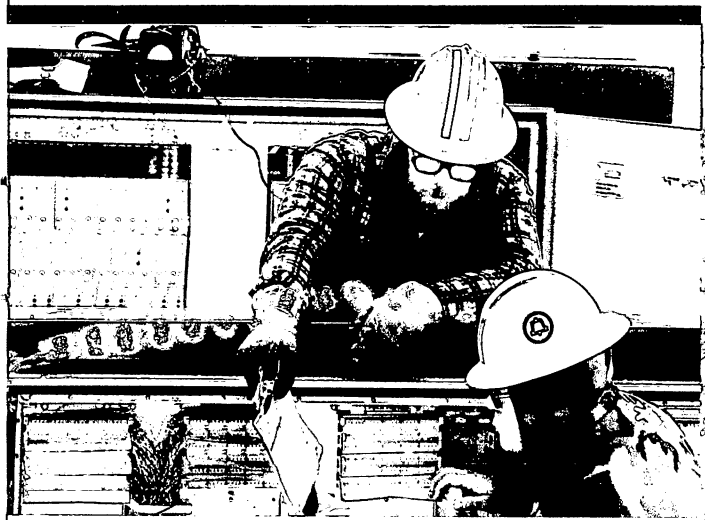
Now, with virtually every facet of our business open to competition, we have even more reason to honor that commitment.

We know that providing top quality service is the surest way to retain our present leadership role and to meet the needs of the new markets emerging in the Information industry.

While we have always managed our business by the strictest standards and measurements, we realize that the ultimate test of quality is not how we grade our service, but how our *customers* perceive it.

We monitor their opinions very carefully and during 1985 they told us we were doing the job well.





We must position ourselves so as to be recognized as the vendor of choice.

One of the objectives of this strategy is to protect and expand the revenue stream from the largest business customers.

We are accomplishing this through the efforts of our authorized sales agents and through personalized service provided to customers by our management personnel.

Our determination to anticipate marketplace demand is evidenced by the introduction during 1985 of a new family of advanced digital network services. This product line, called NYNEX PathwaysSM services, reflects our commitment to the evolving communications technology which will form the core of the Integrated Services Digital Network (ISDN)—the rapidly emerging standard for international communications.

At the same time, we're devising new ways to fill our customers' communications needs with CENTREX. This traditional service is being modernized with advanced technology and made more attractive through new flexible pricing plans.

We also have made organization changes that reflect our understanding of the industry's shift from pervasive regulation to a more competitive environment.

These included the merging of our marketing and pricing functions, and the organization of our staff into distinct groups dedicated to serving specific categories of customers—such as equipment vendors, long distance carriers and users of business services.

In order to sell our services most effectively, it is essential that we be able to package and price them in a manner that will be attractive to our customers. To accomplish this, we must look to our state commissions to permit us to move as swiftly as possible from a system of regulation to one based on the demands of the market.

Our immediate agenda is to seek a relaxation in regulation, to be allowed a degree of pricing flexibility, and to have the rates of competitive services controlled by the marketplace.

Splicing Technicians George Vinal, left, and Stu Paquette install a new transmission system that will provide digital communication service for a growing residential development in South Burlington, VT. This modern technology makes it possible for us to expand our network more efficiently and economically because it can serve up to 96 customers with fewer than a dozen pairs of wires. By the end of 1985, we had more than 3,000 of these systems in operation, serving homes and businesses in all five of our states.

We're also striving to make our operation more efficient by collaborating with NYNEX and New York Telephone on the development of payroll and personnel systems and training programs.

That's the way to be competitive.

Many business customers require dedicated communication lines to transmit their voice and data traffic from one of their company locations to another, to maintain alarm systems, or to fill other kinds of business needs. We provide these special transmission lines and test them routinely to ensure that the signals being carried meet our rigid standards. This quality control process is carried out on special test-boards like this one in Worcester, MA.

The Network Moves With The Speed Of Light

We're making our network more useful to our customers every day by increasing its speed and expanding its capabilities.

We're enhancing our switching and transmission facilities with the very newest technology available anywhere—and concentrating these capabilities where the demand is greatest.

By the end of 1985 we had 18,000 fiber miles in service and we plan to triple that amount by the end of 1988. Fiber optic systems transmit voice, data and video signals through thin strands of glass at the speed of light.

These glass fibers carry far more traffic than traditional copper and, once in place, their capacity can be increased even more by upgrading the electronic components on either end.

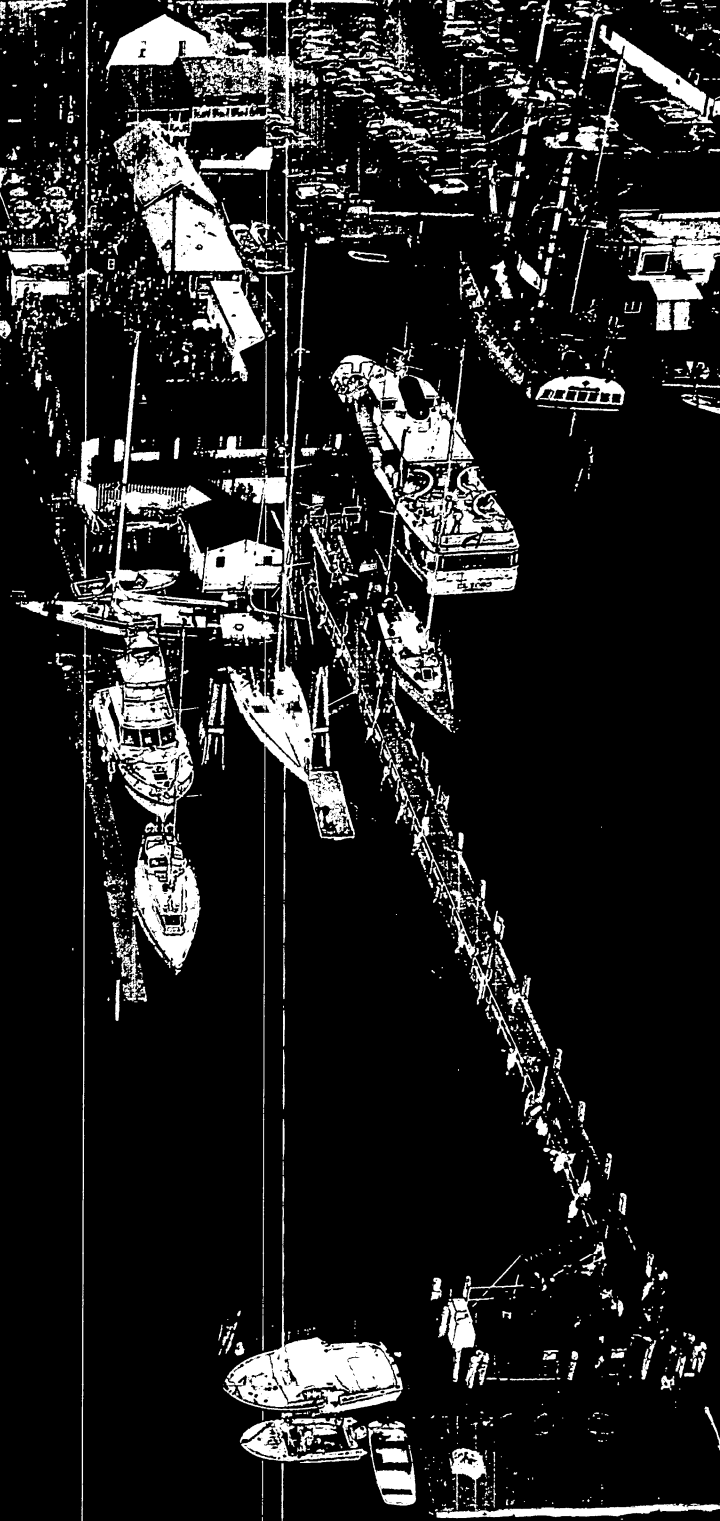
Today's businesses run on computers which "communicate" in a digital language. During 1985 we converted 29 of our central office switches from electro-mechanical to digital—a project involving more than a quarter of a million customer lines.

