

approximately \$45. Significant assumptions for the discount rate, long-term rate of return on plan assets and composite rate of compensation increase used in developing the APBO and related postretirement benefit costs were the same as those used in developing the pension information.

NOTE 13. Other Employee Benefits

Employee Stock Ownership Plans - SBC maintains contributory savings plans which cover substantially all employees. Under the savings plans, SBC matches a stated percentage of eligible employee contributions, subject to a specified ceiling.

SBC has three leveraged Employee Stock Ownership Plans (ESOPs) as part of the existing savings plans. Two of the ESOPs were funded with notes issued by the savings plans to various lenders, the proceeds of which were used to purchase shares of SBC's common stock in the open market. These notes are unconditionally guaranteed by SBC and therefore presented as a reduction to shareowners' equity and an increase in long-term debt. They will be repaid with SBC contributions to the savings plans, dividends paid on SBC shares and interest earned on funds held by the ESOPs.

The third ESOP purchased PAC treasury shares in exchange for a promissory note from the plan to PAC. Since PAC is the lender, this note is not reflected as a liability and the remaining cost of unallocated trust shares is carried as a reduction of shareowners' equity. Principal and interest on the note are paid from employer contributions and dividends received by the trust. All PAC shares were exchanged for SBC shares effective with the merger April 1, 1997. The provisions of this ESOP were unaffected by this exchange.

SBC's match of employee contributions to the savings plans is fulfilled with shares of stock allocated from the ESOPs and with purchases of SBC's stock in the open market. Shares held by the ESOPs are released for allocation to the accounts of employees as employer matching contributions are earned. Benefit cost is based on a combination of the contributions to the savings plans and the cost of shares allocated to participating employees' accounts. Both benefit cost and interest expense on the notes are reduced by dividends on SBC's shares held by the ESOPs and interest earned on the ESOPs' funds.

Information related to the ESOPs and the savings plans is summarized below:

	1997	1996	1995
Benefit expense-net of dividends and interest income	\$46	\$ 65	\$ 66
Interest expense-net of dividends and interest income	18	26	37
Total expense	\$64	\$ 91	\$103
Company contributions for ESOPs	\$98	\$108	\$ 89
Dividends and interest income for debt service	\$58	\$ 62	\$ 72

SBC shares held by the ESOPs are summarized as follows at December 31:

	1997	1996
Unallocated	15,621,250	31,005,792
Committed to be allocated	282,388	355,188
Allocated to participants	43,151,816	31,119,148
Total	59,055,454	62,480,128

NOTE 14. Stock-Based Compensation

Under various SBC plans, senior and other management employees and non-employee directors have received stock options, SARs, performance shares and nonvested stock units to purchase shares of SBC common stock. Options issued through December 31, 1997 carry exercise prices equal to the market price of the stock at the date of grant and have maximum terms ranging from five to ten years. Depending upon the grant, vesting of options may occur up to four years from the date of grant. Performance shares are granted to key employees in the form of common stock and/or in cash based upon the price of common stock at date of grant and are awarded at the end of a two or three year period, subject to the achievement of certain performance goals. Nonvested stock units are also valued at market price of the stock at date of grant and vest over a three-year period. Up to 156 million shares may be issued under these plans.

In 1996 SBC elected to continue measuring compensation cost for these plans using the intrinsic value-based method of accounting prescribed in Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123). Accordingly, no compensation cost for SBC's stock option plans has been recognized. The compensation cost that has been charged against income for SBC's other stock-based compensation plans, primarily SARs and nonvested stock units, totaled \$43, \$22 and \$24 for 1997, 1996 and 1995. Had compensation cost for stock option plans been recognized using the fair-value based method of accounting at the date of grant for awards in 1997, 1996 and 1995 as defined by FAS 123, SBC's net income (loss) would have been \$1,400, \$3,250 and \$(3,074) and basic net income (loss) per share would have been \$0.77, \$1.77 and \$(1.67).

Options and SARs held by the continuing employees of PAC at the time of the AirTouch Communications Inc. spin-off were supplemented with an equal number of options and SARs for common shares of spun-off operations. The exercise prices for outstanding options and SARs held by continuing employees of PAC were adjusted downward to reflect the value of the supplemental spun-off operations' options and SARs. The balance sheet reflects a related liability equal to the difference between the current market price of spun-off operations stock and the exercise prices of the supplemental options outstanding (see Note 10). As of December 31, 1997, 831,139 supplemental spun-off operations options and SARs were outstanding with expiration dates ranging from 1998 to 2003. Outstanding options and SARs that were held by employees of the wireless operations at the spin-off date were replaced by options and SARs for common shares of spun-off operations. The spun-off operations assumed liability for these replacement options and SARs.

For purposes of these pro forma disclosures, the estimated fair value of the options granted after 1994 is amortized to expense over the options' vesting period. Because most employee options vest over a two- to three-year period, these disclosures will not be indicative of future pro forma amounts until the FAS 123 rules are applied to all outstanding

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Dollars in millions except per share amounts

non-vested awards. The fair value for these options was estimated at the date of grant, using a Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1997, 1996 and 1995: risk-free interest rate of 6.57%, 6.26% and 6.34%; dividend yield of 2.99%, 4.92% and 3.61%; expected volatility factor of 15%, 18% and 18%; and expected option life of 5.8, 4.7 and 4.6 years.

Information related to options and SARs is summarized below and has been restated to reflect the two-for-one stock split declared January 30, 1998:

	Number	Weighted Average Exercise Price
Outstanding at January 1, 1995	43,988,164	\$19.52
Granted	16,735,644	23.49
Exercised	(4,373,340)	16.90
Forfeited/Expired	(1,509,368)	21.36
Outstanding at December 31, 1995 (25,524,518 exercisable at weighted average price of \$19.05)	54,841,100	20.89
Granted	24,643,276	22.98
Exercised	(3,767,420)	18.73
Forfeited/Expired	(1,518,552)	21.56
Outstanding at December 31, 1996 (35,522,826 exercisable at weighted average price of \$20.13)	74,198,404	21.68
Granted	32,034,238	27.58
Exercised	(17,118,968)	20.52
Forfeited/Expired	(4,441,532)	25.49
Outstanding at December 31, 1997 (40,802,392 exercisable at weighted average price of \$21.02)	84,672,142	\$23.95

Information related to options and SARs outstanding at December 31, 1997:

	\$12.00	\$12.50	\$20.00	\$22.50
Exercise Price Range	-12.49	-19.99	-22.49	-29.19
Number of options and SARs:				
Outstanding	67,560	9,877,430	18,978,694	55,748,458
Exercisable	67,560	9,877,430	18,944,252	11,913,150
Weighted average exercise price:				
Outstanding	\$ 12.08	\$ 17.50	\$ 20.92	\$ 26.13
Exercisable	\$ 12.08	\$ 17.50	\$ 20.92	\$ 24.14
Weighted average remaining contractual life	0.8 year	5.9 years	6.2 years	7.5 years

The weighted-average grant-date fair value of each option granted during 1997, 1996 and 1995 was \$5.65, \$3.45 and \$4.16.

NOTE 15. Shareowners' Equity

Common Stock Split - On January 30, 1998, the Board of Directors of SBC (Board) declared a two-for-one stock split, effected in the form of a stock dividend, on the shares of SBC's common stock. Each shareholder of record on February 20,

1998 will receive an additional share of common stock for each share of common stock then held. The stock will be issued March 19, 1998. SBC will retain the current par value of \$1.00 per share for all shares of common stock.

Shareowners' Rights Plan - The Shareowners' Rights Plan (Plan) becomes operative in certain events involving the acquisition of 20% or more of SBC's common stock by any person or group in a transaction not approved by the Board, or the designation by the Board of a person or group owning more than 10% of the outstanding stock as an adverse person; as provided in the Plan. Upon the occurrence of these events, each right, unless redeemed by the Board, generally entitles the holder (other than the holder triggering the right) to purchase an amount of common stock of SBC (or, in certain circumstances, of the potential acquiror) having a value equal to two times the exercise price of \$160. The rights expire in January 1999. After giving effect to stock splits in January 1998 and May 1993, effected in the form of a stock dividend, each share of common stock represents one-quarter of a right.

The rights have certain antitakeover effects. The rights will cause substantial dilution to a person or group that attempts to acquire SBC on terms not approved by the Board.

The rights should not interfere with any merger or other business combination approved by the Board since the rights may be redeemed.

NOTE 16. Acquisitions and Dispositions

In May 1997, a consortium made up of SBC and Telekom Malaysia Berhad, 60% owned by SBC, completed the purchase of 30% of Telkom SA Limited (Telkom), the state-owned telecommunications company of South Africa. SBC invested \$760, approximately \$600 of which will remain in Telkom.

In October 1995, SBC combined its United Kingdom cable television operations with those of TeleWest Communications, P.L.C., a publicly held joint venture between Telecommunications, Inc. and U S WEST, Inc. The resulting entity, TeleWest P.L.C. (TeleWest), is the largest cable television operator in the United Kingdom. SBC owns approximately 15% of the new entity and accounts for its investment using the cost method of accounting. Restrictions expiring over the next three years exist on the sale of SBC's interest in TeleWest. SBC recorded an after-tax gain of \$111 associated with the combination.

During 1995, SBC purchased at auction PCS licenses in Los Angeles-San Diego, California; San Francisco-Oakland-San Jose, California; Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma for approximately \$769. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis and Little Rock and other consideration.

These acquisitions were primarily accounted for under the purchase method of accounting. The purchase prices in excess of the underlying fair value of identifiable net assets acquired are being amortized over periods not to exceed 40 years. Results of operations of the properties acquired have been included in the consolidated financial statements from their respective dates of acquisition.

The above developments did not have a significant impact on consolidated results of operations for 1997 or 1995, nor would they had they occurred on January 1 of the respective periods.

NOTE 17. Additional Financial Information

Balance Sheets	December 31,	
	1997	1996
Accounts payable and accrued liabilities		
Accounts payable	\$2,848	\$2,741
Accrued taxes	1,108	893
Advance billing and customer deposits	699	611
Compensated future absences	524	479
Accrued interest	306	279
Accrued payroll	315	194
Other	2,088	1,387
Total	\$7,888	\$6,584

Statements of Income	1997	1996	1995
Interest expense incurred	\$1,067	\$ 948	\$1,000
Capitalized interest	(120)	(136)	(43)
Total interest expense	\$ 947	\$ 812	\$ 957

Allowance for funds used during construction	-	-	\$ 48
--	---	---	-------

Statements of Cash Flows	1997	1996	1995
Cash paid during the year for:			
Interest	\$ 920	\$ 799	\$ 974
Income taxes	\$ 410	\$1,283	\$1,220

No customer accounted for more than 10% of consolidated revenues in 1997, 1996 or 1995.

Several subsidiaries of SBC have negotiated contracts with the Communications Workers of America (CWA). Approximately 67% of SBC's employees are represented by the CWA. Contracts covering an estimated 77,000 employees between the CWA and several SBC subsidiaries end in 1998. New contracts are scheduled to be negotiated in 1998.

NOTE 18. Quarterly Financial Information (Unaudited)

Calendar Quarter	Total Operating Revenues ⁽⁴⁾	Operating Income (Loss)	Net Income (Loss)	Basic Earnings (Loss) per Common Share ⁽³⁾	Stock Price ⁽³⁾		
					High	Low	Close
1997							
First ⁽¹⁾	\$ 5,973	\$1,586	\$ 857	\$ 0.47	\$29.125	\$24.813	\$26.250
Second ⁽¹⁾	5,921	(933)	(787)	(0.43)	30.938	24.625	30.938
Third ⁽¹⁾	6,329	1,472	816	0.45	31.125	26.781	30.719
Fourth ⁽¹⁾	6,633	1,045	588	0.32	38.063	30.000	36.625
Annual ⁽¹⁾	\$24,856	\$3,170	\$1,474	\$ 0.81			
1996							
First ⁽²⁾	\$ 5,564	\$1,458	\$ 888	\$ 0.48	\$30.125	\$24.875	\$26.313
Second	5,731	1,489	803	0.44	25.375	23.125	24.625
Third	5,948	1,532	867	0.47	25.500	23.000	24.063
Fourth	6,202	1,357	721	0.39	27.625	23.500	25.938
Annual ⁽²⁾	\$23,445	\$5,836	\$3,279	\$ 1.78			

⁽¹⁾Net income (loss) includes \$90 first quarter pension settlement gain for 1996 retirements (see Note 12), \$1.6 billion second quarter charges related to post-merger initiatives (see Note 3), \$43 and \$360 of third and fourth quarter merger integration costs and customer number portability expenses and \$33 fourth quarter gain on sale of SBC's interests in Bell Communications Research, Inc.

Net Income and Earnings per Common Share reflect a cumulative effect of accounting change of \$90 or \$0.05 per share from change in accounting for directory operations.

⁽²⁾Restated to reflect two-for-one stock split declared January 30, 1998. Stock prices have not been adjusted to reflect the merger with PAC.

⁽³⁾Quarterly information has been restated to conform to the current presentation of promotional discounts.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Shareowners
SBC Communications Inc.

We have audited the accompanying consolidated balance sheets of SBC Communications Inc. (the Company) as of December 31, 1997 and 1996, and the related consolidated statements of income, shareowners' equity, and cash flows for each of the three years in the period ended December 31, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the 1996 and 1995 financial statements of Pacific Telesis Group, a wholly-owned subsidiary, which statements reflect total assets constituting 42% of the Company's related 1996 consolidated financial statement total and which reflect total operating revenues constituting approximately 41% and 42% of the Company's related consolidated financial statement totals for the years ended December 31, 1996 and 1995, respectively. Those statements were audited by other auditors whose report, which has been furnished to us, included an explanatory paragraph that describes the change in its method of recognizing directory publishing revenues and related expenses, and the discontinuance of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation." Our opinion, insofar as it relates to the 1996 and 1995 data included for Pacific Telesis Group, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and, for 1996 and 1995, the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SBC Communications Inc. at December 31, 1997 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, Pacific Bell, a subsidiary of Pacific Telesis Group, changed its method of recognizing directory publishing revenues and related expenses effective January 1, 1996. As discussed in Note 2 to the consolidated financial statements, SBC Communications Inc. discontinued its application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" in 1995.

Ernst & Young LLP

San Antonio, Texas
February 20, 1998

REPORT OF MANAGEMENT

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles. The integrity and objectivity of the 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 otherwise indicated.

The financial statements of SBC Communications Inc. (SBC) have been audited by Ernst & Young LLP, independent auditors. Management has made available to Ernst & Young LLP all of SBC's financial records and related data, as well as the minutes of shareowners' and directors' meetings. Furthermore, management believes that all representations made to Ernst & Young LLP during its audit were valid and appropriate.

Management has established and maintains a system of internal accounting controls that provides reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition and the prevention and detection of fraudulent financial reporting. The concept of reasonable assurance recognizes that the costs of an internal accounting controls system should not exceed, in management's judgment, the benefits to be derived.

Management also seeks to ensure 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 communication programs aimed at ensuring that its policies, standards and managerial authorities are understood throughout the organization. Management continually monitors the system of internal accounting controls for compliance. SBC maintains an internal auditing program that independently assesses the effectiveness of the internal accounting controls and recommends improvements thereto.

The Audit Committee of the Board of Directors, which consists of eight 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 access to the Audit Committee at any time.

Edward E. Whitacre Jr.

Edward E. Whitacre Jr.
Chairman of the Board and
Chief Executive Officer

Donald E. Kiernan

Donald E. Kiernan
Senior Vice President, Treasurer
and Chief Financial Officer

SBC BOARD OF DIRECTORS

Edward E. Whitacre Jr., 56^(2,4,5)



Chairman of the Board
and Chief Executive Officer
SBC Communications Inc.
San Antonio, Texas
SBC Director since October 1986
Background: Telecommunications

Gilbert F. Amelio, Ph.D., 55⁽³⁾



Partner
The Parkside Group, LLC
Principal
Aircraft Ventures, LLC
San Francisco, California
Advisory Director since April 1997
PTG Director 1995-1997
Background: Technology, electronics
engineering

Clarence C. Barksdale, 65^(1,3)



Vice Chairman,
Board of Trustees
Washington University
St. Louis, Missouri
SBC Director since October 1983
SWBT Director 1982-1983
Background: Banking

James E. Barnes, 64^(1,2)



Chairman of the Board,
President and
Chief Executive Officer
MAPCO Inc.
Tulsa, Oklahoma
SBC Director since November 1990
Background: Diversified energy

Jack S. Blanton, 70⁽⁶⁾



Chairman
Houston Endowment, Inc.
President and
Chief Executive Officer
Eddy Refining Company
Houston, Texas
Advisory Director since April 1997
SBC Director 1983-1997
SWBT Director 1977-1983
Background: Petroleum products

August A. Busch III, 60^(2,4,6)



Chairman of the
Board and President
Anheuser-Busch
Companies, Inc.
St. Louis, Missouri
SBC Director since October 1983
SWBT Director 1980-1983
Background: Brewing, family
entertainment, transportation,
manufacturer of aluminum
beverage containers

Royce S. Caldwell, 59^(4,5)



President-SBC Operations
SBC Communications Inc.
San Antonio, Texas
SBC Director since
April 1997
Background: Telecommunications

Ruben R. Cardenas, 67^(1,3)



Partner
Cardenas, Whitis &
Stephen, L.L.P.
McAllen, Texas
SBC Director since October 1983
SWBT Director 1975-1983
Background: Law

**The Honorable
William P. Clark**, 66⁽³⁾



Chief Executive Officer
Clark Company
Senior Counsel
Clark, Cali and Negranti
Paso Robles, California
SBC Director since April 1997
PTG Director 1985-1997
Background: Law, ranching

Martin K. Eby, Jr., 63^(1,5)



Chairman of the Board and
Chief Executive Officer
The Eby Corporation
Wichita, Kansas
SBC Director since June 1992
Background: General building
construction

Tom C. Frost, 70^(2,5)



Senior Chairman of
the Board
Cullen/Frost Bankers, Inc.
San Antonio, Texas
Advisory Director since April 1997
SBC Director 1983-1997
SWBT Director 1974-1983
Background: Banking

Herman E. Gallegos, 67^(1,3)



Independent Management
Consultant
Brisbane, California
SBC Director since
April 1997
PTG Director 1983-1997
Background: Management consulting

Jess T. Hay, 67^(1,6)



Chairman
Texas Foundation for
Higher Education
Chairman
HCB Enterprises Inc
Dallas, Texas
SBC Director since April 1986
Background: Financial services

Admiral Bobby R. Inman, 66^(5,6)



United States Navy, Retired
Austin, Texas
SBC Director since
March 1985
Background: Private investment

Charles F. Knight, 62^(2,4,5)



Chairman and
Chief Executive Officer
Emerson Electric Co.
St. Louis, Missouri
SBC Director since October 1983
SWBT Director 1974-1983
Background: Electrical manufacturing

Mary S. Metz, Ph.D., 60⁽¹⁾



Dean
University Extension
University of California,
Berkeley
Berkeley, California
SBC Director since April 1997
PTG Director 1986-1997
Background: Education, administration

Dr. Haskell M. Monroe, Jr., 66^(3,5)



Dean of Faculties Emeritus
and Director of Academic
Development
Texas A&M University
College Station, Texas
SBC Director since October 1983
SWBT Director 1982-1983
Background: Education, administration

Toni Rembe, Esq., 61⁽³⁾



Partner
Pillsbury Madison &
Sutro LLP
San Francisco, California
SBC Director since January 1998
Advisory Director 1997-1998
PTG Director 1991-1997
Background: Law

S. Donley Ritchey, 64^(5,6)



Managing Partner
Alpine Partners
Chairman and Chief
Executive Officer (Retired)
Lucky Stores, Inc.
Danville, California
SBC Director since April 1997
PTG Director 1984-1997
Background: Diversified retail

Richard M. Rosenberg, 67^(2,5)



Chairman and Chief
Executive Officer (Retired)
BankAmerica Corporation
San Francisco, California
SBC Director since April 1997
PTG Director 1994-1997
Background: Banking

Ing. Carlos Slim Helú, 58^(3,5)



Chairman of the Board
Grupo Carso, S.A. de C.V.
Mexico City, Mexico
SBC Director since
September 1993
Background: Telecommunications,
consumer goods, automobile parts,
construction, retailing

Patricia P. Upton, 59^(1,3)



President and
Chief Executive Officer
Aromatique, Inc.
Heber Springs, Arkansas
SBC Director since June 1993
Background: Decorative home
fragrances

Committees of the Board:

- (1) Audit
- (2) Corporate Development
- (3) Corporate Public Policy
and Environmental Affairs
- (4) Executive
- (5) Finance/Pension
- (6) Human Resources

EXECUTIVES OF SBC AND ITS SUBSIDIARIES

SBC Senior Executives

Edward E. Whitacre Jr., 56
chairman and
chief executive officer,
SBC Communications

John H. Atterbury III, 49
senior vice president-
international operations,
SBC Communications

Royce S. Caldwell, 59
president-SBC operations,
SBC Communications

Cassandra C. Carr, 53
senior vice president-
human resources,
SBC Communications

William E. Dreyer, 60
senior executive vice
president-external affairs,
SBC Communications

James D. Ellis, 54
senior executive vice president
and general counsel,
SBC Communications

Charles E. Foster, 61
group president-SBC,
SBC Communications

James S. Kahan, 50
senior vice president -
corporate development,
SBC Communications

Donald E. Kiernan, 57
senior vice president, treasurer
and chief financial officer,
SBC Communications

Linda S. Mills, 46
senior vice president-
corporate communications,
SBC Communications

Stanley T. Sigman, 50
president and
chief executive officer,
SBC Wireless Inc.

Other Executives

Wayne S. Alexander, 49
president-SBCI (Chile),
SBC International

Thomas M. Barry, 53
senior vice president-
federal relations,
SBC Telecommunications

William A. Blase, 42
vice president-regulatory,
Pacific Telesis

Blaine Bull, 40
president-government affairs,
Pacific Telesis

James W. Callaway, 51
president-public affairs,
Pacific Telesis

Lee Camp, 55
president and
chief executive officer-
Pacific Telesis
Enhanced Services,
Pacific Telesis

Stephen M. Carter, 44
president-special markets,
SBC Telecommunications

Lea Ann Champion, 39
regional president-
customer services,
Southwestern Bell Telephone

David A. Cole, 49
president (Texas),
Southwestern Bell Telephone

Liam S. Connan, 62
senior vice president and
assistant general counsel,
SBC Communications

Wilbur Crossley, 54
vice president-network
(Telkom South Africa),
SBC International

Patricia Diaz Dennis, 51
senior vice president and
assistant general counsel,
SBC Communications

Richard C. Dietz, 51
president, SBCI (Mexico),
SBC International

William E. Downing, 58
executive vice president,
Pacific Telesis

Durward D. Dupre, 54
vice president and
associate general counsel,
SBC Telecommunications

J. Cliff Eason, 50
president and
chief executive officer,
Southwestern Bell Telephone

Melanie S. Fannin, 47
regional president (Sacramento),
Pacific Telesis

Robert Ferguson, 38
regional president (San Diego),
Pacific Telesis

James D. Gallemore, 46
executive vice president-
strategic marketing,
SBC Operations

R. McRae Geschwind, 56
president-SBCI
(Telkom South Africa),
SBC International

Michael N. Gilliam, 45
regional president-
network operations,
Southwestern Bell Telephone

Edward L. Glotzbach, 49
president and
chief executive officer,
SBC Services

William J. Hannigan, 38
regional president-
customer services,
Southwestern Bell Telephone

Timothy S. Harden, 44
vice president and
general manager-
industry operations,
SBC Telecommunications

Priscilla Hill-Ardoin, 46
president (Missouri),
Southwestern Bell Telephone

Ross K. Ireland, 50
vice president-network
planning and engineering,
Pacific Telesis

Karen E. Jennings, 47
vice president and general
manager-operator services,
SBC Telecommunications

Ronald M. Jennings, 56
vice president and
general manager-
public communications
SBC Telecommunications

Martin A. Kaplan, 60
executive vice president,
Pacific Telesis

Michael Kaufman, 52
president-consumer
communications services,
Pacific Bell

Sandy Kinney, 50
vice president and general
manager-industry markets,
SBC Telecommunications

Robert Lee, 49
executive vice president-
merger transition,
Pacific Bell

Richard G. Lindner, 43
vice president and
chief financial officer,
Southwestern Bell Telephone

David R. Lopez, 46
president (Oklahoma),
Southwestern Bell Telephone

Norma Martinez Lozano, 41
vice president-
diversity marketing,
SBC Operations

Gary W. Lucas, 53
vice president-labor relations,
Southwestern Bell Telephone

Robert M. Lynch, 47
senior vice president and
general counsel-external affairs,
SBC Telecommunications

Mary T. Manning, 47
vice president-
corporate real estate,
SBC Services

Wayne D. Masters, 52
vice president-
customer services,
Southwestern Bell Telephone

William B. McCullough, 46
president and
chief executive officer,
Southwestern Bell Wireless

Shawn M. McKenzie, 39
president (Kansas),
Southwestern Bell Telephone

Forrest E. Miller, 45
president and
chief executive officer,
SBC Directory Operations

Tom E. Morgan, 51
regional president-
customer services,
Southwestern Bell Telephone

Thomas O. Moulton, Jr., 51
vice president-state relations,
Pacific Telesis

Edward A. Mueller, 50
president and
chief executive officer,
Pacific Bell

Carmen Nava, 35
regional president
(Los Angeles),
Pacific Telesis

Robert J. Nelson, 39
president-Midwest,
Cellular One

David Nichols, 40
president (Nevada),
Nevada Bell

Richard W. Odgers, 61
executive vice president
and general counsel,
Pacific Telesis

Thomas A. Pall, 58
senior vice president-sales,
SBC Directory Operations

Patsy F. Parker, 50
president,
SBC Center for Learning

T. Michael Payne, 47
senior vice president,
general counsel and secretary,
Pacific Telesis

Robert B. Pickering, 39
vice president and
chief financial officer,
Pacific Bell

John Polumbo, 45
president and
chief executive officer,
Pacific Bell Mobile Services

Alfred G. Richter Jr., 47
senior vice president and
general counsel-operations,
SBC Telecommunications

A. Dale Robertson, 49
senior vice president-FCC,
SBC Telecommunications

Michael A. Rodriguez, 47
vice president-labor relations,
Pacific Telesis

Charles J. Roesslein, 49
president and
chief executive officer,
SBC Technology Resources

Drew A. Roy, 51
regional president-
Cellular One (Northeast),
Cellular One

Judith M. Sahn, 52
vice president and secretary,
SBC Communications

Robert W. Shaner, 49
president SBCI (Europe
and Middle East),
SBC International

James B. Shelley, 44
president (Arkansas),
Southwestern Bell Telephone

Charles H. Smith, 54
president-network operations,
Pacific Bell

Donna L. Snyder, 46
regional president-
customer services,
Southwestern Bell Telephone

Randall Stephenson, 37
vice president and controller,
SBC Communications

Joyce M. Taylor, 40
regional president,
(San Francisco-Bay Area),
Pacific Telesis

Ian H. Taylor, 49
regional president-
network operations,
Southwestern Bell Telephone

J. Michael Turner, 48
executive vice president-
corporate planning and
capital management,
SBC Communications

Richard J. Vêhige, 52
vice president-
procurement services,
Southwestern Bell Telephone

Joe W. Walkowiak, 50
regional president-
network operations,
Southwestern Bell Telephone

Stephen G. Welch, 54
vice president-procurement,
Pacific Telesis

Paul H. White, 53
senior vice president
and general counsel-
nonregulated enterprises,
SBC Telecommunications

C. Diana Whitehead, 50
vice president and
chief information officer,
Pacific Telesis

Horace Wilkins Jr., 47
regional president-
network operations,
Southwestern Bell Telephone

Rayford Wilkins Jr., 46
president-business
communications services,
Pacific Bell

SHAREOWNER INFORMATION

Toll-Free Shareowner Hotline

Call us at 1-800-351-7221 between
9 a.m. and 5 p.m. Central Time
Monday through Friday.

TDD 1-888-296-5221

We can help with:

- account inquiries
- requests for assistance, including
stock transfers
- information on the SBC Direct Stock
Purchase and Reinvestment Plan

Written Requests

Please mail all account inquiries and
other requests for assistance with
regard to your stock ownership to:
SBC Communications Inc.

c/o The Bank of New York
Church Street Station

P.O. Box 12772

New York, New York 10286-1272

Please mail requests for transactions
involving stock transfers or account
changes to:

SBC Communications Inc.

c/o The Bank of New York

Receive & Deliver Department

P.O. Box 1002

New York, New York 10286-1002

You also may reach The Bank of
New York, the Transfer Agent for SBC,
via e-mail at:

no-shareowners@bankofny.com

The Direct Stock Purchase and Reinvestment Plan (SBC Direct)

SBC Direct allows current shareowners
to purchase SBC stock with a

minimum investment of \$50. Other

persons also may take advantage of

this feature with a minimum initial

investment of \$500. SBC Direct has

many other convenient features,

including automatic monthly deduc-

tions, dividend reinvestment, direct

purchase of dividends and an individual

retirement account.

For a prospectus, corresponding

about your Plan account or send

optional cash investments, write:

SBC Direct

c/o The Bank of New York

P.O. Box 239

Newark, New Jersey 07101-0239

Stock Trading Information

SBC is listed on the New York,
Chicago and Pacific Stock Exchanges
and The Swiss Exchange. SBC is
traded on the London Stock Exchange
through the SEAQ International
Markets facility.

Ticker symbol (NYSE): SBC

Newspaper stock listing:

SBC or SBC Comm

Information Available

Information about SBC is available in
the Internet. Visit our home page on
the World Wide Web at:
<http://www.sbc.com>

Annual Meeting

The annual meeting of shareowners
will be held at 9:00 a.m. Friday,
April 24, 1998, at the
Alzafar Shrine Temple
901 North Loop 1604 West
San Antonio, Texas 78216

Independent Accountants

Ernst & Young LLP

1900 Frost Bank Tower

100 W. Houston

San Antonio, Texas 78215

Requests for Information

The SBC Southwestern
Telephone Company and Pacific Bell
Telephone Company Forms 10-K, filed
with the Securities and Exchange
Commission, are available on request.

Investor Relations

Security analysts and other members
of the professional financial community
may call the Investor Relations
Hotline: 210-351-4105

General Information

SBC Communications Inc.

175 E. Houston

P.O. Box 2933

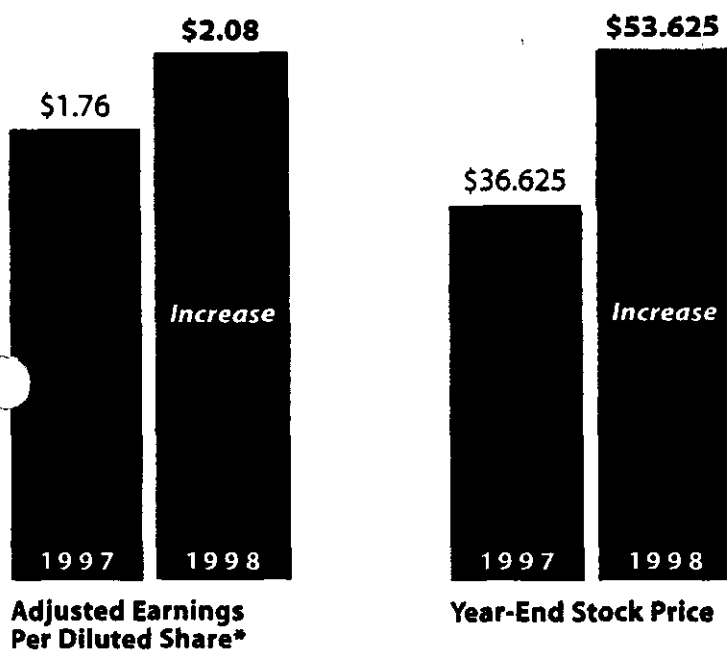
San Antonio, Texas 78215-2933

210-821-4105

SBC Communications Inc.
175 E. Houston
P. O. Box 2933
San Antonio, Texas 78299-2933
210-821-4105

SBC Communications Inc.

1998 ANNUAL REPORT



Nineteen ninety-eight was a year of exceptional progress for SBC Communications, as we strengthened our leadership in telecommunications and continued to shape our future as an integrated, full-service, global competitor...

Amid dynamic industry change, we remain focused on providing our customers a seamless range of high-quality services whenever and wherever they need them, while providing outstanding value to our shareowners.

This document reports progress on our initiatives to remain one of the world's leading telecommunications companies now and in the 21st century.

*Adjusted earnings per diluted share represent income before extraordinary loss and cumulative effect of accounting change adjusted for the following: 1998 excludes a net charge of \$0.03 per diluted share principally for strategic decisions related to the merger of SBC and SNET offset by gains on the sale of certain non-core businesses; 1997 excludes a net charge of \$0.91 per diluted share regarding \$1.8 billion of one-time charges principally for strategic decisions related to the merger of SBC and Pacific Telesis. These adjustments are described on page 6.