By the end of 1986, we expect that nearly 68 percent of the circuits connecting our switching offices will be served by digital facilities.

In addition to making the latest technology available to our customers, we also provided thousands more of them with the ability to reach the long distance company of their choice by simply dialing "1." By the end of 1985, 47 percent of our eligible network access lines were equipped with this capability.

Seeking More Freedom To Market Our Services

In the competitive world of telecommunications, our strategic goal is to anticipate and respond to the moves and demands of the marketplace.





In short, we are working to create and maintain an environment in which all the men and women in our multi-cultural work force have the opportunity to use their unique and creative talents to benefit themselves, our customers and the corporation.

Service Representative Gail Caulfield is one of nearly 70 employees in the Residence Service Center in Manchester, NH. Service representatives assist customers throughout each business day, arranging for new service installations, handling requests for movement of existing service, and answering questions on all aspects of the business. The Manchester office handles some 1,600 calls each business day and serves more than 150,000 customers across all of southern New Hampshire.

Good Citizenship Is Part Of Our Heritage

While our management and marketing styles are changing, our dedication to good citizenship remains constant.

As a corporation and as individuals, we feel justifiably proud of our heritage of service to the communities in which we live and work.

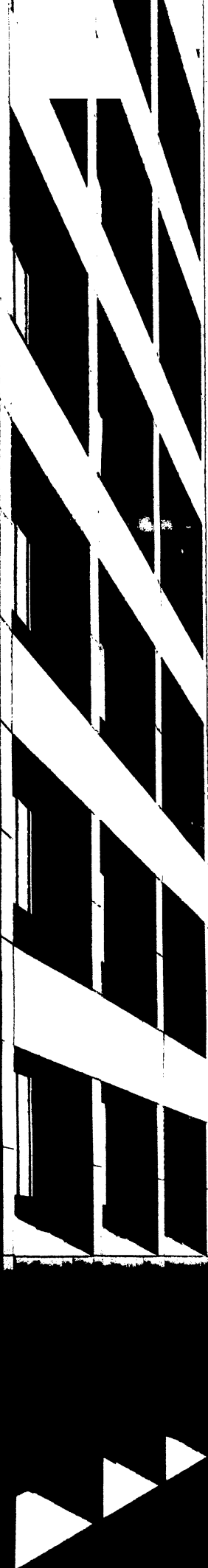
During 1985, for example, our employees contributed \$3.1 million to United Ways throughout New England. They also gave nearly \$34,000 to cultural organizations and \$208,000 to colleges—with both totals being matched by the company.

On a more personal level, Telephone Pioneers—an organization of employees with at least 18 years service—volunteered 250,000 hours of their time during 1985 to a variety of projects to aid the sick, the elderly, the physically and mentally impaired, and others in need in our society.

Countless other employees also served their communities by working on behalf of various community, social and civic programs—ranging from United Way boards to the coaching of youth sports.

Meanwhile, the company continued its corporate contributions program, giving \$3.2 million to libraries, museums, colleges, and various other civic and charitable organizations in our five-state area.

The company also participates in high school partnerships to help improve the quality of education in the community. And, in a related effort, we once again took part in a summer jobs program, providing employment for high school students in the greater Boston area.



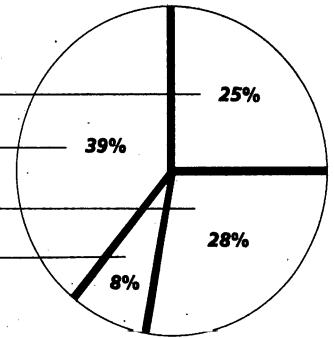
Revenues by Service

Toll Service

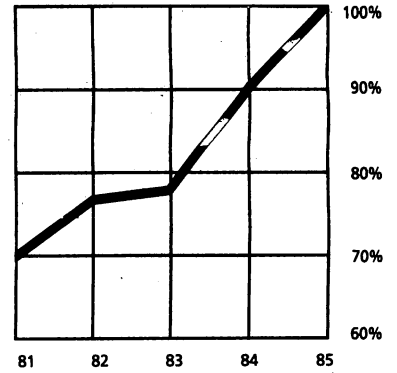
Local Service

Network Access

Directory and Other



Internal Funding



Revenues by Customer

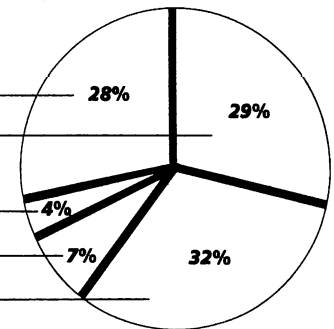
Long Distance Companies

Residence

Public Phones

Other

Business



Financial Information

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New England Telephone And Telegraph Company

Selected Financial Data*

Dollars in Millions	1985	1984	1983	1982	1981
Operating revenues	\$3,086	\$2,844	\$3,088	\$2,976	\$2,698
Operating expenses	\$2,121	\$1,945	\$2,174	\$2,068	\$1,825
Interest expense	\$ 164	\$ 179	\$ 181	\$ 163	\$ 162
Net income	\$ 380	\$ 325	\$ 327	\$ 321	\$ 296
Telephone plant—net	\$5,733	\$5,448	\$5,669	\$5,316	\$4,930
Total assets	\$6,595	\$6,321	\$6,511	\$6,046	\$5,587
Long-term debt	\$1,774	\$1,726	\$1,718	\$1,715	\$1,713
Share owner's equity	\$2,625	\$2,532	\$2,580	\$2,515	\$2,446
Return to equity	14.51%	13.55%	12.75%	12.85%	13.32%
Total construction	\$ 843	\$ 765	\$ 830	\$ 806	\$ 728
Ratio of earnings to fixed charges†	4.59	3.78	3.84	3.91	3.79

Selected Operating Data

In thousands	1985	1984	1983	1982	1981
Network access lines in service at December 31	4,804	4,651	4,479	4,347	4,269

*Financial data for 1985 and 1984 reflect post-divestiture results of New England Telephone and Telegraph Company (the "Company"), a restructured entity with new modes of operation and new tariff structures. Financial data for 1981 through 1983 reflect the historical financial data of the Company as a wholly owned subsidiary of American Telephone and Telegraph Company ("AT&T"). The extent of the changes required as a result of divestiture generally does not permit meaningful comparisons of post-divestiture and pre-divestiture financial data.