1998 Progress Report

Financial information (dollars in millions)	1998	1997	Change
Reported net income	\$4,023	\$1,674	140.3%
Accounting change and Extraordinary loss - net	\$ 45	\$ —	—
Reported earnings	\$4,068	\$1,674	143.0%
Special charges	\$ 49	\$1,776	—
Adjusted earnings	\$4,117	\$3,450	19.3%

Adjusted earnings for 1998 exclude \$49 million for net charges principally for strategic decisions related to the merger of SBC and SNET offset by gains on the sales of certain non-core businesses. Adjusted earnings for 1997 exclude \$1.8 billion of one-time net charges principally for strategic decisions related to the merger of SBC and Pacific Telesis. These adjustments are described on page 6.

Per Share of Common Stock	1998	1997	Change
Adjusted earnings per diluted share	\$ 2.08	\$ 1.76	18.2%
Dividend	\$ 0.935	\$ 0.895	4.5%
Year-end stock price	\$53.625	\$36.625	46.4%

HIGHLIGHTS

- ▶ **SBC advances its global strategy** by announcing plans to merge with Ameritech and then expand to 30 markets beyond the new company's combined region. The merger will provide increased scale and geographic scope, enabling the company to provide high-quality, competitive services to customers in the nation's 50 largest markets.
- ▶ **SBC acquires Southern New England Telecommunications (SNET)**, gaining another great brand, strong wireline and complementary wireless businesses, long-distance experience and expanded presence in the Northeastern United States.
- ▶ **Synergies from the Pacific Telesis merger are ahead of schedule** to add \$1 billion in net income by next year.
- ▶ **In January 1999, SBC launches the nation's largest rollout of Asymmetrical Digital Subscriber Line (ADSL)** — a high-speed Internet access service — at affordable prices, capitalizing on opportunities in the rapidly growing data market.
- ▶ **The February 1999 alliance with Williams Communications** provides SBC with a high-quality fiber-based broadband network for long-distance service.

DEAR FELLOW INVESTOR:

Nineteen ninety-eight was an **excellent year** for SBC Communications.

It was, first and foremost, a year in which your company delivered **strong earnings growth**. We also took **strategic steps** to ensure that, as our industry continues to evolve, SBC will continue to create outstanding value for you well into the future.

In 1998, our adjusted earnings rose by 19.3 percent. Accounting for our February 1998 two-for-one stock split, SBC's diluted earnings per share were \$2.08, up 18.2 percent over 1997.

Including stock price appreciation and reinvested dividends, total shareowner return in 1998 was 49.72 percent. This brings our total compounded annual return since 1984 — when we became an independent company — to 23.15 percent. That result exceeds a combined return during the same period of 22.04 percent for our telecommunications peers, and 17.84 percent for the Standard & Poor's 500.

We are pleased but not satisfied. To ensure that we continue delivering excellent performance in 1999 and beyond, the SBC team moved forward in 1998 on four strategic fronts:

Continuing to maximize growth in our core businesses. Over the years, SBC has established a solid record for making the most of our core wireline and wireless businesses by increasing revenues while controlling expenses. Nineteen ninety-eight was no exception:

- Revenues were \$28.8 billion, up 7.9 percent over the previous year.
- Access line growth remained impressive in 1998, with a 4.1 percent increase in residential lines. Meanwhile, our business line growth was 15.6 percent, including both voice lines and data circuits.
- We achieved outstanding sales of additional calling features. Pacific Bell, for example, ended the year with more than 1.5 million Caller ID customers, and increased the penetration of features for residential customers by more than 44 percent to 1.26 vertical features per line.
- Southwestern Bell achieved an industry-leading residential Caller ID penetration rate of more than 50 percent.

The company's wireless operations also performed well in 1998. Our new Personal Communications Services (PCS) offering in California and Nevada, in particular, experienced exceptional growth. Across all of our markets, including Southwestern Bell, Pacific Bell, and Cellular One, we increased our number of subscribers to 6.9 million and added digital service to meet the demands of high-use customers. This includes the half million subscribers we serve through the acquisition of Southern New England Telecommunications (SNET) that further increased our wireless customer base. In January 1999, we agreed to acquire Comcast Cellular Corporation, which has cellular properties in Pennsylvania, New Jersey and Delaware, subject to regulatory approval. With these significant acquisitions, we are confident of our ability to grow our wireless base — and maintain healthy margins — despite fierce competition.

We also accelerated the process of value creation from the Pacific Telesis merger. Thanks to the hard work and dedication of our merger integration teams, we took full advantage of the best practices of both companies through operational initiatives that are ahead of schedule in adding \$1 billion to our annual income by the end of 2000. Equally important, the completion of our merger with Southern New England Telecommunications established SNET as a solid anchor for our expansion in the Northeast.

Aggressively expanding our data capabilities. To remain a communications industry leader, SBC must be a data communications leader. Our 1998 data service revenues increased 32 percent over 1997, as demand for data services continued to expand rapidly.

We made major strides in meeting that demand. We introduced industry-leading, high-speed Asymmetrical Digital Subscriber Line (ADSL) services in California, a flexible offering that will provide customers with much faster Internet access to move integrated packages of voice, data and video quickly and securely.

Developing national and international reach. As the telecommunications industry evolves, we believe two types of companies will emerge. A small group of full-service, global carriers will offer customers what they increasingly demand — integrated services, including local, long distance, wireless, and high-speed data communications. A second, larger group will consist of smaller, narrowly focused regional providers. SBC intends to be a global competitor. Only by doing so can we provide the financial returns you expect well into the future.

As a result, we decided in 1998 to expand our resources and geographic reach, gaining size and scope to provide our customers a seamless range of high-quality services whenever and wherever they need them. Our planned merger with Ameritech, which has received overwhelming approval from the shareowners of both companies, is a critical step in this direction.

Based on both companies' combined 1998 revenues, the Ameritech merger will create a powerful competitor, with more than \$45 billion in revenues and some 200,000 of the best employees in our business. Our combined territories will include the headquarters of almost half of the *Fortune* 500 companies, and we will have a presence in 20 of the top 50 markets in the country. But what really sets this merger apart is the role it plays in our becoming a global company.

Our merged company will move aggressively to enter the top 30 markets outside our combined territories. We plan to provide residential and business customers in those markets with one-stop shopping for their telecommunications needs. As we build a competitive presence in the nation's top 50 markets, we plan to develop a state-of-the-art voice and data network that will carry our customers' voice and data traffic anywhere in the world. Our ability to do just that took a major step forward in February 1999, when we announced an alliance with Williams Communications. This agreement gives us access to one of the industry's highest quality data and voice broadband networks, while enabling us to have a voice in the future expansion and development of that network around the needs of our customers.

We expect to complete the Ameritech merger in the second half of 1999, then move quickly to integrate Ameritech's operations into SBC, as we did with Pacific Telesis and are doing with SNET.

Providing long-distance services. To be a true full-service provider, SBC must have the freedom to offer long-distance service to all our customers, wherever they live or work. In 1998, we moved closer to securing that capability by continuing to open our local markets to competitors. And we are working closely with regulators to gain their support for our long-distance entry. While we are disappointed that the process has taken so long, our alliance with Williams ensures that, as soon as we receive regulatory approval to offer long distance, we can move immediately to add this critical offering to our range of services.

SBC entered 1998 strongly positioned to build value for our shareowners, with great markets, great businesses and a proven ability to execute our plans. During the year, we expanded those markets, strengthened our businesses and enhanced our reputation for superior execution.

More important, by refining our strategies and taking decisive steps to become an integrated, worldwide competitor, we are guiding SBC toward a clearly defined objective — becoming a global enterprise with the resources and flexibility to take advantage of the most promising growth opportunities.

That is where SBC's focus has always been. And, despite the changes ahead, that is where it will stay — on building value for our owners.

We will keep you informed as we move ahead in 1999. In the meantime, thank you for your continued confidence and support.



Edward E. Whitacre Jr.

Edward E. Whitacre Jr.

Chairman and Chief Executive Officer

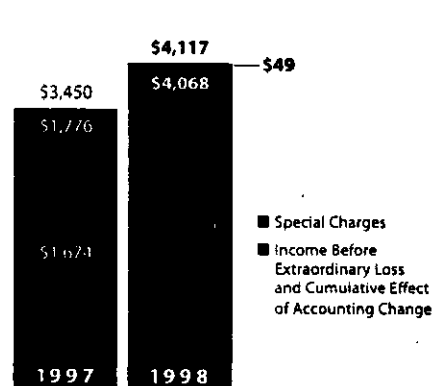
February 12, 1999

FINANCIAL CONTENTS

4	Selected Financial Highlights
5	Selected Financial and Operating Data
6	Management's Discussion and Analysis
20	Consolidated Statements of Income
21	Consolidated Balance Sheets
22	Consolidated Statements of Cash Flows
23	Consolidated Statements of Shareowners' Equity
24	Notes to Consolidated Financial Statements
38	Report of Independent Auditors
38	Report of Management
39	SBC Board of Directors
40	Executives of SBC and Its Subsidiaries
41	Shareowner Information

SELECTED FINANCIAL HIGHLIGHTS

Dollars in millions except per share amounts, as of or for the year ended December 31.

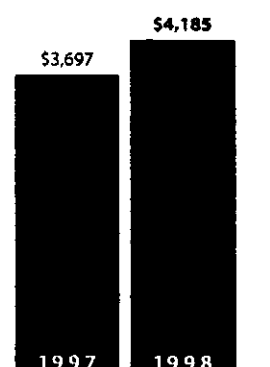


Income Before Extraordinary Loss and Cumulative Effect of Accounting Change

Results for 1998 and 1997 were adjusted for special charges.



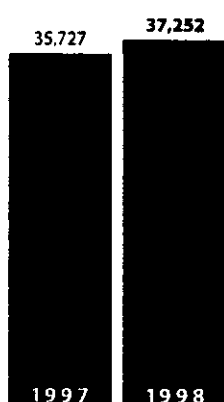
Wireline Operating Revenues
Results for 1998 and 1997 were adjusted for special charges.



Wireless Operating Revenues



Dividends Declared Per Common Share



Access Lines*



Wireless Customers*

*in thousands

SELECTED FINANCIAL AND OPERATING DATA

Dollars in millions except per share amounts

At December 31 or for the year ended:	1998 ¹	1997 ²	1996	1995	1994
Financial Data					
Operating revenues	\$28,777	\$26,681	\$25,202	\$23,356	\$22,555
Operating expenses	\$21,891	\$23,103	\$18,976	\$17,878	\$17,216
Operating income	\$ 6,886	\$ 3,578	\$ 6,226	\$ 5,478	\$ 5,339
Interest expense	\$ 993	\$ 1,043	\$ 901	\$ 1,043	\$ 1,010
Equity in net income of affiliates	\$ 236	\$ 201	\$ 207	\$ 120	\$ 226
Income taxes	\$ 2,306	\$ 984	\$ 2,070	\$ 1,632	\$ 1,575
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes³	\$ 4,068	\$ 1,674	\$ 3,387	\$ 3,132	\$ 2,962
Net income (loss)	\$ 4,023	\$ 1,674	\$ 3,477	\$ (3,577)	\$ 2,985
Earnings per common share:					
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes³	\$ 2.08	\$ 0.86	\$ 1.73	\$ 1.60	\$ 1.53
Net income (loss)	\$ 2.06	\$ 0.86	\$ 1.78	\$ (1.83)	\$ 1.54
Earnings per common share – Assuming Dilution:					
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes³	\$ 2.05	\$ 0.85	\$ 1.72	\$ 1.60	\$ 1.53
Net income (loss)	\$ 2.03	\$ 0.85	\$ 1.77	\$ (1.82)	\$ 1.54
Total assets	\$45,066	\$44,836	\$42,057	\$40,361	\$49,525
Long-term debt	\$11,612	\$13,176	\$12,100	\$11,592	\$11,698
Construction and capital expenditures	\$ 5,927	\$ 6,230	\$ 5,855	\$ 4,729	\$ 4,262
Free cash flow ⁴	\$ 2,454	\$ 1,366	\$ 2,046	\$ 2,572	\$ 3,058
Dividends declared per common share ⁵	\$ 0.935	\$ 0.895	\$ 0.86	\$ 0.825	\$ 0.79
Book value per common share	\$ 6.52	\$ 5.38	\$ 5.22	\$ 4.50	\$ 7.36
Ratio of earnings to fixed charges	5.89	2.77	5.22	5.12	4.99
Debt ratio	48.86%	57.07%	56.83%	63.04%	48.71%
Weighted Average Common Shares					
Outstanding (000,000)	1,957	1,945	1,956	1,955	1,936
Weighted Average Common Shares					
Outstanding With Dilution (000,000)	1,984	1,962	1,967	1,963	1,940
End of Period Common Shares					
Outstanding (000,000)	1,959	1,954	1,942	1,960	1,952
Operating Data					
Network access lines in service (000)	37,252	35,727	34,003	32,385	31,173
Access minutes of use (000,000)	148,560	139,470	128,716	112,874	100,800
Wireless customers (000)	6,851	5,951	4,827	3,995	3,158
Number of employees	129,850	128,100	119,270	117,260	120,140

¹As detailed in management's discussion and analysis of Results of Operations, 1998 results include charges for strategic initiatives related to the merger with Southern New England Telecommunications Corporation (SNET) and gains on sales of certain non-core businesses. Excluding these items, SBC reported an adjusted income from continuing operations before extraordinary loss and cumulative effect of accounting change of \$4,117 and an adjusted net income of \$4,072 for 1998.

²As detailed in management's discussion and analysis of Results of Operations, 1997 results include charges for several items including strategic initiatives and ongoing merger integration costs, gain on the sale of SBC's interests in Bell Communications Research, Inc. and a first quarter after-tax settlement gain. Excluding these items, SBC reported an adjusted net income of \$3,450 for 1997.

³1998, Early retirement of debt and Change in directory accounting; 1996, Change in directory accounting; 1995, Discontinuance of Regulatory Accounting; and 1994, Income from spun-off operations.

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

⁵Dividends declared by SBC's Board of Directors; these amounts do not include dividends declared and paid by Pacific Telesis Group and SNET prior to their respective mergers.

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

Dollars in millions except per share amounts

SBC Communications Inc. (SBC) is a holding company whose subsidiaries and affiliates operate predominantly in the communications services industry. SBC's subsidiaries and affiliates provide landline and wireless telecommunications services as well as equipment and directory advertising both domestically and worldwide.

The consolidated financial results reflect SBC's mergers with Southern New England Telecommunications Corporation (SNET) in 1998 and Pacific Telesis Group (PAC) in 1997 as pooling of interests (see Note 2 of Notes to Consolidated Financial Statements).

SBC's principal wireline subsidiaries are Southwestern Bell Telephone Company (SWBell), providing telecommunications services in Texas, Missouri, Oklahoma, Kansas and Arkansas

(five-state area), Pacific Bell (PacBell, which also includes Pacific Bell Information Services), The Southern New England Telephone Company (SNETel) and Nevada Bell (collectively referred to as the Telephone Companies). SBC's principal wireless subsidiaries are Southwestern Bell Mobile Systems, Inc. (Mobile Systems), Pacific Bell Mobile Services (PBMS) and SNET Cellular, Inc. SBC's principal directory subsidiaries are Southwestern Bell Yellow Pages, Inc. (SWBYP), Pacific Bell Directory (PB Directory) and SNET Information Services, Inc. The Telephone Companies are subject to regulation by each of the states in which they operate and by the Federal Communications Commission (FCC).

This discussion should be read in conjunction with the consolidated financial statements and the accompanying notes.

RESULTS OF OPERATIONS

Summary

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

	1998	1997	1996	Percent Change	
				1998 vs. 1997	1997 vs. 1996
Operating revenues	\$28,777	\$26,681	\$25,202	7.9%	5.9%
Operating expenses	\$21,891	\$23,103	\$18,976	(5.2)%	21.7%
Income before extraordinary loss and cumulative effect of accounting change	\$ 4,068	\$ 1,674	\$ 3,387	—	—
Extraordinary loss	\$ (60)	—	—	—	—
Cumulative effect of accounting change	\$ 15	—	\$ 90	—	—
Net income	\$ 4,023	\$ 1,674	\$ 3,477	—	—

In 1998 and 1996, SBC reflected a cumulative effect of accounting change related to accounting for directory revenues and expenses (see Note 1 of Notes to Consolidated Financial Statements). In 1998, SBC incurred an extraordinary loss related to the early retirement of debt at PacBell (see Note 10 of Notes to Consolidated Financial Statements).