†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 estimated portion of rentals representative of the interest factor; and (ii) fixed charges are comprised of interest expense and the estimated interest portion of rentals.

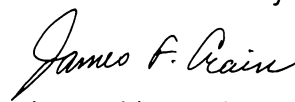
Report of Management

The financial statements on the following pages have been prepared in conformity with generally accepted accounting principles and, in the judgement of management, present fairly the Company's financial position and results of operations.

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. Accordingly, management maintains a system of internal accounting controls which is reviewed and evaluated on an ongoing basis. Our internal auditors monitor compliance with the system of internal accounting controls in connection with the annual plan 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 from the system. 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. 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 assets are 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 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 35), which is comprised of Directors who are not employees, meets periodically with management, the internal auditors and Coopers & Lybrand to review the manner in which they are performing their responsibilities and to discuss matters relating to auditing, internal accounting controls and financial reporting. Both the internal auditors and Coopers & Lybrand periodically meet privately with the Audit Committee and have free access to the Audit Committee at any time.



Vice President—Finance and Comptroller

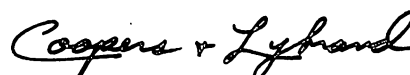
Report Of Independent Certified Public Accountants

To the Board of Directors
and the Share Owner of
New England Telephone and
Telegraph Company

We have examined the balance sheets of New England Telephone and Telegraph Company as of December 31, 1985 and 1984, and the related statements of income and retained earnings and sources of funds supporting construction activity for each of the three years in the period ended December 31, 1985. 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 as of December 31, 1985 and 1984, and the results of its operations and sources of funds supporting its construction activity for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Coopers & Lybrand
Boston, Massachusetts
February 7, 1986



Operating Revenues

Total 1985 operating revenues increased \$242.4 million, an 8.5% increase over 1984.

Local service revenues increased \$85.4 million, or 7.5%, due to rate awards which generated \$44.1 million and increased demand for telecommunications services which accounted for \$41.3 million.

Network access revenues increased \$114.1 million, or 14.8%, due principally to (a) \$50.1 million in increased reimbursement of depreciation and other expenses; (b) \$24.0 million due to a higher rate of return on inter-exchange plant investment; (c) increased message volume and growth in access lines together contributing \$27.0 million; and (d) the Federal Communications Commission's decision not to reestablish an interim pooling arrangement for special access revenues which resulted in recognition of \$9.3 million that had been previously deferred.

Toll service revenues increased \$100.9 million, or 15.1%, due to increased usage of \$80.6 million and the effect of rate awards which generated \$20.3 million.

Directory and other operating revenues decreased \$58.1 million, or 19.8%, due principally to the recording of directory revenues net of related expenses in 1985, as compared to the presentation of gross revenues and expenses in 1984. Other items that contributed to the decrease were reductions in interstate billing and collection rates which decreased revenues by \$14.9 million primarily due to the fact that the Company's contractual agreement to provide billing inquiry services for AT&T Communications ("ATTCOM") ended prior to 1985; and a \$9.0 million reduction in revenues from ATTCOM related to shared network facilities.

Operating Expenses

Total operating expenses increased \$175.5 million, or 9.0%, from 1984. This increase is principally due to Depreciation which increased \$118.7 million due to an increase in capital recovery rates and changes in practices. The remaining \$34.4 million increase in depreciation expense is a result of increased plant investment.

Marketing and customer services increased \$12.6 million, or 6.1%, principally as a result of the loss of a contract with AT&T Information Systems ("ATTIS"), under which the Company had been compensated for expenses related to its service order and billing activity on behalf of ATTIS. The Company also incurred higher advertising and commission expenses.

Other operating expenses increased \$9.8 million, principally due to (a) a \$29.6 million effect of the loss of the ATTIS billing contract mentioned above and (b) \$2.8 million in increased charges associated with the Shared Network Facilities agreement with ATTCOM. These increases were partially offset by a reduction in expenses related to directory contracts mentioned above and decreases in payroll and related benefit costs, primarily due to attrition.

Operating Taxes

Total operating taxes increased \$29.4 million, or 7.1%, from 1984, reflecting an increase in Federal and State income taxes resulting from higher pre-tax income and a higher effective tax rate. [See Note (C) to the financial statements.] This increase was partially offset by lower property taxes primarily as a result of a final billing of 1984 taxes in 1985 at lower rates than were accrued for in 1984.

Interest Expense

Total interest expense decreased \$15.1 million, or 8.4%, from 1984 due to (a) reductions in interest rates and short-term borrowings; and (b) the retirement of \$131.6 million of 15.25% long-term Debentures in February 1985 through the issuance of \$200.0 million of 12.125% long-term Debentures in January 1985. These decreases were partially offset by additional interest related to the net increase in long-term debt.

New England Telephone And Telegraph Company
Statements Of Income And Retained Earnings [Note (A)]

Dollars in Millions	For the Year Ended December 31,		
	1985	1984	1983
Operating Revenues			
Local service			
Service and equipment charges	\$ 966.5	\$ 902.1	\$ 1,198.0
Message charges	168.6	155.6	139.8
Public telephones and other	86.8	78.8	72.4
Network access [Note (J)]	884.8	770.7	—
Toll service			
Message charges	487.2	440.9	1,013.2
WATS, private lines and other	280.8	226.2	568.3
Directory and other [Notes (J) and (K)]	235.2	293.3	136.8
Provision for uncollectibles	(23.5)	(23.6)	(40.2)
Total operating revenues	<u>3,086.4</u>	<u>2,844.0</u>	<u>3,088.3</u>
Operating Expenses			
Maintenance	651.2	644.3	755.8
Depreciation	563.8	410.7	449.6
Marketing and customer services	220.3	207.7	247.6
Provisions for pensions and other employee benefits [Note (D)]	208.1	219.6	249.4
Network and operator services	138.8	144.8	182.4
Financial operations	104.1	95.7	103.8
Centralized services [Notes (J) and (K)]	96.7	79.8	45.8
Other	137.8	142.7	140.0
Total operating expenses	<u>2,120.8</u>	<u>1,945.3</u>	<u>2,174.4</u>
Net operating revenues	<u>965.6</u>	<u>898.7</u>	<u>913.9</u>
Operating Taxes			
Federal income [Note (C)]	237.8	193.8	218.1
State income [Note (C)]	42.1	33.2	36.4
Property	44.9	64.5	45.3
Other [Note (L)]	118.6	122.5	129.3
Total operating taxes	<u>443.4</u>	<u>414.0</u>	<u>429.1</u>
Operating income	<u>522.2</u>	<u>484.7</u>	<u>484.8</u>
Other Income and Deductions—Net	<u>21.3</u>	<u>19.2</u>	<u>23.0</u>
Income before interest expense	<u>543.5</u>	<u>503.9</u>	<u>507.8</u>
Interest Expense	<u>164.0</u>	<u>179.1</u>	<u>180.5</u>
Net Income	<u>\$ 379.5</u>	<u>\$ 324.8</u>	<u>\$ 327.3</u>
Retained Earnings			
Beginning of year	\$ 755.7	\$ 704.8	\$ 734.6
Net income	379.5	324.8	327.3
Dividends	(301.4)	(273.9)	(268.7)
End of year	<u>\$ 833.8</u>	<u>\$ 755.7</u>	<u>\$ 793.2</u>

See notes to financial statements.

Dollars in Millions	December 31,	
	1985	1984
Assets		
Telephone plant		
In service	\$7,868.9	\$7,338.1
Under construction	170.1	146.1
	<u>8,039.0</u>	<u>7,484.2</u>
Less: accumulated depreciation	2,306.3	2,036.3
	<u>5,732.7</u>	<u>5,447.9</u>
Current assets		
Cash [Note (E)]	15.7	22.2
Receivables		
Customers (net of allowance of \$11.8 and \$16.7, respectively) [Note (J)]	587.1	628.4
Affiliates [Note (K)]	4.9	5.2
Other	37.0	33.4
Material and supplies	53.6	49.9
Charges deferred for one year	70.7	76.0
Prepaid expenses and other current assets	15.7	11.2
	<u>784.7</u>	<u>826.3</u>
Other assets and deferred charges	77.6	47.0
Total Assets	<u>\$6,595.0</u>	<u>\$6,321.2</u>
Share Owner's Equity, Liabilities and Deferred Credits		
Share owner's equity		
Common stock—one share, without par value [Note (F)]	\$1,791.1	\$1,776.5
Retained earnings	833.8	755.7
	<u>2,624.9</u>	<u>2,532.2</u>
Long-term debt [Note (G)]	1,773.7	1,726.0
Current liabilities		
Accounts payable [Note (E)]		
AT&T [Note (J)]	146.4	190.0
Compensated absences	76.4	76.0
Affiliates [Note (K)]	61.1	40.8
Trade and other	232.5	200.1
Debt maturing within one year [Note (H)]	117.4	186.4
Dividends payable	76.8	—
Taxes accrued	40.7	49.2
Interest accrued	35.0	26.3
Advance billing and customers' deposits	31.5	30.1
Income taxes deferred for one year	7.0	3.8
	<u>824.8</u>	<u>802.7</u>
Deferred credits		
Accumulated deferred income taxes	991.7	901.4
Unamortized investment tax credits	363.8	334.2
Other	16.1	24.7
	<u>1,371.6</u>	<u>1,260.3</u>
Commitments and contingencies [Notes (I) and (M)]		
Total Share Owner's Equity, Liabilities and Deferred Credits	<u>\$6,595.0</u>	<u>\$6,321.2</u>

See notes to financial statements.

Statements Of Sources Of Funds Supporting Construction Activity [Note (A)]

Dollars in Millions	For the Year Ended December 31,		
	1985	1984	1983
Funds from operations:			
Net Income	\$ 379.5	\$324.8	\$327.3
Add expenses not requiring funds currently:			
Depreciation	563.8	410.7	449.6
Deferred income taxes—net	96.9	107.3	102.3
Deferred tax credits—net	34.2	46.9	40.0
Deduct income not providing funds currently:			
Interest charged construction	12.9	17.9	24.6
Total funds from operations	1,061.5	871.8	894.6
Less: dividends	301.4	273.9	268.7
	<u>760.1</u>	<u>597.9</u>	<u>625.9</u>
Funds from external financing:			
Equity investment by parent	14.6	151.9	6.3
Issuance of long-term debt	197.0	—	—
Change in short-term borrowings—net	(69.0)	(92.4)	179.5
	<u>142.6</u>	<u>59.5</u>	<u>185.8</u>
Less: retirement of long-term debt	154.6	—	—
	<u>(12.0)</u>	<u>59.5</u>	<u>185.8</u>
Changes in working capital			
<i>(excluding debt maturing within one year and income taxes deferred for one year):</i>			
Cash	6.5	(7.0)	(3.5)
Receivables	38.0	(100.1)	(76.7)
Material and supplies	(3.7)	.7	(15.4)
Charges deferred for one year	5.3	(2.6)	7.7
Prepaid expenses and other current assets	(4.5)	40.2	(6.4)
Accounts payable	9.5	118.8	81.2
Dividends payable	76.8	—	—
Taxes accrued	(8.5)	(13.2)	(6.1)
Interest accrued	8.7	.2	.5
Advance billing and customers' deposits	1.4	1.1	3.5
	<u>129.5</u>	<u>38.1</u>	<u>(15.2)</u>
Other changes:			
Other assets and deferred charges	(30.6)	23.5	(15.5)
Other—net	(16.5)	28.6	23.9
	<u>(47.1)</u>	<u>52.1</u>	<u>8.4</u>
Funds supporting construction activity	830.5	747.6	804.9
Add: interest charged construction	12.9	17.9	24.6
Total Construction	\$ 843.4	\$765.5	\$829.5

See notes to financial statements.

(A) Basis of Presentation

New England Telephone and Telegraph Company (the "Company") is a wholly owned subsidiary of NYNEX Corporation ("NYNEX"). Prior to 1984, the Company was a wholly owned subsidiary of American Telephone and Telegraph Company ("AT&T"). The transfer of ownership of the Company on January 1, 1984 was accomplished under the terms of the Modification of Final Judgment (the "Consent Decree") which required AT&T to divest those parts of the Bell System operating companies that provide exchange telecommunications and exchange access services within Local Access and Transport Areas ("LATAs"), printed directory advertising and cellular radio telecommunications services. At divestiture, certain assets and certain liabilities were transferred between the Company and AT&T, with AT&T retaining ownership of those portions of each Bell System operating company providing interLATA service and customer premises equipment. These transfers were recorded on January 1, 1984 and had no impact on net income for any period presented. As a result of divestiture, the financial information presented for 1985 and 1984 is not comparable to the financial information presented for 1983.

Effective January 1, 1984, the directory operations of the Company were transferred to NYNEX Information Resources Company ("NYNEX Information Resources"), a wholly owned subsidiary of NYNEX. In addition, the Company transferred certain other net assets to NYNEX.

On January 1, 1985, NYNEX transferred a 33 $\frac{1}{3}$ % ownership interest in NYNEX Service Company ("NYNEX Service") to the Company. The remaining ownership interest was transferred to New York Telephone Company, a wholly owned subsidiary of NYNEX. The share owners' voting rights are divided equally between the Company and New York Telephone Company. The Company uses the equity method of accounting for its investment in NYNEX Service.