Results for 1998 and 1997 also include several items that SBC normalizes for management purposes. For 1998, normalizing items included \$219 of gains on sales of certain non-core businesses, principally the required disposition of SBC's interest in Mobile Telephone Networks (MTN), a South African national cellular company, due to SBC's investment in Telkom SA Limited (Telkom), and \$268 of charges related to strategic initiatives resulting from the merger integration process with SNET. For 1997, normalizing items included \$1,899 of costs related to strategic initiatives resulting from the merger integration process with PAC, the impact of several second quarter 1997 regulatory rulings and charges for ongoing merger integration costs (see Note 2 of Notes to Consolidated Financial Statements for further discussion of merger integration costs), as well as \$33 of gain on the sale of the Telephone Companies' interests in Bell Communications Research, Inc. (Bellcore) and \$90 of first quarter 1997 settlement gain at PAC associated with lump-sum pension payments that exceeded the projected service and interest costs for 1996 retirements. Collectively these items decreased income before extraordinary

loss and cumulative effect of accounting change by \$49 and \$1,776 in 1998 and 1997. Excluding these items, 1998 income before extraordinary loss and cumulative effect of accounting change would have been \$4,117, or 19.3% higher than 1997 earnings of \$3,450. The corresponding diluted per share amounts would be \$2.08 in 1998, or 18.2% higher than \$1.76 in 1997.

Excluding these items, the 1998 increase in income before extraordinary loss and cumulative effect of accounting change was due primarily to broad-based growth in demand for SBC's Wireline, Wireless and Directory operations. Results for 1998 also reflect reduced dilution from Personal Communications Services (PCS) operations in California and Nevada. Demand growth was also the primary factor contributing to the 1997 increases, partially offset by a high level of expenses for the introduction of PCS in California and Nevada.

Segment Results

SBC has four reportable segments: Wireline, Wireless, Directory and Other. The Wireline segment provides landline telecommunications services, including local, network access and long distance services, messaging and Internet services and sells customer premise and private business exchange equipment. The Wireless segment provides wireless telecommunications services, including local and long distance services, and sells wireless equipment. The Directory segment sells advertising for and publication of yellow pages and white pages directories and electronic publishing. The Other segment includes SBC's international investments

and other domestic operating subsidiaries. (See Note 9 of Notes to Consolidated Financial Statements.)

SBC evaluates performance of these segments based on income before income taxes, adjusted for normalizing items. Normalizing items for 1998 and 1997 are described above. There were no normalizing items for 1996.

Collectively, these normalizing items had the effect of reducing operating revenues in 1998 and 1997 by \$8 and \$188 and

increasing operating expenses in 1998 and 1997 by \$422 and \$2,550, as well as affecting non-operating income and expenses. If all of the normalizing items were included in their respective segments, the effect would be to increase (reduce) each segment's income before income tax in 1998 and 1997 as follows: Wireline \$(306) and \$(2,007); Wireless \$(49) and \$(100); Directory \$12 and \$(75); and Other \$268 and \$0. The following sections will discuss SBC's operations excluding these normalizing items.

Operating Revenues

Following are SBC's normalized operating revenues, including segment totals and percentage changes from the prior year (reductions of \$8 in 1998 and \$188 in 1997 are excluded):

	1998	1997	1996	Percent Change	
				1998 vs. 1997	1997 vs. 1996
Wireline	\$22,210	\$20,926	\$19,919	6.1%	5.1%
Wireless	4,185	3,697	3,137	13.2	17.9
Directory	2,393	2,286	2,145	4.7	6.6
Other	85	57	43	49.1	32.6
Corporate, adjustments & eliminations	(88)	(97)	(42)	(9.3)	—
Total Normalized Operating Revenues	\$28,785	\$26,869	\$25,202	7.1%	6.6%

Wireline

Wireline operating revenues increased \$1,284, or 6.1%, in 1998 and \$1,007, or 5.1%, in 1997. Components of Wireline operating revenues, including percentage changes from the prior year, are as follows:

	1998	1997	1996	Percent Change	
				1998 vs. 1997	1997 vs. 1996
Local service	\$11,154	\$10,434	\$ 9,513	6.9%	9.7%
Network access:					
Interstate	4,612	4,494	4,354	2.6	3.2
Intrastate	1,917	1,884	1,851	1.8	1.8
Long distance service	2,353	2,351	2,523	0.1	(6.8)
Other	2,174	1,763	1,678	23.3	5.1
Total Wireline	\$22,210	\$20,926	\$19,919	6.1%	5.1%

Local Service revenues increased \$720, or 6.9%, in 1998 and \$921, or 9.7%, in 1997 due primarily to increases in demand which totaled \$656 and \$799 in 1998 and 1997, including increases in access lines and vertical services revenues. The number of access lines increased by 4.3% and 5.1% in 1998 and 1997. Approximately 40% and 31% of access line growth in 1998 and 1997 was due to sales of additional access lines to existing residential customers. In both years, approximately 46% of the access line growth was in California and 32% was in Texas. Access lines in Texas and California account for approximately 75% of the Telephone Companies' access lines. Vertical services revenues, which include custom calling options, Caller ID, voice mail and other enhanced services, increased by approximately 20% in both years and totaled approximately \$1,892 and \$1,582 in 1998 and 1997.

Additionally, local service revenues increased as a result of several regulatory actions that also had the effect of decreasing one or more other types of operating revenues. In 1998 and 1997,

federal payphone regulation, introduction of extended area service plans and the introduction of the California High Cost Fund (CHCFB) collectively increased local service revenues by approximately \$157 and \$211, and decreased long distance revenue by approximately \$53 and \$117, interstate network access revenue by \$20 and \$53, intrastate network access revenue by approximately \$24 and \$26 and other operating revenue by approximately \$7 and \$0. The net effect on Wireline operating revenue was an increase of \$53 and \$15 in 1998 and 1997. The California Public Utilities Commission (CPUC) has stated that the CHCFB is intended to directly subsidize the provision of service to high-cost areas and allow PacBell to set competitive rates for other services.

These increases in local service revenues were partially offset by decreases of approximately \$43 and \$18 resulting from cellular interconnection rate reductions in 1998 and 1997. Rate reductions under CPUC price cap orders also reduced 1997 local service revenues by approximately \$56.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

Network Access Interstate network access revenues increased \$118, or 2.6%, in 1998 and \$140, or 3.2%, in 1997 due largely to increases in demand for access services by interexchange carriers; and growth in revenues from end-user charges attributable to an increasing access line base, which collectively resulted in an increase of approximately \$420 and \$361 in 1998 and 1997. Partially offsetting these increases were the effects of rate reductions of approximately \$189 in 1998 and \$120 in 1997 related to the FCC's productivity factor adjustment, access reform and other changes and regulatory shifts related to payphone deregulation of approximately \$20 and \$53 as noted in local service above. Additional decreases in 1998 totaling approximately \$76 resulted from an increase in universal service fund net payments implemented in the first quarter of 1998 that exceeded the 1997 net payments of long-term support, which were designed to subsidize universal service. The net federal universal fund payments and receipts will be exogenous factors in future federal price cap filings. Interstate network access revenues in 1997 also had a net decrease of approximately \$42 due to the reversal of 1996 revenue sharing and proposed 1996 tariff decrease estimates at the Telephone Companies.

Intrastate network access revenues increased \$33 in both 1998 and 1997, due largely to increases in demand totaling approximately \$79 and \$121 in 1998 and 1997, including usage by alternative intraLATA toll carriers. These increases in 1998 and 1997 were partially offset by state regulatory rate reductions at PacBell and SWBell totaling approximately \$23 and \$50 and the effects of the CHCFB described above in local service totaling approximately \$24 and \$26.

Wireless

Wireless operating revenues increased \$488, or 13.2%, in 1998 and \$560, or 17.9%, in 1997. Components of Wireless operating revenues, including percentage changes from the prior year, are as follows:

	1998	1997	1996	Percent Change	
				1998 vs. 1997	1997 vs. 1996
Subscriber	\$3,783	\$3,372	\$2,907	12.2%	16.0%
Other	402	325	230	23.7	41.3
Total Wireless	\$4,185	\$3,697	\$3,137	13.2%	17.9%

Subscriber revenues consist of wireless local service and long distance. Wireless subscriber revenues increased \$411, or 12.2%, in 1998 and \$465, or 16%, in 1997 due primarily to growth in the number of customers of 15.1% and 23.3%, partially offset by declines in average revenue per customer. Increases in 1997 wireless subscriber revenues of approximately \$103 also resulted from the introduction of PCS operations in California, Nevada and Oklahoma. At December 31, 1998, SBC had 5,924,000 traditional

Long Distance Service revenues were relatively unchanged in 1998 and decreased approximately \$172, or 6.8%, in 1997. Long distance service revenues decreased due to the effect of the regulatory shifts discussed in local service above of approximately \$53 and \$117 in 1998 and 1997 related to the CHCFB, introduction of extended area service plans and payphone deregulation, price competition from alternative intraLATA toll carriers of approximately \$43 and \$100 in 1998 and 1997 at SWBell and SNETel and regulatory rate reductions of approximately \$34 in 1997. These decreases were offset in 1998 and partially offset in 1997 by revenues from increased toll messages and demand at PacBell totaling approximately \$48 and \$45 in 1998 and 1997 and increased customer migration to SNET All Distance®, an interstate and intrastate toll service, of approximately \$20 and \$42 in 1998 and 1997. In addition, revenues in 1998 increased by approximately \$22 due to the net effect of regulatory rate orders and local exchange carrier billing settlements.

Other operating revenues increased \$411, or 23.3%, in 1998 and \$85, or 5.1%, in 1997 due primarily to increased sales from nonregulated products and services at the Telephone Companies totaling approximately \$201 and \$72 in 1998 and 1997, increased equipment sales at the Telephone Companies of approximately \$92 and \$6 in 1998 and 1997 and revenues from new business initiatives, primarily Internet services, totaling approximately \$71 and \$39 in 1998 and 1997. In addition, net payments for state universal funds of approximately \$15 in 1998 contributed to the increase. These increases were partially offset in 1998 by approximately \$7 related to the CHCFB, discussed in local service above.

cellular customers, 81,000 resale customers and 846,000 PCS customers. At December 31, 1997, SBC had 5,526,000 traditional cellular customers, 60,000 resale customers and 365,000 PCS customers.

Other wireless revenues increased \$77, or 23.7%, in 1998 and \$95, or 41.3%, in 1997 due primarily to increases in equipment revenue attributable to growth in the number of customers and conversion to digital equipment.

Directory

Directory operating revenues increased \$107, or 4.7%, in 1998 and \$141, or 6.6%, in 1997. Directory operating revenues, including percentage changes from the prior year, are as follows:

	1998	1997	1996	Percent Change	
				1998 vs. 1997	1997 vs. 1996
Total Directory	\$2,393	\$2,286	\$2,145	4.7%	6.6%

Directory operating revenues increased in 1998 due mainly to increased demand, including benefits from merger initiatives. Also contributing to the increase was approximately \$17 from directory rescheduling from the first quarter of 1999 into the

fourth quarter of 1998. Directory advertising revenues increased in 1997 due mainly to increased demand and the publication of directories in 1997 that were not published in 1996 due to rescheduling.

Operating Expenses

Following are SBC's normalized operating expenses, including percentage changes from the prior year (additions of \$422 in 1998 and \$2,550 in 1997 are excluded):

	1998	1997	1996	Percent Change	
				1998 vs. 1997	1997 vs. 1996
Operations and support:					
Wireline	\$12,711	\$12,291	\$11,464	3.4%	7.2%
Wireless	2,786	2,610	1,994	6.7	30.9
Directory	1,227	1,230	1,159	(0.2)	6.1
Other	152	93	46	63.4	—
Corporate, adjustments & eliminations	(363)	(368)	(153)	(1.4)	—
Total operations and support	16,513	15,856	14,510	4.1	9.3
Depreciation and amortization*	4,956	4,697	4,466	5.5	5.2
Total Normalized Operating Expenses	\$21,469	\$20,553	\$18,976	4.5%	8.3%

*See Note 9 of Notes to Consolidated Financial Statements for breakdown by segment.

Wireline Operations and support expenses increased \$420, or 3.4%, in 1998 and \$827, or 7.2%, in 1997. Increases for 1998 include costs of approximately \$262 related to progress in the merger implementation process including centralizing support functions and other merger initiatives at SWBell and PacBell. Offsetting these increased costs were reductions in 1998 primarily related to realization of merger initiative benefits that totaled approximately \$317. These reductions included lower use of contract labor, primarily at PacBell, lower costs associated with customer number portability and reduced research and development costs. Operations and support expense also increased in 1998 due to costs associated with reciprocal compensation for the termination of Internet traffic of approximately \$136 at the Telephone Companies (see "Federal Regulation" for further discussion about reciprocal compensation). Increased expenses in 1998 of approximately \$55 related to new business initiatives, primarily voice mail, Internet, long distance and cable. Additional costs in 1998 totaling approximately \$172 related to increased wages and salaries, benefits, materials and right to use fees.

Comparisons to 1997 are also impacted by the absence of the recognition of 1997 pension settlement gains relating to 1997 retirees after the merger with PAC totaling approximately \$136.

Increases in 1997 include costs for wages, salaries, benefits, sales commissions and contract labor totaling approximately \$327. Increases in 1997 also include costs associated with customer number portability after the merger with PAC, interconnection, other regulatory mandated network enhancements and materials of approximately \$414. Increased expenses in 1997 of approximately \$156 related to new business initiatives, primarily voice mail, Internet, long distance and cable. These increases were partially offset by a reduction related to the recognition of pension settlement gains discussed above.

Wireless Wireless expenses increased \$176, or 6.7%, in 1998 and \$616, or 30.9%, in 1997 due primarily to growth in the number of customers and increased equipment sales. The large increase in 1997 expenses includes approximately \$362 of expenses from the introduction of PCS operations. These increases were partially offset by decreased customer acquisition costs of 11% and 4% in 1998 and 1997.

Directory Directory expenses remained relatively unchanged in 1998 as lower costs resulting from the merger integration process, including decreased employee-related costs, were offset by expenses from increased demand and directory rescheduling discussed in directory operating revenue above. Directory

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

expenses increased in 1997 due mainly to increased demand and the publication of directories in 1997 that were not published in 1996 due to rescheduling.

Depreciation and Amortization expense is primarily in the Wireline and Wireless segments. In total, depreciation and amortization increased \$259, or 5.5%, in 1998 due primarily to increased depreciation expense of \$201 in the Wireline segment and \$41 in the Wireless segment resulting from overall higher plant levels. The increase in 1998 was partially offset by reduced depreciation at PacBell related to analog switching equipment of \$42. Total depreciation and amortization increased \$231, or 5.2%, in 1997. The increase was due to increased depreciation expense of \$193 in the Wireline segment and \$141 in the Wireless segment resulting from overall higher plant levels. The Wireless increase was due primarily to the launch of PCS operations. Reduced depreciation of \$107 at PacBell related to analog switching equipment partially offset the increase.

Interest Expense on a consolidated basis for 1998 decreased by \$50, or 4.8%, in 1998 and increased by \$142, or 15.8%, in 1997. Interest expense for 1998 includes \$3 of one-time charges for SNET merger-approval costs and 1997 includes \$27 associated with one-time charges, primarily interest on the PAC merger-approval costs. Excluding these charges, interest expense for 1998 decreased \$26, or 2.6%, and increased \$115, or 12.8%, for 1997. The 1998 decrease was due primarily to reductions in interest expense resulting from lower average debt levels and lower weighted average interest rates, partially offset by lower capitalization of interest during construction. The 1997 increase was due primarily to increased average debt levels.

Equity in Net Income of Affiliates increased \$35 in 1998 and decreased \$6 in 1997. The 1998 increase reflects increased equity in net income of \$78 from SBC's investment in Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company, SBC's May 1997 investment in Telkom and SBC's wireless operations. Also contributing to the increase were lower losses resulting from reduced involvement in Tele-TV. These increases were partially offset by a reduction of \$53 in contribution from investments in Switzerland, France and Israel, primarily resulting from expenditures on long distance and wireless in Switzerland and long distance in France and Israel.

The 1997 decrease reflects decreased equity in net income of \$49 from Telmex. This lower income resulted from the change in the functional currency used by SBC to record its interest in Telmex from the peso to the U.S. dollar beginning in 1997 and SBC's reduced ownership percentage after the sale of Telmex L shares. Results also reflect preoperating expenses of \$32 in several international investments, including long distance in France, Switzerland and Israel and cellular communications in Taiwan, and decreased contribution of \$13 from SBC's wireless operations. These decreases were mainly offset by equity in net income of \$58 from Telkom and \$27 in lower losses from Tele-TV.

SBC's earnings from foreign affiliates will continue to be generally sensitive to exchange rate changes in the value of the respective local currencies. SBC's foreign investments are recorded under U.S. generally accepted accounting principles,

which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries, such as inflation adjustments.