The 1984 and 1983 financial statements have been reclassified to conform to the current year's format.

(B) Accounting Policies

The financial statements have been prepared in conformity with generally accepted accounting principles applicable to regulated utilities. Such accounting principles are consistent in all material respects with accounting prescribed by the Federal Communications Commission (the "FCC"), except for certain intrastate items accorded a different accounting treatment by state regulatory commissions.

Telephone Plant

Telephone plant is stated at its original cost.

When depreciable plant is retired, the amount at which such plant has been carried in telephone plant in service, as well as the cost to remove such plant, is charged to accumulated depreciation.

Material and Supplies

Material and supplies are carried principally at average cost.

Depreciation

Depreciation rates used by the Company are prescribed by the FCC. All rates are calculated using the "remaining life" method. Most new plant is depreciated using the equal life group method, which approximates a straight-line unit depreciation method. Older plant is depreciated using the vintage group method, which provides depreciation at lesser amounts than would be provided under a straight-line unit depreciation method.

Station Connections

Certain costs of installing telephone service on a customer's premises have been expensed since January 1981, as prescribed by the FCC. The balance of the investment in installation costs capitalized prior to 1981 is being amortized to expense over ten years.

Interest Charged Construction

Regulatory authorities allow the Company to accrue interest, including an allowance on share owner's equity, as a cost of constructing certain plant and as an item of income, which is included in Other Income and Deductions—Net. 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 through the rate-making process.

Compensated Absences

The Company accrues a liability for employees' rights to receive compensation for future absences. In accordance with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" ("Statement No. 71"), the Company defers such costs in the balance sheets until the compensation is paid and recovered through rates. However, in 1985 the Company expensed the portion of the compensated absences liability for employees to be transferred on January 1, 1986 to NYNEX Service. These amounts were not material to the financial statements.

Income Taxes

Since 1984, NYNEX and its subsidiaries, including the Company, have filed a consolidated Federal income tax

return. Prior to divestiture, the Company joined with AT&T and its subsidiaries, including Western Electric, in filing consolidated Federal income tax returns. The Company's provision for Federal income taxes currently payable is allocated in accordance with its contribution to the respective consolidated group's taxable income and tax credits.

Income tax regulations allow recognition of certain transactions for tax purposes in time periods other than the period during which the transactions will be recognized in the determination of net income for financial reporting purposes. Appropriate income charges and their subsequent reversal, reflected as Federal income taxes deferred—net [See Note (C)], prevent the tax effect of these timing differences from distorting net income. Deferred income tax provisions are recorded for timing differences when recognized currently by regulators in the rate-making process.

The principal timing difference relates to depreciation. For income tax purposes depreciation is determined based on accelerated methods and shortened lives which cause 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 the 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 Note (C).]

Investment tax credits result from provisions of Federal tax law which allow for a reduction in tax liability based on certain capital expenditures. Corresponding reductions in tax expense are deferred and are amortized as reductions in tax expense over the life of the plant which gave rise to the credits.

(C) Income Taxes

The components of operating income tax expense are as follows:

Dollars in Millions	1985	1984	1983
Federal:			
Current	\$123.5	\$ 54.3	\$ 87.5
Deferred—net	80.1	92.6	90.6
Deferred tax credits—net	34.2	46.9	40.0
	<u>237.8</u>	<u>193.8</u>	<u>218.1</u>
State:			
Current	25.3	18.5	24.7
Deferred—net	16.8	14.7	11.7
	<u>42.1</u>	<u>33.2</u>	<u>36.4</u>
Total	<u>\$279.9</u>	<u>\$227.0</u>	<u>\$254.5</u>

Income tax expense (benefit) included in Other Income and Deductions—Net was \$6.4, \$3.2 and (\$1.3) million in 1985, 1984 and 1983, respectively.

Federal income tax expense for each of the years ended December 31, 1985, 1984 and 1983 was less than the amounts computed by applying the statutory Federal income tax rate to pre-tax income. The reasons for the differences are as follows:

	1985	1984	1983
Statutory rate	46.0%	46.0%	46.0%
a. Amortization of investment tax credits over the life of the plant which gave rise to the credits	(6.3)	(5.7)	(4.8)
b. Certain taxes and payroll-related construction costs capitalized for financial statement purposes, but deducted currently for income tax purposes, net of applicable depreciation	(.2)	(1.2)	(.5)
c. Interest charged construction, which is excluded from taxable income, net of applicable depreciation	(.2)	(.9)	(1.4)
d. Other differences	(.2)	(.5)	.6
Effective tax rate	<u>39.1%</u>	<u>37.7%</u>	<u>39.9%</u>

The amortization of investment tax credits was \$39.5, \$29.5 and \$26.2 million in 1985, 1984 and 1983, respectively.

The cumulative net amounts of income tax timing differences for which deferred income taxes are not provided are represented principally by (b), (c) and (d) above. The tax effects of these amounts are not recorded currently because regulatory commission procedures result in such costs being charged to customers when the timing differences reverse and the taxes are paid. As of December 31, 1985, the cumulative net amount of these items was \$477.8 million.

(D) Pension and Employee Benefits

Prior to divestiture, employees of the Company were covered by two national Bell System noncontributory pension plans ("Bell System plans") sponsored by AT&T and the Bell System companies, one for management and one for nonmanagement. As a part of divestiture, the respective share of the assets and obligations to provide benefits to these employees were allocated to NYNEX.

NYNEX established two new noncontributory defined benefit plans ("NYNEX plans"), one for management and one for nonmanagement.

Contributions to the NYNEX plans are made to an irrevocable trust. It is 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 the Aggregate Cost Method. Total costs for the Company were \$74.2 million in 1985. This amount was developed using an assumed investment earnings rate of 8¼% for 1985, followed by a graduated decline to 5¼% for 1998 and for all years thereafter. Total costs were \$81.6 million in 1984 for the Company's contribution to the NYNEX plans and \$99.1 million in 1983 for the Bell System plans. These amounts were developed using an assumed investment earnings rate of 8% for 1983 through 1985 and followed by a graduated decline to 5% for 1998 and for all years thereafter.

During 1985, there were amendments to both plans, designed primarily to comply with revisions to applicable laws, increase benefits and to grant special increases to previously retired employees. The effect of these amendments was to increase 1985 costs by approximately \$8.5 million. Changes in the assumed earnings rate mentioned above had the effect of decreasing 1985 costs by approximately \$10.2 million. The remaining decrease in 1985 costs was principally the result of recognition of 1984 actuarial experience. There were no plan amendments in 1984.