Other Income (Expense) – Net for 1998 and 1997 includes amounts that SBC management normalized for reviewing results. Normalizing amounts for 1998 include \$358 in gains on the sale of non-core businesses, primarily the required disposition of SBC's interest in MTN and the sale of SBC Media Ventures, Inc., pending from the prior year. Amounts for 1997 reflect gains of \$54 from the sale of SBC's interests in Bellcore and \$32 in second quarter charges related to SBC's strategic initiatives, primarily writeoffs of nonoperating plant. Absent these items, other income (expense) for 1998, 1997 and 1996 was \$(113), \$(100) and \$(75).

During 1998, several offsetting transactions impacted other income and expense contributing to the normalized increase of net other expense of \$13. SBC recognized other expense of \$237 related to an impairment of an international investment and investments in certain wireless technologies, primarily wireless video. Also increasing other expense were higher minority interest, lower interest income and call premiums and unamortized discounts on early retirement of debt at SWBell that totaled \$67 more than the previous year. Offsetting these decreases were other income related to a special dividend of \$158 received from a software affiliate and gains of \$127 recognized on the sales and the charitable contribution of SBC's available-for-sale investment in Telewest Communications plc (see Note 7 of Notes to Consolidated Financial Statements for further discussion of the gains). Movement in the market value of Telmex L shares requires a market valuation adjustment on certain SBC debt redeemable either in cash or Telmex L shares. Additionally, Telmex under their repurchase program from time to time repurchases enough shares in the market that SBC is required to sell part of its Telmex L share holdings to Telmex to remain under 10% ownership of Telmex. The net of these activities contributed \$90 more to other income than in 1997. Also affecting comparisons with 1997 was approximately \$64 in royalties and gains recognized in 1997.

During 1997, there were also several offsetting transactions contributing to the normalized increase in net other expense of \$25. Higher minority interest, including distributions paid on an additional \$500 of Trust Originated Preferred Securities (TOPRS) sold by PAC in June 1996, and lower interest income resulted in \$43 more net expense than in 1996. The net activity related to market movement on Telmex L shares increased other expense by \$47 more than in 1996. Partially offsetting these net other expenses were royalty payments associated with software development by an affiliate and other investment gains totaling \$64.

Income Taxes for 1998 include taxes related to the sale of certain non-core businesses discussed in other income (expense) – net and tax benefits associated with merger integration initiatives relating to SNET. Income taxes for 1997 reflect the tax effect of charges for strategic initiatives resulting from SBC's comprehensive review of operations and the impact of several regulatory rulings. Income taxes for 1997 also included taxes on the first quarter pension settlement gain discussed in operations and support. The net effective tax rate on these items was lower

is a result of non-deductible items included in the charge and valuation adjustments to certain deferred tax assets which may not be utilized due to restrictions associated with the merger. Excluding these items, income taxes for 1998 and 1997 would have been \$2,332 and \$1,951. Income taxes for 1998 were higher due primarily to higher income before income taxes. Income taxes for 1997, excluding the non-recurring items, were slightly lower than income taxes for 1996 of \$2,070.

Extraordinary Loss In 1998, SBC recorded an extraordinary loss of \$60 related to the refinancing of \$684 of long-term debt at PacBell.

Cumulative Effect of Accounting Change As discussed in Note 1 of Notes to Consolidated Financial Statements, SNET Information Services, Inc. and PB Directory changed their methods of recognizing directory publishing revenues and related expenses effective January 1, 1998 and January 1, 1996, respectively. The cumulative after-tax effect of applying the new method to prior years for SNET Information Services, Inc. was recognized as of January 1, 1998 as a one-time, non-cash gain applicable to continuing operations of \$15, or \$0.01 per share. The gain is net of deferred taxes of \$11. The one-time gain recognized as of January 1, 1996 for PB Directory was \$90, net of deferred taxes of \$53, or \$0.05 per share. Management believes the change to the issue basis method is preferable because it is the method generally followed in the publishing industry, including SWBYP, and better reflects the operating activity of the businesses. These accounting changes are not expected to have a significant effect on net income in future periods.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

Regulatory Environment

Overview

The telecommunications industry is in a period of dynamic transition from a tightly regulated industry overseen by multiple regulatory bodies to a market-driven industry monitored by state and federal agencies. The Telephone Companies' wireline telecommunications operations remain subject to regulation by the eight state regulatory commissions for intrastate services and by the FCC for interstate services.

Consolidation of companies is occurring within the marketplace for local telephone service and across other telecommunications services, such as long distance, cellular, cable television, Internet and other data transmission services. Companies operating in some of these markets are also expanding into others, such as the provision of local service by long distance companies. Additionally, new technologies are also affecting the way people view and use communications services.

The telecommunications industry is also changing internationally, as government-owned telephone monopolies are being privatized in many countries and competitive entrants are authorized. U.S.-controlled companies may acquire or form investment, joint venture or strategic relationships with these newly privatized companies or their new competitors involving any or all of the range of telecommunications services.

Foreign-controlled companies also may acquire or form such relationships with U.S. companies.

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

Wireline

Federal Regulation

Through affiliates, SBC offers landline interLATA long distance services to customers in selected areas outside the Telephone Companies' operating areas. Further, SBC offers interLATA long distance services to customers in Connecticut through SNET America, Inc. (SAI). Under the Telecommunications Act of 1996 (Telecom Act), before being permitted to offer landline interLATA long distance service in any state within the regulated operating areas of SWBell, PacBell and Nevada Bell, SBC must apply for and obtain state-specific approval from the FCC. The FCC's approval, which involves consultation with the United States Department of Justice and the appropriate state commission, requires favorable determinations that certain of the Telephone Companies have entered into interconnection agreement(s) that satisfy a 14-point "competitive checklist" with predominantly facilities-based carrier(s) that serve residential and business customers or, alternatively, that certain of the Telephone Companies have a statement of terms and conditions effective in that state under which they offer the "competitive checklist" items. The FCC must also make favorable public interest and structural separation determinations in connection with each application. See "State Regulation" for status of the state applications.

In December 1997, the United States District Court for the Northern District of Texas ruled that parts of the Telecom Act were unconstitutional on the grounds that they improperly discriminate against certain subsidiaries of SBC by imposing restrictions that prohibit certain of the Telephone Companies by name from offering interLATA long distance and other services that other Local Exchange Carriers (LECs) are free to provide. In September 1998, the United States Court of Appeals for the Fifth Circuit (5th Circuit) reversed this decision and ruled that the challenged provisions of the Telecom Act were constitutional. In January 1999, the United States Supreme Court (Supreme Court) declined to hear an appeal of the 5th Circuit's decision.

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

In July 1997, the United States Court of Appeals for the Eighth Circuit (8th Circuit) held that the FCC did not have the authority to promulgate rules related to the pricing of local intrastate telecommunications and that its rules in that regard were invalid.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

The 8th Circuit also overturned the FCC's rules which allowed competitors to "pick and choose" among the terms and conditions of approved interconnection agreements. In October 1997, the 8th Circuit issued a subsequent decision clarifying that the Telecom Act does not require the incumbent LECs to deliver network elements to competitors in anything other than completely unbundled form.

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

In January 1999, the Supreme Court ruled on an appeal of the 8th Circuit's order. The ruling held that the Telecom Act gives the FCC the authority to set guidelines for states to follow in setting prices under the Telecom Act, and reinstated the FCC rules allowing those seeking to interconnect to "pick and choose" specific provisions from previous interconnection agreements. Because the 8th Circuit's decision did not address the lawfulness of the content of the FCC pricing guidelines, the Supreme Court remanded that issue to the 8th Circuit for further consideration. The ruling also upheld FCC rules forbidding incumbent LECs from separating already combined network elements, but remanded back to the FCC its determination of which network elements must be made available. The Supreme Court also held that, before the FCC could require telecommunications carriers to make a particular network element available to requesting carriers, the FCC must first consider as to proprietary elements, whether access to the elements was necessary and whether the failure to provide access to a particular element would impair the requesting carrier's ability to provide the service it seeks to offer. The effect of this ruling on the telecommunications industry cannot be determined at this time.

Reciprocal Compensation Reciprocal compensation is billed to SBC's subsidiaries by Competitive Local Exchange Carriers (CLECs) for the termination of certain local exchange traffic to CLEC customers. SBC believes that under the Telecom

Act the state commissions have authority to order reciprocal compensation for intrastate or local traffic, while only the FCC has authority over interstate and interexchange traffic. SBC believes most Internet traffic is interexchange and interstate. Several state commissions, including the CPUC in an October 1998 order, have taken the position that Internet communications is intrastate or local traffic and ordered SBC to pay reciprocal compensation to certain CLECs pursuant to then existing contracts. State commissions in the five-state area other than Kansas have also issued orders finding that SBC is required to pay reciprocal compensation to certain CLECs. In June 1998, a U.S. District Court in Texas affirmed the Texas Public Utility Commission's (TPUC) determination and upheld payment of reciprocal compensation, holding that an Internet call is comprised of two portions, and that the TPUC has jurisdiction over the local portion of the traffic and the FCC over the Internet component. Similar decisions regarding Internet traffic have been made by other state commissions. SBC has sought review or reconsideration of these cases.

The question whether Internet communications should be classified as local/intrastate or interstate traffic for reciprocal compensation purposes is the subject of a pending FCC proceeding and the FCC is expected to rule on this issue in the near future. SBC's subsidiaries have been recording amounts sought by certain CLECs for the termination of Internet traffic to Internet Service Providers.

Asymmetrical Digital Subscriber Line (ADSL) is a high-speed data service principally used for Internet access. In June 1998, SBC filed with the FCC a petition requesting relief for ADSL from pricing, unbundling and resale regulatory restrictions. The FCC denied the petition and declared that incumbents, such as the Telephone Companies, must offer such services for resale at a discount and must offer unbundled access to the equipment used in ADSL provisioning to the extent possible. SBC has filed with the FCC a petition for reconsideration of this order. The FCC sought comments on offering the incumbent LECs the option of providing deregulated advanced services through an affiliate with appropriate safeguards.

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

State Regulation

The following provides an overview of state regulation in the eight states in which the Telephone Companies operated at December 31, 1998.

State	Alternative Regulation ¹	Dialing Parity ²	Number of Signed Wireline Interconnection Agreements ³	Long Distance Application Status
Arkansas	Yes, indefinite	Presently not required prior to long distance authorization	54	Decision expected in 1999 ⁴
California	Yes, ends 1/2002	Proceeding pending	66	Decision expected in 1999 ⁴
Connecticut	Yes, ends 2/2001	Dialing parity exists	13	Long distance service provided by the retail entity ⁵
Kansas	Yes, indefinite	Commission ordered implementation by 2/1999; state statute presently prohibits requirement before long distance authorization	55	Decision expected in 1999 ⁴
Missouri	Yes, indefinite	Proceeding pending	61	Decision expected in 1999 ⁴
Nevada	Yes, ends 12/2002	Presently not required prior to long distance approval; proceeding pending	19	No activity
Oklahoma	Yes, ends 2/2001	Ordered by 3/1999	52	Decision expected in 1999 ⁴
Texas	Yes, ends 9/2001	TPUC deferred its decision pending FCC issuance of new dialing parity rules; state statute presently prohibits requirement before long distance authorization	175	Decision expected in 1999 ⁴

Other significant notes:

¹Alternative regulation is other than rate of return regulation.

²In a January 1999 decision, the Supreme Court ruled that the FCC had the authority to issue rules implementing intrastate and intraLATA dialing parity. Several interexchange carriers are arguing in pending state proceedings that the ruling requires immediate implementation of dialing parity, preempting state requirements. The Telephone Companies take the position that dialing parity requirements should be consistent with state laws and that they should not be required to provide intraLATA toll dialing parity prior to receiving authorization to provide interLATA long distance services. In states where dialing parity exists, customers are able to subscribe to an intraLATA toll carrier just as they do for long distance services.

³Interconnection agreements are signed with CLECs for the purpose of allowing the CLECs to exchange local calls with the incumbent telephone company.

⁴Awaiting determination by state commissions on the Telephone Companies' compliance with the 14-point competitive checklist. FCC approval is required subsequent to state determination.

⁵NETel is restricted from providing interLATA long distance service in any of the other Telephone Companies' operating regions.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

The following presents highlights of certain regulatory developments.

California In October 1998, the CPUC issued a decision modifying the current regulatory framework for PacBell effective January 1, 1999. The decision adopted PacBell's proposal that the current cap on basic residential rates be continued for three more years, through 2001, with the CPUC retaining the ability to adjust basic telephone rates. The decision suspended earnings sharing, rate of return reviews and the use of earnings caps and floors through 2001. In addition, the decision adopted PacBell's proposal to eliminate depreciation reviews and granted PacBell the freedom to set its own depreciation rates and methodology. It also continued the suspension of the productivity factor adjustment. In addition, the CPUC decision eliminated most future exogenous cost adjustments, including the recovery of future costs related to a 1993 accounting change for postretirement benefits other than pensions. Management currently estimates the items embodied within the new regulatory framework will have the net effect of reducing annual revenue by approximately \$100 from 1999 through 2004.

In July 1998, the CPUC issued a rate rebalancing decision related to its 1996 order on universal service. The CPUC's decision was implemented prospectively beginning September 1, 1998 and reduces PacBell's non-basic local service, network access and long distance service revenues by \$305 annually to offset the approximately \$305 annually that PacBell expects to receive from the CHCFB. Beginning in February 1997, PacBell, and all other California telecommunications carriers, began collecting funds via customer surcharges consistent with the CPUC's 1996 decision. The CPUC has yet to decide on the specific mechanism to be employed to ensure the distribution of funds collected by PacBell and other carriers from February 1997 through August 1998 is revenue neutral.

Connecticut In January 1997, SNET submitted to the Connecticut Department of Public Utility Control (DPUC) its proposal on corporate restructure. The proposal recommended that SNETel functions be split: ownership and maintenance of switching and transmission network facilities, i.e., all wholesale functions, would remain in the telephone company, SNETel, and all retail functions would go to SAI, which was the long distance subsidiary. Both would be wholly-owned by SNET. In June 1997, the DPUC granted SNET permission to restructure its telephony operations, with several DPUC-imposed modifications.

Under the plan, all retail operations (retail marketing and customer service) have been transferred to SAI, and SAI will be treated by the regulators like all other CLECs. SNET local service customers will choose their provider via a balloting process, which has been scheduled for September 1999. All wholesale services and the network infrastructure will remain with SNETel, which will be restricted to meeting the needs of CLECs, including SAI and other wholesale customers. SAI can buy its wholesale service from SNETel or any other wholesale provider. SAI has been providing interstate and international long distance service since

1993, and received certification to provide local service and intrastate toll in Connecticut in 1997.

Missouri Effective September 26, 1997, the Missouri Public Service Commission (MPSC) determined that SWBell is subject to price cap regulation. Prices in effect as of December 31, 1996 are the initial maximum allowable rates for services and cannot be adjusted until January 1, 2000 for basic and access services and on January 1, 1999 for non-basic services. On an exchange basis where a competitor began operations, the freeze on maximum allowable rates for non-basic services was removed. After January 1, 2000, caps for basic and access services may be adjusted based on one of two government indices. After January 1, 1999, caps for non-basic services may be increased up to 8% per year. In an exchange where competition for basic local service exists for five years, services will be declared competitive and subject to market pricing unless the MPSC finds effective competition does not exist. The Office of Public Counsel and MCI WorldCom, Inc. (MCI WorldCom) sought judicial review of the MPSC determination and in May 1998 the state circuit court affirmed the MPSC decision.

Texas Under the Public Utility Regulatory Act, which became effective in May 1995 (PURA), SWBell elected to move from rate of return regulation to price regulation with elimination of earnings sharing. Basic local service rates are capped at existing levels for four years following the election, i.e., until September 1999. The TPUC is prohibited from reducing switched access rates charged by LECs to interexchange carriers while rates are capped.

LECs electing price regulation are committed to network and infrastructure improvement goals, including expansion of digital switching and advanced high-speed services to qualifying public institutions, such as schools, libraries and hospitals, requesting the services. PURA also established an infrastructure grant fund for use by public institutions in upgrading their communications and computer technology. The 1997 Texas legislative session changed the funding for this infrastructure grant fund from annually collecting \$150 for ten years to a fixed percentage (1.25%) applied to all telecommunications providers' sales taxable revenues. The law also provides a cap of \$1,500 for the life of the fund. SWBell's annual payments were approximately \$36 in 1997 and \$56 in 1998. Due to the industry's growth in revenues, the fund should be completely funded before the original ten years.