The actuarial present value of accumulated plan benefits and the fair value of net assets available for plan benefits are required disclosures. However, such disclosures are not presented for the Company as the structure of the NYNEX plans does not readily permit the plans' assets and the accumulated benefits data to be disaggregated. Based on the actuarial valuation of the NYNEX plans as of January 1, 1985 and 1984 utilizing assumed rates of return averaging 9.6% and 9.1%, respectively, the fair value of the net assets available for plan benefits exceeded the actuarial present value of vested and non-vested accumulated plan benefits.

The Company believes that misleading inferences concerning the NYNEX 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 the Employee Retirement Income Security Act of 1974, as amended, while the determination of the actuarial present value of accumulated plan benefits

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 does not include probable future events, such as wage and salary increases and continued employee service, which have been taken into consideration by the Company in determining costs for the plans. Furthermore, the fair value of net assets available for plan benefits will fluctuate, which may be misleading with respect to future funding of the pension plans.

The Company also provides certain health care and life insurance benefits for retired employees and their families. Substantially all of the Company's employees may become eligible for these benefits if they reach normal retirement age while working for the Company. Most of these benefits are provided through an insurance company whose premiums are based principally on the amount of benefits paid during the year. Total costs of providing benefits for active and retired employees and their families were \$92.1, \$94.8 and \$99.4 million in 1985, 1984 and 1983, respectively. The major portion of the costs of providing these benefits for the approximately 14,100 retirees is not separable from the costs of providing these benefits for the approximately 28,100 active employees.

(E) Cash

It is the practice of the Company to make certain payments by draft and to record such drafts as accounts payable until such time as the banks honoring the drafts have presented them for payment. Accordingly, outstanding drafts of \$78.2 and \$54.0 million at December 31, 1985 and 1984, respectively, are reflected in Accounts payable.

(F) Common Stock

The equity capital of the Company increased by \$9.6 and \$145.0 million, in 1985 and 1984, respectively, through an equity investment made by NYNEX and by \$5.0 and \$6.9 million in 1985 and 1984, respectively, in connection with the NYNEX Corporation Employee Stock Ownership Plan. The equity capital of the Company increased \$6.3 million in 1983 in connection with the Bell System Employee Stock Ownership Plan.

(G) Long-Term Debt

Interest rates and maturities on long-term debt outstanding at December 31, 1985 were as follows:

Dollars in Millions	Interest rates				Total Outstanding
	3½% to 4½%	6½% to 7¾%	8% to 9½%	12½% to 15¼%	
Maturities					
Debentures:					
1988-1999	\$150.0	\$ —	\$ —	\$ —	\$ 150.0
2002-2010	110.0	425.0	600.0	—	1,135.0
2017-2025	—	—	—	518.4	518.4
Other	—	—	—	9.3	9.3
	<u>\$260.0</u>	<u>\$425.0</u>	<u>\$600.0</u>	<u>\$527.7</u>	<u>\$1,812.7</u>
Unamortized (discount) premium—net					(39.0)
Total					<u>\$1,773.7</u>

In 1988, \$30.0 million of the Debentures will mature.

In January 1985, the Company sold its Forty Year, 12½% Debentures due February 1, 2025 in the aggregate principal amount of \$200 million, with a discount of \$2.5 million. A portion of the proceeds was applied to repurchase approximately \$131.6 million, with a premium of

approximately \$23.0 million, of its outstanding Thirty-seven Year, 15¼% Debentures due June 15, 2018. This premium was deferred and is being amortized over the period in which the new Debentures are outstanding. The remaining proceeds from the sale of Debentures were used to retire outstanding short-term debt.

(H) Debt Maturing Within One Year

In 1985, the Company financed construction of telephone plant principally through advances from NYNEX, and prior to March 1985 through bank loans, other

notes and the issuance of commercial paper. All such borrowings are payable in twelve months or less after issuance, pending long-term financing.

Debt maturing within one year and weighted average interest rates are as follows:

Dollars in Millions	Weighted average interest rate					
	Dec. 31, 1985	Dec. 31, 1984	Jan. 1, 1984	Dec. 31, 1985	Dec. 31, 1984	Jan. 1, 1984
Advances from NYNEX	\$115.7	\$ —	\$ —	8.02%	—	—
Commercial paper	—	185.7	268.4	—	8.24%	9.55%
Long-term debt maturing within one year	1.7	.7	10.4			
Total	<u>\$117.4</u>	<u>\$186.4</u>	<u>\$278.8</u>			

Dollars in Millions	1985	1984	1983	1985#	1984#	1983#
Average amounts of advances from parent* outstanding during the year	\$ 22.3†	—	\$189.9†	7.94%	—	8.79%
Average amounts of notes payable outstanding during the year	\$ 17.7†	\$186.3†	\$ 84.0†	8.34%	10.46%	9.05%
Maximum amounts of advances from parent* payable at any month end during the year	\$115.7	—	\$210.0			
Maximum amounts of notes payable at any month end during the year	\$111.0	\$281.0	\$268.4			

Interest expense on Advances from parent* was \$1.8 and \$16.7 million in 1985 and 1983, respectively.

*For 1985 and 1984, the parent is NYNEX; prior thereto the parent was AT&T.

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

†Computed by dividing the sum of the aggregate principal amounts outstanding each day during the year by the total number of calendar days in the year.

(I) Lease Commitments

The Company leases certain facilities and equipment used in its operations and reflects lease payments as rental expense for the periods to which they relate. Rental expense was \$64.7, \$62.4 and \$71.9 million for 1985, 1984 and 1983, respectively. At December 31, 1985, the minimum lease commitments under noncancelable operating and capital leases for the periods shown are as follows:

Dollars in Millions		
Year	Operating	Capital
1986	\$ 22.5	\$ 9.7
1987	20.5	8.8
1988	18.5	8.7
1989	14.6	8.7
1990	12.3	7.5
Thereafter	88.6	21.4
Total minimum lease payments	<u>\$177.0</u>	64.8
Less: executory costs		<u>15.0</u>
Net minimum lease payments		49.8
Less: interest		<u>15.3</u>
Present value of net minimum lease payments		<u>\$34.5</u>

Included in rental expense is \$51.8 and \$40.0 million for 1985 and 1984, respectively, representing a portion of the costs incurred in accordance with an agreement with AT&T for the use of shared network facilities. The Company can terminate or extend the period of use of these facilities by providing notice in accordance with the terms of the agreement. Furthermore, the amounts payable vary according to the volume of use of these facilities. Accordingly, no amounts for shared network facilities have been included in the above schedule of minimum lease commitments.

In accordance with Statement No. 71, capital leases with inception dates after December 31, 1982 have been recorded in the financial statements. The amount of net assets and related obligations included in the accompanying balance sheets is not significant. Capital leases with inception dates before January 1, 1983 are currently accounted for as operating leases and will be recorded in the balance sheets beginning in 1987. Had such leases been capitalized, the amount of net assets and related obligations included in the balance sheets would have increased by \$28.5 and \$39.3 million at December 31, 1985 and 1984, respectively.

(J) Transactions with AT&T

In both 1985 and 1984, AT&T provided approximately 31% of the Company's total operating revenues, primarily Network access revenues. Included in Directory and other revenues are charges for billing and collection services performed by the Company for AT&T. In connection

with such services, the Company purchases the related receivables with recourse.

In 1983, AT&T provided management, technical and support services (which included research and development) to the Company under a license contract agreement; charges for these services were \$45.8 million. This agreement was terminated pursuant to the Consent Decree, effective January 1, 1984.

(K) Transactions with Affiliates

The Company receives a number of management and support services (including certain services not previously provided by AT&T) from NYNEX and NYNEX Service. NYNEX Service owns a one-seventh interest in Bell Communications Research, Inc. ("Bell Research"). Bell Research furnishes to NYNEX and its subsidiaries, including the Company, technical and support services relating to exchange telecommunications and exchange access services which include research and development. For 1985 and 1984, the Company recorded charges of \$96.7 and \$79.8 million, respectively, in connection with these services. Effective January 1, 1986, the Company and New York Telephone Company transferred certain personnel performing internal data processing and related services to NYNEX Service. Under the terms of the transfer, NYNEX Service will perform such data processing and related services on behalf of the Company and New York Telephone Company on a centralized basis.

The Company was charged approximately \$344.5 and \$210.2 million in 1985 and 1984, respectively, by NYNEX Materiel Enterprises for the purchase of materials (including items charged to plant accounts) and for various other procurement support activities including materials management, warehousing and transportation services.

Subsequent to divestiture, the Company entered into an agreement with NYNEX Information Resources pursuant to which NYNEX Information Resources publishes directories previously published by the Company and in return pays to the Company a publishing rights fee for the right to produce, publish and distribute alphabetical and classified directories for the Company. For the years ended December 31, 1985 and 1984 publishing rights fees included in Directory and other revenues amounted to \$73.9 and \$64.8 million, respectively.

During 1984, the Company transferred certain portions of its sales and marketing work force to NYNEX Business Information Systems Company ("NYNEX Business Information Systems") under an agreement which stated the Company would be provided with a sales and marketing effort by NYNEX Business Information Systems in return for sales commissions. In 1985 and 1984, the Company

recorded \$10.5 and \$4.2 million, respectively, in sales commissions, to NYNEX Business Information Systems, pursuant to this agreement.

(L) Other Operating Taxes

The major components of Other operating taxes are as follows:

Dollars in Millions	1985	1984	1983
Gross receipts	\$ 58.6	\$ 57.5	\$ 58.4
Payroll-related	59.4	59.9	70.5
Other6	5.1	.4
Total	<u>\$118.6</u>	<u>\$122.5</u>	<u>\$129.3</u>

Supplementary Information Quarterly Financial Information (Unaudited)

Dollars in Millions			
Calendar Quarter	Total Operating Revenues	Operating Income	Net Income
1985			
1st	\$ 768.8	\$141.1	\$102.9
2nd	760.9	126.3	93.4
3rd	776.2	133.7	99.8
4th	780.5	121.1	83.4
Total	<u>\$3,086.4</u>	<u>\$522.2</u>	<u>\$379.5</u>
1984			
1st	\$ 684.0	\$113.8	\$ 74.9
2nd	703.9	116.9	77.6
3rd	722.1	131.1	91.9
4th	734.0	122.9	80.4
Total	<u>\$2,844.0</u>	<u>\$484.7</u>	<u>\$324.8</u>

All adjustments (consisting only of normal recurring accruals) necessary for a fair statement of income for each period have been included in the table above.

Net income for the fourth quarter of 1985 includes charges related to the antitrust settlement reached with MCI Communications Corporation and elevated expenses associated with Hurricane Gloria, which struck the Company's region in late September.

Supplementary Information Effects of Changing Prices (Unaudited)

The accompanying supplementary information has been prepared in accordance with the guidelines provided in Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," as amended.

The method used to calculate these changes in specific prices involved numerous assumptions, approximations and estimates and should be viewed in that context.

(M) Litigation and Other Contingencies

Various legal actions and regulatory proceedings are pending which may affect the Company, including matters involving antitrust treble damage and tax deficiency claims. The outcome of these matters is not presently determinable, but, in the opinion of management based on the advice of counsel, the ultimate resolution of such matters will not have a material adverse impact on the Company's financial position.

Current cost amounts reflect the changes in specific prices from date of acquisition of an item to the present. The current cost of Telephone plant, net of accumulated depreciation, was determined by applying internally generated indices to investments in each of the major telephone plant accounts, net of accumulated depreciation.

Material and supplies have not been adjusted under the current cost method, as any inflationary adjustment would be immaterial to the supplemental information taken as a whole.

In computing Net income under the current cost method, only depreciation expense has been adjusted to show the effects of inflation. As most other operating expense items are current year transactions they are recorded in dollars of approximately current purchasing power.

No adjustment is required to be made to income tax expense under the current cost method. As a result, the effective tax rate of 39.1% as reported for 1985 in the financial statements increases to 87.0% under the current cost method.

Under the rate-making process prescribed by the regulatory commissions to which the Company is subject, only the historical cost of telephone plant is recoverable in revenues as depreciation. Therefore, the excess of the cost of net telephone plant, stated in terms of current cost over the average historical cost of net telephone plant, is not presently recoverable in rates as depreciation and is presented as Reduction to net recoverable cost in Table A. Although the rate-making process gives no recognition to the current cost of replacing telephone plant, based on past practices, the Company believes it will be allowed to earn a return on the increased cost of its net investment when replacement of facilities actually occurs.

During a period of inflation, holders of monetary assets (claims to receive a fixed dollar amount) suffer a loss of general purchasing power while holders of monetary

liabilities (obligations to pay a fixed dollar amount) experience a gain. To further reflect the economics of rate regulations, the reduction of net telephone plant to net recoverable costs should be offset by the gain from the decline in purchasing power of net amounts owed. The gain from the decline in purchasing power of net amounts owed is primarily attributable to the substantial

amount of debt which has been used to finance construction activity. Since the depreciation on plant is limited to the recovery of historical costs, the Company does not have the opportunity to realize a holding gain on debt and is limited to recovery only of the embedded cost of debt.