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

voided portions of PURA that required certain buildout requirements. Furthermore, the FCC also preempted rules that excluded competitors from entering markets with fewer than 31,000 access lines and which made resale of Centrex phone services subject to a limited property restriction. AT&T and MCI WorldCom have dismissed their suits regarding this matter. In October 1997, SWBell filed with the FCC a petition for reconsideration regarding the preemption of the property restriction for Centrex services. This issue is still pending before the FCC.

Competition

Wireline

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

Recent state legislative and regulatory developments allow increased competition for local exchange services. Companies wishing to provide competitive local service have filed numerous applications with each of the state commissions throughout the Telephone Companies' regulated operating areas, and the commissions of each state have been approving these applications since late 1995. Under the Telecom Act, companies seeking to interconnect to the Telephone Companies' networks and exchange local calls must enter into interconnection agreements with the Telephone Companies. These agreements are then subject to approval by the appropriate state commission. SBC has reached approximately 495 interconnection and resale agreements with competitive local service providers, and most have been approved by the relevant state commission. AT&T, MCI WorldCom and other competitors are reselling SBC local exchange services, and as of December 31, 1998, there were approximately 800,000 SBC access lines supporting services of resale competitors throughout the Telephone Companies' regulated operating areas, most of them in Texas and California. Many competitors have placed facilities in service and have begun advertising campaigns and offering services. SBC also was granted facilities-based and resale operating authority in certain territories served by other LECs and now offers local exchange service offerings to these areas.

In California, the CPUC authorized facilities-based local services competition effective January 1996 and resale competition effective March 1996. While the CPUC has established local competition rules and interim prices, several issues still remain to be resolved, including final rates for resale and LEC provisioning and pricing of certain network elements to competitors. PacBell has incurred substantial costs implementing local competition and number portability. In November 1998, the CPUC issued a decision allowing PacBell to begin recovery of local competition implementation costs.

In Texas, the TPUC set rates in December 1997 that SWBell may charge for access and interconnection to its telephone

network. The TPUC decision sets pricing for dozens of network components and completes a consolidated arbitration between SWBell and six of its wholesale customers, including AT&T and MCI WorldCom.

In Missouri, the MPSC issued orders on a consolidated arbitration hearing with AT&T and MCI WorldCom and on selected items with Metropolitan Fiber Systems. Among other terms, the orders established discount rates for resale of SWBell services and prices for unbundled network elements. SWBell appealed the interconnection agreement resulting from the first arbitration proceeding on November 5, 1997; a decision is still pending. A second arbitration process to address other interconnection issues with AT&T has concluded, and the MPSC ordered that a conforming interconnection agreement be filed. SWBell appealed this order in April 1998.

The Telephone Companies expect increased competitive pressure in 1999 and beyond from multiple providers in various markets, including facilities-based CLECs, interexchange carriers and resellers. At this time, management is unable to assess the effect of competition on the industry as a whole, or financially on SBC, but expects both losses of market share in local service and gains resulting from new business initiatives, vertical services and new service areas. Competition also continues to intensify in the Telephone Companies' intraLATA long distance markets. For example, it is estimated that providers other than PacBell now serve more than half of the business intraLATA long distance customers in PacBell's service areas. In addition, if intraLATA toll dialing parity is required, competition in intraLATA long distance markets is expected to increase.

In the international arena, Telmex was granted a concession in 1990, which expired in August 1996, as the sole provider of long distance services in Mexico. Several large competitors have received licenses to compete with Telmex and have begun operations. As of December 31, 1998, Telmex has retained approximately 75% of its long distance customers. Telmex's share of international long distance traffic is expected to decline significantly when the proportional return mechanism, which guarantees Telmex the same percentage of incoming traffic as outgoing traffic, expires at the end of 1999. Aggressive local competition is expected in 1999, primarily in the business segment.

Wireless

In 1993, the FCC adopted an order allocating radio spectrum and licenses for PCS. PCS utilizes wireless telecommunications digital technology at a higher frequency radio spectrum than cellular. Like cellular, it is designed to permit access to a variety of communications services regardless of subscriber location. In an FCC auction, which concluded in March 1995, PCS licenses were awarded in 51 major markets. SBC or affiliates acquired PCS licenses in the Major Trading Areas of Los Angeles-San Diego, California; San Francisco-Oakland-San Jose, California; Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma. The California licenses cover substantially all of California and Nevada. SBC is currently operational in all of its major California-Nevada markets and Tulsa, Oklahoma. During 1996, SBC received several

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis, Tennessee, and Little Rock, Arkansas, and other consideration.

PCS service was formally launched in all the major California and Nevada markets at different times throughout 1997, with the buildout to other areas continuing. The network incorporates the Global System for Mobile Communications standard, which is widely used in Europe. PBMS is selling PCS as an off-the-shelf product in retail stores, through exclusive agents and in company-owned stores across California and Nevada. Significant competition exists, particularly from the two established cellular companies in each market.

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

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

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

Under the Telecom Act of 1996, SBC may offer interLATA long distance over its wireless network both inside and outside the regulated operating areas. SBC has entered the wireless long distance markets, and offers wireless long distance service in all of its wireless service areas.

Directory

SWBYP, PB Directory and SNET Information Services, Inc. face competition from over 100 publishers of printed directories in their operating areas. Direct and indirect competition also exists from other advertising media, including newspapers, radio, television and direct mail providers, as well as from directories offered over the Internet.

OTHER BUSINESS MATTERS

New Accounting Standards In June 1998, the Financial Accounting Standards Board issued Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133), which will require all derivatives to be recorded on the balance sheet at fair value, and will require changes in the fair value of the derivatives to be recorded in net income or comprehensive income. FAS 133 must be adopted for years beginning after June 15, 1999, with earlier adoption permitted. Management is currently evaluating the impact of the change in accounting required by FAS 133, but is not able to quantify the effect at this time.

See Note 1 of Notes to Consolidated Financial Statements for a discussion of the new accounting standard on software costs.

Wireless Acquisition See Note 17 of Notes to Consolidated Financial Statements for a discussion of the acquisition of Comcast Cellular Corporation.

Long Distance Agreement On February 8, 1999, SBC announced an agreement with Williams Communications (Williams), a subsidiary of Williams Cos., Inc., under which Williams will serve as SBC's long distance provider. As part of this agreement, SBC plans to acquire 10% of the common stock of Williams. This investment will occur simultaneously with an initial public offering of common stock by Williams, scheduled for the second quarter of 1999.

Merger See Note 3 of Notes to Consolidated Financial Statements for a discussion of the merger agreement with Ameritech Corporation.

SBC's Year 2000 Project SBC operates numerous date-sensitive computer applications and systems throughout its businesses. Since 1996, SBC has been working to upgrade its networks and computer systems to properly recognize the Year 2000 and continue to process critical operational and financial information. Companywide teams are in place to address and resolve Year 2000 issues and processes are under way to evaluate and manage the risks and costs associated with preparing SBC's date-impacted systems and networks for the new millennium.

SBC is using a four-step methodology to address the issue. The methodology consists of inventory and assessment, hardware and software fixes, testing and deployment. SBC measures its progress by tracking the number of completed hardware and software applications, network components, personal computers and building facilities that can correctly process Year 2000 dates.

Inventory and assessment is estimated to require 20% of the overall effort and includes the identification of items (i.e., line-by-line review of software code, switch generics, vendor products, etc.) that could be impacted by the Year 2000 and the determination of the work effort required to ensure compliance. The inventory and assessment phase has been completed. This process involved reviewing over 340 million lines of software code, 1,200 central office switches, 7,000 company buildings, conducting an inventory and assessment of 117,000 personal computers, and coordinating with 1,300 suppliers of 14,000 products to obtain adequate assurance they will be Year 2000 compliant or determine and address any appropriate contingency plans or backup systems.

Making the hardware and software fixes is the second phase of the process and is estimated to require 25% of the overall effort. This activity involves modifying program code, upgrading computer software and upgrading or replacing hardware. As of December 31, 1998, the hardware and software fixes were substantially complete.

Testing involves ensuring that hardware and software fixes will work properly in 1999 and beyond and occurs both before and after deployment. Testing is estimated to comprise 45% of the overall effort. Testing began early in 1998, is more than two-thirds complete, and will continue through 1999 to allow for thorough testing before the Year 2000. Contingency plans and backup systems are currently being written.

Deployment involves placing the "fixed" systems into a live environment to ensure they are working properly. Additional testing is done after deployment as well. Deployment is estimated to require 10% of the overall effort. More than half of the deployment phase was completed as of December 31, 1998.

SBC expects to spend approximately \$265 on the entire project, with approximately \$140 spent through December 31, 1998. As testing and hardware and software fixes are estimated to require most of the expenditures, there is not a strict correlation between expenditures and project completion.

The activities involved in SBC's Year 2000 project necessarily require estimates and projections, as described above, of activities and resources that will be required in the future. These estimates and projections could change as work progresses on the project.

LIQUIDITY AND CAPITAL RESOURCES

SBC had \$460 of cash and cash equivalents available at December 31, 1998. Commercial paper borrowings as of December 31, 1998 totaled \$1,044. SBC has entered into agreements with several banks for lines of credit totaling \$1,460, all of which may be used to support commercial paper borrowings (see Note 10 of Notes to Consolidated Financial Statements). SBC had no borrowings outstanding under these lines of credit as of December 31, 1998.

Cash from Operating Activities

During 1998, as in 1997 and 1996, SBC's primary source of funds continued to be cash generated from operations, as shown in the Consolidated Statements of Cash Flows. Net cash provided by operating activities exceeded SBC's construction and capital expenditures during 1998, as in 1997 and 1996; this excess is referred to as free cash flow, a supplemental measure of liquidity. SBC generated free cash flow of \$2,454, \$1,366 and \$2,046 in 1998, 1997 and 1996.

Cash from Investing Activities

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

SBC's capital expenditures totaled \$5,927, \$6,230 and \$5,855 for 1998, 1997 and 1996. Capital expenditures in the Wireline segment were relatively unchanged in 1998 compared to 1997. The Wireline segment's capital expenditures increased 12% in 1997 due primarily to demand-related growth, network upgrades, customer-contracted requirements, ISDN projects and SWBell's regulatory commitments. The Wireless segment's capital expenditures decreased 17% and 23% in 1998 and 1997 due primarily to expenditures for initial buildout of the PCS network and conversion of SBC's largest cellular markets to digital during 1997 and 1996.

In 1999, management expects total capital spending to be between \$6,400 and \$6,800. Capital expenditures in 1999 will

relate primarily to the continued evolution of the Telephone Companies' networks, including amounts agreed to under regulation plans at SWBell, and continued buildout of Mobile Systems' markets and PBMS. SBC expects to fund ongoing capital expenditures with cash provided by operations.

SWBell has substantially completed the additional network and infrastructure improvements to be made over periods ranging through 2001 to satisfy regulatory commitments.

Cash from Financing Activities

Dividends declared by the Board of Directors of SBC were \$0.935 per share in 1998, \$0.895 per share in 1997, and \$0.86 per share in 1996. These per share amounts do not include dividends declared and paid by PAC and SNET prior to their respective mergers. The total dividends paid by SBC, PAC and SNET were \$1,836 in 1998, \$1,755 in 1997 and \$1,795 in 1996. Pursuant to the terms of the merger agreement, PAC reduced its dividend beginning in the second quarter of 1996. The lower second and third quarter dividends paid in 1996 improved 1996 cash flow by approximately \$195. SBC's dividend policy considers both the expectations and requirements of shareowners, internal requirements of SBC and long-term growth opportunities.

In February 1998, SBC called \$630 of long-term debt for retirement, including \$175 at PacBell and \$425 at SWBell, and issued approximately \$200 in debentures at PacBell due February 2008 and approximately \$200 in debentures at SWBell due March 2048. In September 1998, SBC called \$175 of long-term debt for retirement, all at SWBell. In October 1998, PacBell repurchased \$684 of debentures.

Total debt increased during 1997 due primarily to the issuance of medium-term notes and debentures at the Telephone Companies and debt redeemable either in cash or Telmex L shares.

During 1996 PAC issued \$1,000 of TOPRs, \$500 at 7.56% in January 1996 and \$500 at 8.5% in June 1996 (see Note 11 of Notes to Consolidated Financial Statements). The proceeds were used to retire outstanding short-term debt, primarily commercial paper that had increased significantly during 1995.

SBC's total capital consists of debt (long-term debt and debt maturing within one year), TOPRs and shareowners' equity. Total capital increased \$108 in 1998 and \$1,056 in 1997. The increase in 1998 was due to 1998 earnings, partially offset by lower debt levels. The increase in 1997 was primarily due to higher debt levels and 1997 earnings.

SBC's debt ratio was 48.9%, 57.1% and 56.8% at December 31, 1998, 1997 and 1996. The debt ratio is affected by the same factors that affect total capital.

MARKET RISK

SBC's capital costs are directly linked to financial and business risks. SBC seeks to manage the potential negative effects from market volatility and market risk. Certain financial instruments used to obtain capital are subject to market risks from fluctuations in market interest rates. The majority of SBC's financial instruments are medium- and long-term fixed rate notes and debentures. Fluctuations in market interest rates can lead to

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

significant fluctuations in the fair value of these notes and debentures. It is the policy of SBC to manage its debt structure and foreign exchange exposure in order to manage capital costs, control financial risks and maintain financial flexibility over the long term. Where appropriate, SBC will take actions to limit the negative effect of interest and foreign exchange rates, liquidity and counterparty risks on shareowner value.

Quantitative Information about Market Risk

Foreign Exchange Risk Sensitivity Analysis

	U.S. Dollar Value of Net Foreign Exchange Contracts	Net Underlying Foreign Currency Transaction Exposures
December 31, 1998		
Swiss Franc	\$ 24	\$ 24
Japanese Yen	142	142
French Franc	37	37
Chilean Peso	32	32
Total Exposure	\$235	\$235

Note: There is no net exposed long/short currency position and no foreign exchange loss from a 10% depreciation of the U.S. dollar.

The preceding table describes the effects of a change in the value of the Swiss franc, Japanese yen, Chilean peso and French franc given a hypothetical 10% depreciation of the U.S. dollar. Since the identified exposure is fully covered with forward contracts, changes in the value of the U.S. dollar which affect the value of the underlying foreign currency commitment are fully offset by changes in the value of the foreign currency contract. If the underlying currency transaction exposure changed, the resulting mismatch would expose the company to currency risk of the foreign exchange contract. For this reason, all contracts are related to firm commitments and matched by maturity and currency.

Equity Price Risk Sensitivity Analysis

SBC is exposed to equity price risk related to the change in the price of AirTouch Communications, Inc. (AirTouch) common stock related to the settlement of employee stock options. At December 31, 1998, the net appreciated value of the equity swap contract entered in 1994 was \$26, while the value of the underlying employee stock option exposures for AirTouch common stock was \$25, leaving a net exposed long equity position of \$1. If the value of AirTouch common stock increased by 26%, the net exposed long equity position would increase by \$1 to \$2. Since January 1, 1995, the average yearly share price of AirTouch common stock has increased 26%. The equity swap contract expires April 1999 and the last option grant expires January 2003. (See Note 11 of Notes to Consolidated Financial Statements.) In February 1999, management evaluated the exposure to future appreciation of AirTouch common stock and the benefit to "unwinding" the swap. As a result, SBC began exiting the equity swap contract, receiving cash for the appreciated value of the contract and recognizing a minimal gain. Once exited, SBC will record in other income (expense) - net future changes in the value of the underlying employee stock option exposure. If the value of AirTouch common stock were to increase by an

additional 26% from mid-February 1999, SBC would record additional expense of approximately \$8.

Interest Rate Sensitivity

The principal amount by expected maturity, average interest rate and fair value of SBC's liabilities that are exposed to interest rate risk are described in Notes 10 and 11 of Notes to Consolidated Financial Statements. Following are SBC's interest rate derivatives subject to interest rate risk (none of these derivatives mature in 2000 through 2003):

	Maturity		Fair Value	
	1999	After 2003	Total	12/31/98
Interest Rate Derivatives				
Interest Rate Swaps				
Receive Variable/Pay Fixed				
Notional Amount ¹	\$50	—	\$50	\$(1)
Fixed Rate Payable	7.2%	—		
Weighted Average Variable				
Rate Receivable ²	5.1%	—		
Receive Variable/Pay Fixed				
Notional Amount ³	—	\$13	\$13	\$(1)
Fixed Rate Payable	6.7%	6.7%		
Weighted Average Variable				
Rate Receivable ⁴	5.0%	5.5%		

¹Receive Variable/Pay Fixed amount is offset equally by \$50 in Variable Rate Debt maturing in 1999 with an average interest rate of 4.5% and a fair value of \$50.

²Weighted Average Variable Rate Receivable based on current and the implied forward rate in the yield curve at the reporting date for Constant Maturity Treasury minus 20 basis point

³Receive Variable/Pay Fixed amount offsets \$13 in lease obligation due after 2003 with an average interest rate of 5.8% and a fair value of \$13.

⁴Weighted Average Variable Rate Receivable based on current and the implied forward rate in the yield curve at the reporting date for One Month LIBOR.

As a result of interest rate fluctuations, if SBC were to terminate the contracts, it would be required to pay \$2 to replace the fixed rate flows or "unwind" the interest swaps. SBC does not intend to terminate the \$50 contract as it is linked to the variable rate debt issued by SBC that also matures in 1999.

There has been no material change in the updated market risks since December 31, 1997.

Qualitative Information about Market Risk

Foreign Exchange Risk

From time to time SBC makes investments in operations in foreign countries, is paid dividends, receives proceeds from sales or borrows funds in foreign currency. Before making an investment, or in anticipation of a foreign currency receipt, SBC will often enter into forward foreign exchange contracts. The contracts are used to provide currency at a fixed rate. SBC's policy is to measure the risk of adverse currency fluctuations by calculating the potential dollar losses resulting from changes in exchange rates that have a reasonable probability of occurring. SBC covers the exposure that results from changes that exceed acceptable amounts. SBC does not speculate in foreign exchange markets.

SBC ADVANCED SOLUTIONS, INC.

**DIRECTORS
AND OFFICERS**

A. Dale "Zeke" Robertson
Chairman

Albert F. Porta
Director

J. Michael Turner
Director

John H. Atterbury
President

Rebecca De La Cruz
VP-Customer Service

Royce King
VP-Operations

Bradley Lee
VP-Finance

Joseph E. Cosgrove, Jr
VP, General Counsel
and Secretary

John J. Stephens
VP-Taxes

Michael Wagner
Treasurer

BUSINESS ADDRESS

530 McCullough
Room 1449
San Antonio, Texas 78215

530 McCullough
Room 11-A-10
San Antonio, Texas 78215
530 McCullough
Room 1415
San Antonio, Texas 78215

530 McCullough
Room 1460
San Antonio, Texas 78215

1010 N. St. Mary's
Room 11-R-1
San Antonio, Texas 78215

9505 Arboretum Blvd.
Room 900
Austin, Texas 78759

175 E. Houston
Room 8-B-80
San Antonio, Texas 78205

175 E. Houston
Room 7-U-30
San Antonio, Texas 78205

175 E. Houston
Room 8-H-60
San Antonio, Texas 78205

175 E. Houston
Room 7-U-30
San Antonio, Texas 78205

State of Delaware
Office of the Secretary of State

PAGE 1

I, EDWARD J. FREEL, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY "SBC ADVANCED SOLUTIONS, INC." IS DULY INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE AND IS IN GOOD STANDING AND HAS A LEGAL CORPORATE EXISTENCE SO FAR AS THE RECORDS OF THIS OFFICE SHOW, AS OF THE SIXTH DAY OF AUGUST, A.D. 1999.

AND I DO HEREBY FURTHER CERTIFY THAT THE FRANCHISE TAXES HAVE NOT BEEN ASSESSED TO DATE.



A handwritten signature in cursive script, reading "Edward J. Freel".

Edward J. Freel, Secretary of State

3074726 8300

991327714

AUTHENTICATION: 9909033

DATE: 08-06-99

ATTACHMENT 2

ARTICLES OF INCORPORATION

State of Delaware
Office of the Secretary of State

PAGE 1

I, EDWARD J. FREEL, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY THE ATTACHED IS A TRUE AND CORRECT COPY OF THE CERTIFICATE OF INCORPORATION OF "SBS ADVANCED SOLUTIONS, INC.", FILED IN THIS OFFICE ON THE TWENTY-SEVENTH DAY OF JULY, A.D. 1999, AT 10 O'CLOCK A.M.

A FILED COPY OF THIS CERTIFICATE HAS BEEN FORWARDED TO THE NEW CASTLE COUNTY RECORDER OF DEEDS.



A handwritten signature in cursive script, reading "Edward J. Freel", is written over a horizontal line.

Edward J. Freel, Secretary of State

3074726 8100

991307980

AUTHENTICATION:

9887540

DATE:

07-27-99

**CERTIFICATE OF INCORPORATION
OF
SBC ADVANCED SOLUTIONS, INC.**

ARTICLE ONE

The name of the corporation is SBC Advanced Solutions, Inc.

ARTICLE TWO

The address of the registered office of the Corporation in the State of Delaware is Corporation Trust Center, 1209 Orange Street, Wilmington, New Castle County, Delaware 19801. The name of the registered agent of the Corporation at such address is The Corporation Trust Company.

ARTICLE THREE

The purpose of the Corporation is to engage in any lawful act or activity for which Corporations may be organized under the General Corporation Law of the State of Delaware.

ARTICLE FOUR

The total number of shares of stock which the Corporation is authorized to issue is one thousand (1,000) shares of common stock, having a par value of one dollar (\$1.00) per share.

ARTICLE FIVE

The business and affairs of the Corporation shall be managed by the Board of Directors. The directors need not be elected by ballot unless required by the Bylaws of the Corporation.

No director of this Corporation shall be liable to this Corporation or its stockholders for monetary damages, for breach of fiduciary duty as a director, except for liability 1) for any breach of the director's duty of loyalty to the Corporation or its stockholders; 2) for acts or omissions not in good faith of which involve intentional misconduct or knowing violation of the law; or 3) for any transaction from which a director derived an improper benefit.

ARTICLE SIX

In furtherance and not in limitation of the powers conferred by the laws of the State of Delaware, the Board of Directors is expressly authorized to adopt, amend or repeal the Bylaws.

ARTICLE SEVEN

The initial Board of Directors of the Corporation shall be constituted of the following individuals having the respective business office addresses stated herein:

A. Dale "Zeke" Robertson	530 McCullough, San Antonio, Texas 78215
J. Michael Turner	530 McCullough, San Antonio, Texas 78215
Albert F. Porta	530 McCullough, San Antonio, Texas 78215

ARTICLE EIGHT

The Corporation reserves the right to amend and repeal any provision contained in this Certificate of Incorporation in the manner prescribed by the laws of the State of Delaware. All rights herein conferred are granted subject to this reservation.

ARTICLE NINE

The incorporator is Robert A. Shives, Jr., whose mailing address is 175 East Houston Street, San Antonio, Texas 78205.

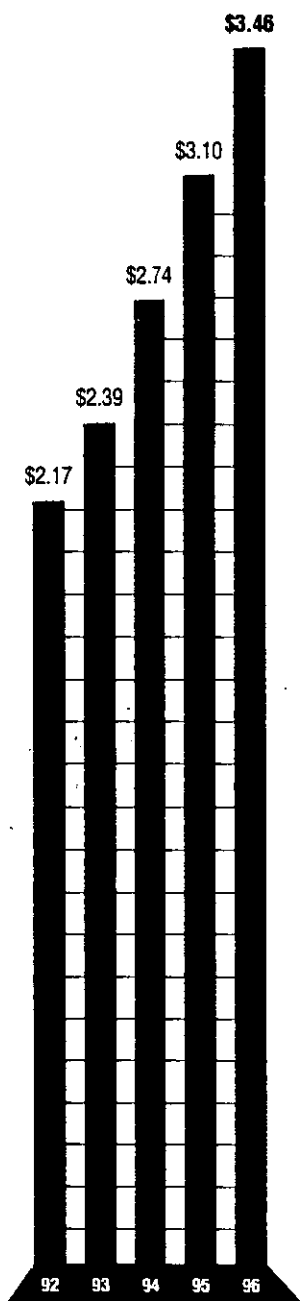
I, the undersigned, being the incorporator, for the purpose of forming a corporation under the laws of the State of Delaware do make, file and record this Certificate of Incorporation, do certify that the facts herein stated are true, and, accordingly, have hereto set my hand this 26th day of July, 1999.



Robert A. Shives, Jr.

ATTACHMENT 3

SBC ANNUAL REPORTS & 10Ks



Earnings per share, 1992-1996
(before extraordinary items)

Nineteen ninety-six was SBC's fifth consecutive year of double-digit earnings growth, the best record among the major telecommunications companies, including the regional Bells.

SBC Communications Inc. 1996 Annual Report

SBC is one of the world's leading diversified telecommunications companies, with growing wireless, telephone and directory businesses in the United States and abroad.

Within its traditional five-state region—Texas, Missouri, Oklahoma, Kansas and Arkansas—SBC provides innovative products and services under the Southwestern Bell brand name.

SBC's national businesses include wireless and wireline local

and long distance services sold under the Cellular One brand name in the Chicago, Boston, Baltimore and Washington, D.C. metropolitan areas and a broad market area spanning upper New York State. SBC also offers video services in the Washington, D.C. metropolitan area.

Internationally, SBC owns interests in local, long distance, wireless, video and directory services in France, the United Kingdom, Israel, Chile, Mexico, South Korea, South Africa and Australia.

financial highlights

Per Share of Common Stock

	1996	1995	Change
Income	\$ 3.46	\$ 3.10*	11.6%
Dividends	\$ 1.72	\$ 1.65	4.2%
Year-end stock price	\$ 51.88	\$ 57.25	(9.4%)

Financial Information (dollars in millions)

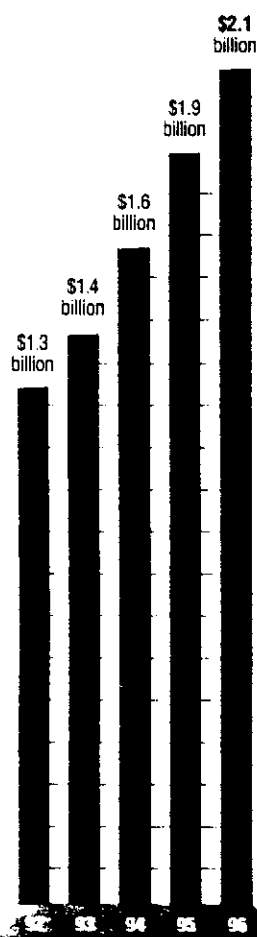
	1996	1995	Change
Total operating revenues	\$ 13,898	\$ 12,670	9.7%
Total operating expenses	\$ 10,342	\$ 9,633	7.4%
Income	\$ 2,101	\$ 1,889*	11.2%

*Before extraordinary loss

SBC's goal is to deliver superior return to shareowners

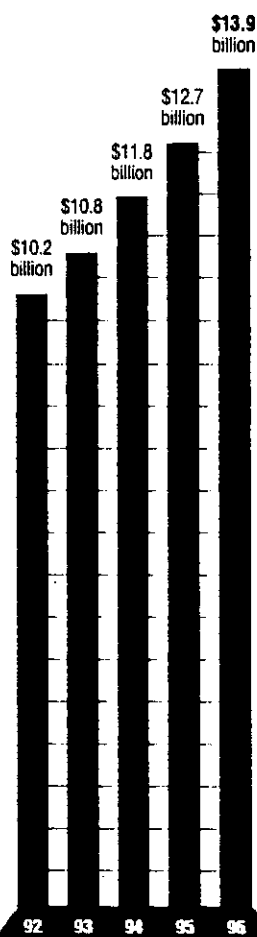
through solid growth in revenues, cash flow and earnings.

Over the past five years we have led the regional Bell companies in earnings and revenue *growth*.



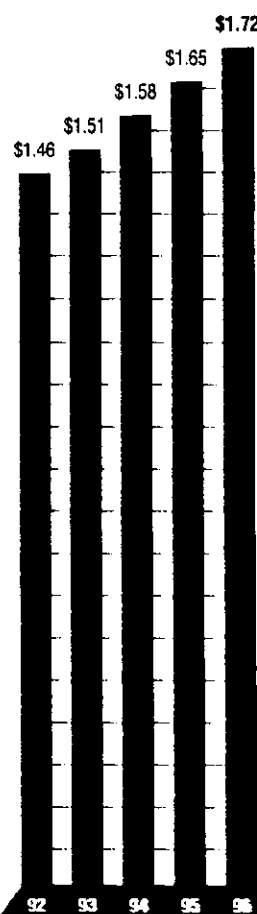
Strong Earnings Growth

SBC's Earnings Growth has increased 60% from 1992 to 1996 (based on earnings per share).



Best Revenue Growth

Expanding demand and effective marketing have produced SBC's outstanding revenue growth.



Continuing Dividend Growth

Strong earnings momentum allows SBC both to increase dividends and aggressively pursue growth opportunities.

Dear Fellow Investor:

SBC had a great year in 1996, achieving our fifth consecutive year of double-digit earnings growth. That's the best record among the major telecommunications companies. We continue to seek and take advantage of the tremendous growth opportunities in our industry.



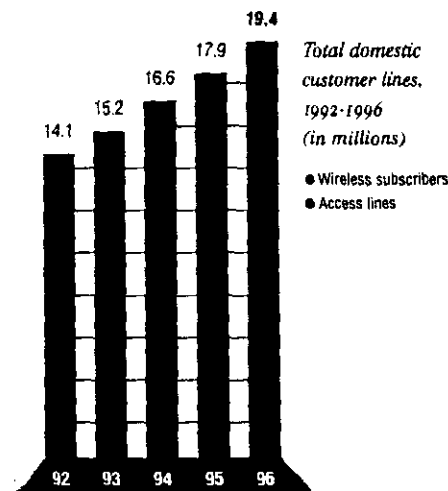
Edward E. Whitacre Jr.
Chairman of the Board and
Chief Executive Officer

One of those opportunities is our agreement to merge with Pacific Telesis Group. This merger agreement, the first under the new telecommunications law, reflects our fundamental growth strategy of identifying and seizing opportunities to enter attractive markets and provide a broad range of telecommunications services to excellent customer bases.

Combining SBC and Pacific Telesis is a positive move for customers, communities and shareowners. The merger would create a strong platform from which we will be better able to realize the potential of our deep local market presence and extensive wireline and wireless networks. The markets served by the combined companies would include California and Texas, the states that economists expect to be first and second in population growth over the next 10 years. And our combined border with Mexico offers the potential for increased international telecommunications traffic.

The merger is currently expected to close shortly after you receive this briefier-than-usual annual report; should the merger be completed, we will present the "new SBC" in a follow-up report to all of our shareowners.

Overall, the passage of the Telecommunications Act made 1996 a watershed year for our industry and our company. The Act is designed to open local markets to full competition, with competitors offering local service in our markets and SBC providing long-distance service. We worked hard for passage of the



In an
increasingly
competitive
environment,
*achieving
growth*

requires... access to fast-growing markets and some of the nation's premium telecommunications customers...

SBC's domestic customer base – 15 million access lines and 4.4 million wireless subscribers – has grown 7.8 percent a year, compounded annually, over the last five years – and we'll add over 16 million access lines and 33 million potential

wireless customers when we merge with Pacific Telesis. Internationally, we serve (on a percentage of ownership basis) one million access lines, 307,000 wireless subscribers and 354,000 video subscribers in eight countries.

legislation, because it enables us to offer our customers the broad array of services and one-stop shopping they tell us they want. The Act has already sharply altered the competitive landscape. The announcement of our agreement with Pacific Telesis was followed by announcements of several other major mergers and scores of strategic initiatives, as competitors tried to position themselves for the new marketplace.

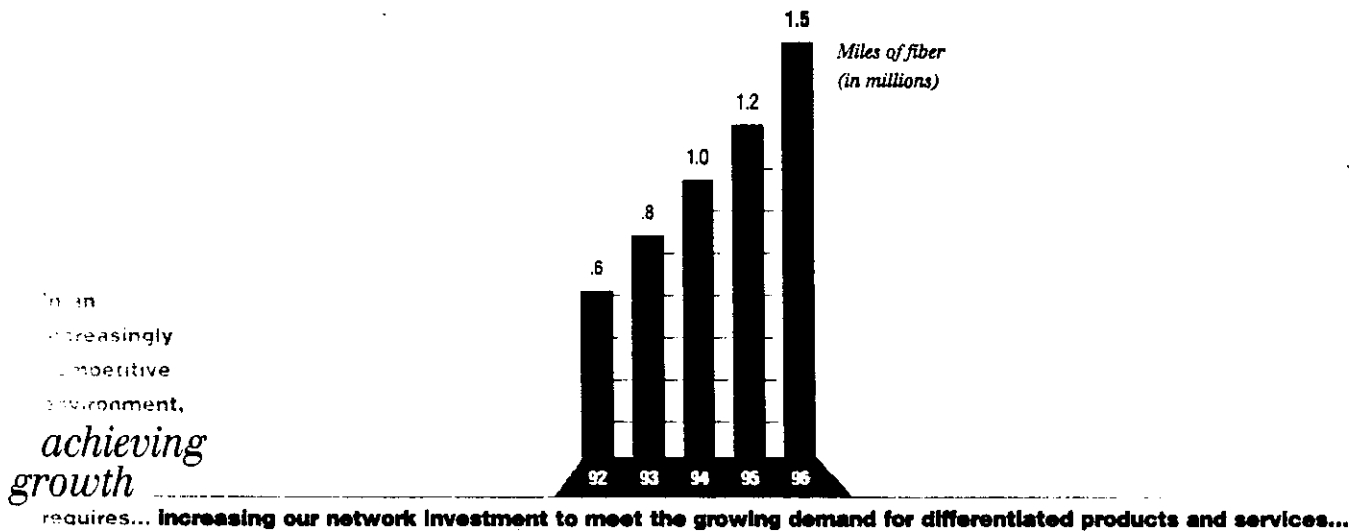
We also know that the implications of telecommunications reform reach well beyond the U.S. marketplace. Telecommunications has clearly become a global business; ultimately, the regulators of our industry in this country must have as one of their goals the enhancement of our industry's ability to compete around the world.