Table A

Supplementary Financial Information
Adjusted for Effects of Changing Prices
For the Year Ended December 31, 1985 (Unaudited)

Dollars in Millions	As Reported	Current Cost
Operating revenues	<u>\$3,086.4</u>	<u>\$3,086.4</u>
Expenses:		
Depreciation	563.8	907.9
Operating (excluding depreciation)	1,557.0	1,557.0
Federal income taxes	237.8	237.8
Other operating taxes	205.6	205.6
Interest and other	142.7	142.7
	<u>\$2,706.9</u>	<u>\$3,051.0</u>
Net income	<u>\$ 379.5</u>	<u>\$ 35.4</u>
Effect of increase in general price level		\$ 308.5
Increase in specific prices (current cost) of net telephone plant held during the year		<u>234.8</u>
Excess of increase in general price level over increase in specific prices		<u>\$ 73.7</u>
Reduction to net recoverable cost		<u>\$ 226.6</u>
Gain from decline in purchasing power of net amounts owed		<u>\$ 97.2</u>
Telephone plant, net of accumulated depreciation	<u>\$5,732.7</u>	<u>\$9,093.2</u>

Table B

Five-Year Comparison of Selected Supplementary Financial Information
Adjusted for Changing Prices (Unaudited)†

Average 1985 Dollars in Millions	1985	1984	1983	1982	1981
Operating revenues	\$3,086.4	\$2,942.7	\$3,332.6	\$3,313.3	\$3,189.1
Net income*	\$ 35.4	\$ 21.6	\$ 11.7	\$ 35.7	\$ 66.2
Excess (deficiency) of increase in general price level over increase in specific prices	\$ 73.7	\$ 148.4	\$ (16.7)	\$ (246.2)	\$ 457.0
Net assets at year end	\$5,985.4	\$6,288.7	\$6,585.1	\$6,686.9	\$6,474.4
General Information:					
Purchasing power gain on net monetary liabilities	\$ 97.2	\$ 113.8	\$ 112.7	\$ 118.1	\$ 276.3
Average Consumer Price Index	321.9	311.1	298.4	289.1	272.4

*Excluding reduction to net recoverable costs.

†Financial data for 1985 and 1984 reflect post-divestiture results of the Company, a restructured entity with new modes of operation and new tariff structures. Financial data for 1981 through 1983 reflect the historical data of the Company as a wholly owned subsidiary of AT&T. The extent of the changes required as a result of divestiture generally does not permit meaningful comparisons of post-divestiture and pre-divestiture financial data.

Board Of Directors



Gerhard M. Freche
President and Chief
Executive Officer, New
England Telephone and
Telegraph Company



Raymond F. Burke
Vice President and
General Counsel, NYNEX
Corporation, New York,
New York



Kenneth M. Curtis
Partner, Curtis, Thaxter,
Lipez, Stevens, Broder
& Micoleau, Portland, Maine



Luther F. Hackett
President, Hackett, Valine
& MacDonald, Inc.
Burlington, Vermont



Ronald A. Homer
President, Boston Bank
of Commerce, Boston,
Massachusetts



William C. Mercer
Former Chairman of The
Board, New England Telephone
and Telegraph Company



David B. Perini
Chairman, President and
Chief Executive Officer,
Perini Corporation,
Framingham, Massachusetts



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



Frederic V. Salerno
Executive Vice President,
New England Telephone and
Telegraph Company



Mrs. George L. Sargent
Chairman of the Board of
Overseers, New England
Medical Center, Inc.,
Boston, Massachusetts



Maurice Segall
President and Chief
Executive Officer, Zayre
Corp., Framingham,
Massachusetts



Adele S. Simmons
President, Hampshire
College, Amherst,
Massachusetts



Kimon S. Zachos
Partner, Sheehan,
Phinney, Bass & Green,
Manchester, New Hampshire

*Board Of Directors
Changes:*

Two new directors were elected to the Board in 1985. They were Ronald A. Homer and Frederic V. Salerno.

Mr. Homer, elected April 16, is President and Chief Executive Officer of the Boston Bank of Commerce. He previously served as Executive Vice President and Chief Operating Officer of Freedom National Bank of New York City.

Mr. Salerno, elected July 16, is Executive Vice President and Chief Operating Officer of New England Telephone and Telegraph Company. He previously served as Vice President of Customer Services for New York Telephone.

John S. North, a Director, and Executive Vice President and Chief Operating Officer, retired September 2. His 30-year career included executive positions at AT&T and Michigan Bell.

Executive Committee

Gerhard M. Freche
Chairman

William C. Mercer
David B. Perini
Donald A. Roach
Frederic V. Salerno
Maurice Segall
Kimon S. Zachos

Audit Committee

Luther F. Hackett
Chairman

David B. Perini
Mrs. George L. Sargent

**Corporate Public
Policy Committee**

Adele S. Simmons
Chairman

Kenneth M. Curtis
Ronald A. Homer

Company Officers

Gerhard M. Freche
President and Chief
Executive Officer

Frederic V. Salerno
Executive Vice President

Walter E. Bartlett
Vice President—External Affairs

Peter W. Bertschmann
Vice President—Human Resources

Richard W. Blackburn
Vice President and General Counsel

James F. Crain
Vice President—Finance and Comptroller

William F. Highland
Vice President—Switched Services

Richard A. Jalkut
Vice President—Staff

Peter C. Manus
Vice President—Marketing

W. Russell Scott, Jr.
Vice President—Distribution Services

John H. Cogswell
Secretary-Treasurer

State Vice Presidents

Joseph J. Kelley, Jr.
Maine

John J. Coleman
Massachusetts

Donald B. Reed
New Hampshire

Rita A. O'Brien
Rhode Island

Deighton K. Emmons
Vermont

Senior Executive Officer Changes:

On July 16, Frederic V. Salerno was elected Executive Vice President and Chief Operating Officer.

Also on July 16, Richard A. Jalkut was elected Vice President—Staff; and Peter L. Haynes, Vice President—Marketing, was named Chairman and President of NYNEX Materiel Enterprises.

On June 1, Thomas J. Norris, Vice President—Staff, was named Vice President—Methods for the NYNEX Service Company.

On June 15, Delbert L. Emery, Vice President—Staff, retired after 33 years of service. He had been an officer of the company since 1974.

On September 2, John S. North retired as Executive Vice President and Chief Operating Officer after 30 years of service.

New England Telephone and Telegraph Company is incorporated under the laws of the State of New York and has its principal offices at 185 Franklin Street, Boston, Massachusetts 02107, telephone number 617-743-9800. The company is engaged in the business of furnishing telecommunications services—including the transmission of voice, data and video—to customers in Maine, Massachusetts, New Hampshire, Rhode Island and Vermont. It is a subsidiary of NYNEX Corporation, a communications enterprise serving the northeastern region of the United States. Copies of this report or the NYNEX Corporation annual report are available, upon request, through the Office of the Secretary, New England Telephone, Room 100, at the above address.

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

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New England Telephone

A **NYNEX** Company

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

Joseph R. Plati
Division Staff Manager-Financial Assurance/Taxes

March 28, 1986

City Clerk/Town Clerk

Dear Sir:

Enclosed is a copy of Annual Report to the Share Owners of New England Telephone and Telegraph Company for the year 1985 filed in accordance with Massachusetts General Laws (Ter. Ed.), Chapter 166 Section 12A.

Very truly yours,

A handwritten signature in cursive script, appearing to read "J.R. Plati".

Enclosure

4374A/0176A

5.

S-236

Comm. from Joseph R. Plati, Div. Staff Mgr./
Financial Assurance/Taxes, transmitting for
informational purposes a copy of the New
England Telephone & Telegraph Co. annual
report for the year 1985.

In City Council,

April 7, 1986

Placed on file