As events unfolded during the year, we became more convinced than ever that our local networks and market presence, combined with the experience we have gained in our international markets, not only enhance SBC's competitive positioning but also provide a superior platform for growth.

Those strengths are why, in an environment that offers tremendous potential for the best companies, I believe SBC's future is bright:

We are in an excellent growth industry. Growth trends are everywhere – in exploding demand for Internet access and high-speed data services; in the continuing strong growth of wireless services; in the accelerating movement toward work-at-home applications; and in the demand from our business customers for technology solutions, not just products, as networks expand and become more complex. Combine all that with tremendous overseas growth opportunities, especially in developing countries, and with the opportunities technological advances give us to reduce costs and improve quality and network speed for our customers – and there are few industries with so much potential for profitable growth.

We are well on our way to the deregulated marketplace. This transition involves many complex issues and requires decisions by federal and state regulators, but its momentum is unstoppable. We still have much hard work to do to secure the full promise of the Telecommunications Act, and you can expect us to challenge unfair regulatory decisions. But, I'm confident the outcome will be a deregulated marketplace that gives us a fair opportunity to serve all of our customers' telecommunications needs and service requirements.



Since 1991, we've invested \$12.1 billion in our networks, including \$3 billion in 1996, to meet expanding consumer demand and ensure our revenue growth. Ninety percent of our investments are in networks, and our network encompasses 2,702 wireless

cell sites and over 1,100 fiber Sonet rings. But providing solutions is not technology. That's why U.S. telecommunications companies offer a variety of services, including Internet access by routing Internet calls to our

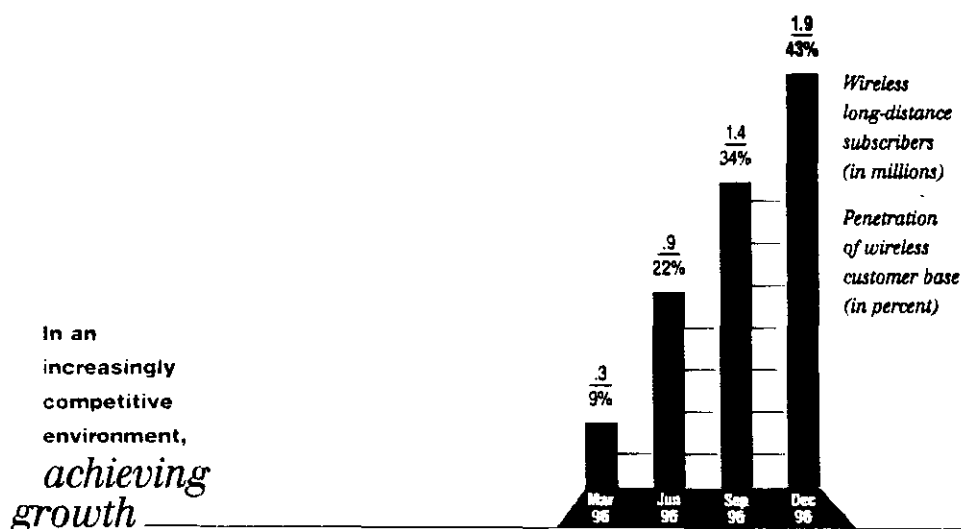
SBC is positioned for continued success. We are focused on growth, and we have the strategies, networks, competitive skills and dedicated employees to extend our record of outstanding performance. We're moving quickly to realize the opportunities the new legislation gives us to provide a full range of telecommunications services to customers in all of our markets.

Let me take a moment to review our 1996 performance highlights:

- **Double-digit earnings growth.** Earnings per share increased 11.6 percent, before an accounting change in 1995.
- **Record revenues.** Our revenues were up 9.7 percent to \$13.9 billion. Strong revenue growth is the foundation of our success; we achieved it by responding to strong demand in our wireline, wireless and international markets and by effectively marketing our products and services.
- **Outstanding operating results.** In our five-state telephone operations, revenues increased a record 8.9 percent and normalized operating cash flow was up 10.4 percent to \$4.3 billion. Access lines grew 5.1 percent for the year – our best access-line growth ever, up significantly over the record 4.5 percent growth in 1995. **Our domestic wireless business** added 739,000 customers during the year, and we achieved 10.8 percent penetration of our markets, the best among the major U.S. wireless companies. With 4.4 million customers in 63 markets, our wireless business is an excellent growth platform. We're realizing this potential by delivering an array of additional services – wireless and wireline long distance, Internet access, wireline local service – to our wireless customers outside our five-state region.

Unfortunately, the stock market did not reward us – or, in fact, most of the companies in our industry – for these accomplishments. During the year, our cumulative return to shareowners – including price appreciation and reinvested dividends – declined 6.3 percent. I'm not happy with that, and I know you're not.

But I do understand why investors treated our industry with caution in 1996. Investors tell me that industry change creates uncertainty as to when competitors will enter our markets, when we can offer long-distance



requires... utilizing our networks and highly skilled employees to provide and support a full range of products...

SBC has moved aggressively to take advantage of new freedoms. We began by offering wireless long distance in all of our markets, and followed with wireline long distance and Internet access in our Cellular One markets. In our

traditional five-state region, we're quickly signing interconnection agreements that are a major step in gaining regulatory approval to add wireline long distance to our in-region product offerings.

service to our customers, and, in short, who will be the winners and losers in a more open, competitive marketplace. This uncertainty was clearly among the reasons most of the stocks in our industry lagged the market during 1996.

In the face of this change and uncertainty, it's reasonable to ask: **Can SBC maintain its growth momentum in light of increased competition?**

My answer is simple: Yes.

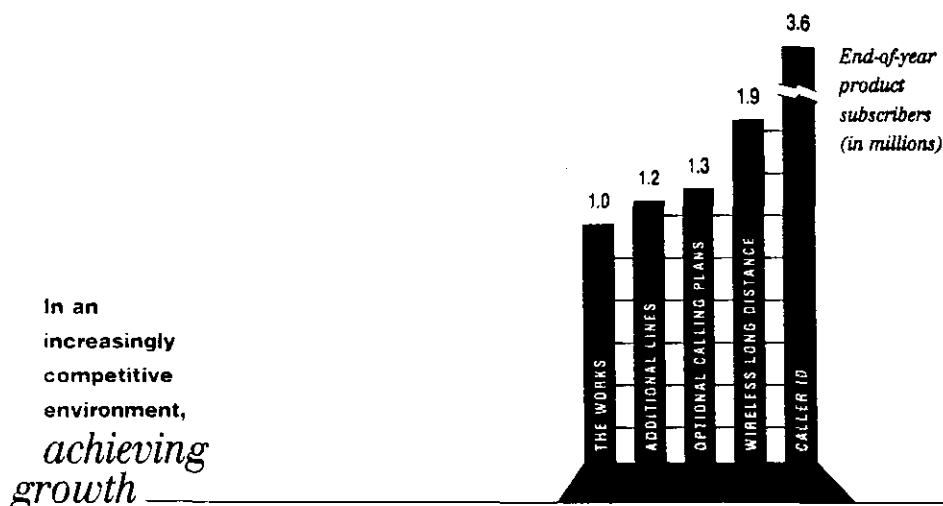
Let me tell you why I'm so confident.

First, SBC already has what it takes to succeed in competitive markets:

- *More than 65 million direct customer contacts* every month, and an employee workforce that gives us deep roots in our communities. This local presence is an important competitive edge, and we have an active, effective program to ensure that the diversity of our communities is reflected throughout the company.
- *Brands* – Southwestern Bell and Cellular One – that customers equate with quality, reliability and performance.
- *Expansive distribution channels* that reach new customers and offer convenient access to our products and services.
- *A strong marketing organization* skilled at identifying and effectively targeting new fast-growing markets.
- *A globally focused corporate development team* with the proven ability to identify and quickly acquire new opportunities for growth.
- *And a skilled management team focused on creating shareowner value* by making investments – in our employees, our networks, and our customer service operations – that grow revenues without sacrificing margins or cash flow.

Second, you can be confident in your investment in SBC because we don't just talk about growth.

We deliver it. We've built our growth momentum by creating strategies that put customers at the center of our plans, then executing those plans well. The results are clear – in our industry-leading sales of additional services



requires... offering new products and services that meet our customers' growing telecommunications needs...

Want a pizza? Dial a single number and your call automatically goes to the nearest store. That's IntelliNumber, and it's an example of new products – and new packaging – that meet specific customer needs. Of more than 300 products and

services, about one-third are new in the last two years – including products like PC Back-Up, Video Conferencing, Freedom Link and Internet access. These new products join continuing success stories like Caller ID, with 37 percent residential penetration.

to our telephone customers; in the 8.6 percent growth of business lines in 1996, our largest increase ever; in strong additional line sales, which accounted for more than 60 percent of the increase in residential access lines in 1996; in the 43 percent penetration of our wireless customer base with our long-distance offering; in our accomplishments in international markets such as France, where we doubled our wireless customer base in 1996.

I expect this growth momentum, combined with the opportunities the deregulated marketplace will give us to increase revenues per customer by delivering a broader array of services to an expanding customer base, to be very positive for our shareowners. While we will inevitably lose some of our retail customers, most of those customers will still generate wholesale revenue, as competitors lease portions of our expansive local wireline networks. And our plans show continued strong margins, with increased spending on marketing and advertising offset by productivity gains as we continue to redesign our processes.

I view the future with great enthusiasm. We're in an excellent growth industry. We have strong positions in excellent markets. We have the local networks and operating systems that can provide the products and services our customers demand. We are dedicated to understanding and meeting the needs of our customers. And we have a talented team of employees who think like shareowners because most of them are. They're the primary reason why SBC, for the second year in a row, was voted the "most admired" telecommunications company in America by *Fortune* magazine.

Underlying these attributes is an unwavering focus on the creation of shareowner value.

Throughout our organization, we know that the essential indicator of our success is our ability to build long-term value for our shareowners, and we measure everything we do by that yardstick.

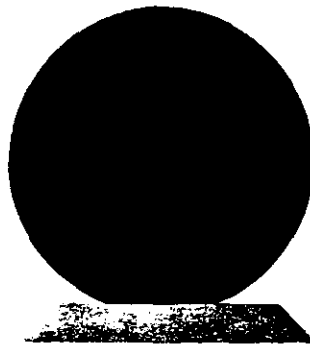
On behalf of our employees and our Board of Directors, I would like to express our appreciation to you – our shareowners – for the confidence you have placed in us. We remain determined to justify that confidence with continued industry-leading performance in the years ahead.

Edward E. Whitacre Jr.

Edward E. Whitacre Jr.

Chairman of the Board and Chief Executive Officer

February 19, 1997



*achieving
growth*

building alliances at home and abroad that keep us at the forefront of new growth opportunities.

Financial Section

- 8 Selected Financial and Operating Data**
- 9 Management's Discussion and Analysis of Financial Condition and Results of Operations**
- 20 Consolidated Statements of Income**
- 21 Consolidated Balance Sheets**
- 22 Consolidated Statements of Cash Flows**
- 23 Consolidated Statements of Shareowners' Equity**
- 24 Notes to Consolidated Financial Statements**
- 34 Report of Management**
- 34 Report of Independent Auditors**
- 35 Executives of SBC and its Subsidiaries**
- 36 SBC Board of Directors**
- 37 Shareowner Information**

Selected Financial and Operating Data

Dollars in millions except per share amounts

At December 31 or for the year ended:	1996	1995	1994	1993	1992	CAGR*
Financial Data						
Operating revenues	\$13,898	\$12,670	\$11,772	\$10,840	\$10,150	8.2%
Operating expenses	\$10,342	\$ 9,633	\$ 9,010	\$ 8,480	\$ 7,953	6.8%
Operating income	\$ 3,556	\$ 3,037	\$ 2,762	\$ 2,360	\$ 2,197	12.8%
Interest expense	\$ 472	\$ 515	\$ 480	\$ 496	\$ 530	-
Equity in net income of affiliates	\$ 244	\$ 156	\$ 223	\$ 250	\$ 208	-
Income taxes	\$ 1,166	\$ 903	\$ 785	\$ 625	\$ 568	-
Income before extraordinary loss and cumulative effect of changes in accounting principles ¹	\$ 2,101	\$ 1,889	\$ 1,649	\$ 1,435	\$ 1,302	12.7%
Net income (loss)	\$ 2,101	\$ (930)	\$ 1,649	\$ (845)	\$ 1,302	-
Earnings per common share:						
Income before extraordinary loss and cumulative effect of changes in accounting principles ¹	\$ 3.46	\$ 3.10	\$ 2.74	\$ 2.39	\$ 2.17	12.4%
Net income (loss)	\$ 3.46	\$ (1.53)	\$ 2.74	\$ (1.41)	\$ 2.17	-
Total assets	\$23,449	\$22,002	\$26,005	\$24,308	\$23,810	-
Long-term debt	\$ 5,505	\$ 5,672	\$ 5,848	\$ 5,459	\$ 5,716	-
Construction and capital expenditures	\$ 3,027	\$ 2,336	\$ 2,350	\$ 2,221	\$ 2,144	9.0%
Free cash flow ²	\$ 1,797	\$ 1,685	\$ 1,618	\$ 1,220	\$ 1,470	5.2%
Dividends declared per common share	\$ 1.72	\$ 1.65	\$ 1.58	\$ 1.51	\$ 1.46	4.2%
Book value per common share ³	\$ 11.39	\$ 10.27	\$ 13.72	\$ 12.61	\$ 15.47	-
Ratio of earnings to fixed charges	6.59	5.81	5.41	4.51	3.96	-
Return on weighted average shareowners' equity ⁴	31.22%	24.18%	20.61%	19.29%	14.28%	-
Debt ratio ⁵	51.40%	54.03%	47.36%	47.49%	42.99%	-
Operating Data*						
EBITDA ¹	\$ 5,796	\$ 5,207	\$ 4,800	\$ 4,367	\$ 4,040	9.4%
Network access lines in service (000)	14,955	14,223	13,612	13,145	12,724	4.1%
Access minutes of use (000,000)	58,668	53,681	48,430	44,203	41,235	-
Long-distance messages (000,000)	998	988	1,018	1,012	974	-
Cellular customers (000)	4,398	3,659	2,992	2,049	1,413	-
Number of employees	61,540	59,300	58,800	58,400	59,500	-

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

¹1995 Discontinuance of Regulatory Accounting; 1993 Early Extinguishment of Debt and Cumulative Effect of Changes in Accounting Principles.

²Free cash flow is net cash provided by operating activities less construction and capital expenditures.

³Shareowners' equity used in book value per common share and debt ratio calculations includes extraordinary loss and changes in accounting principles.

⁴Calculated using income before extraordinary loss and changes in accounting principles. These impacts are included in shareowners' equity.

⁵EBITDA is earnings before interest, taxes, depreciation and amortization (operating income plus depreciation and amortization). SBC considers EBITDA an important component in our economic value added systems as an indicator of the operational strength and performance of our businesses. It is provided as supplemental information and is not intended to be a substitute for operating income, net income or net cash provided by operating activities as a measure of financial performance or liquidity.

*Compound Annual Growth Rate from 1992 to 1996.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Dollars in millions except per share amounts

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

SBC's largest subsidiary is Southwestern Bell Telephone Company (Telephone Company), which provides telecommunications services over approximately 15 million access lines in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area). The Telephone Company is subject to regulation by each of the state jurisdic-

tions in which it operates and by the Federal Communications Commission (FCC). In 1996, the Telephone Company provided 70% of SBC's operating revenues and 65% of its net income.

This discussion should be read in conjunction with the consolidated financial statements and the accompanying notes.

Results of Operations

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

	1996	1995	1994	Percent Change	
				1996 vs. 1995	1995 vs. 1994
Operating revenues	\$13,998	\$12,670	\$11,772	9.7%	7.6%
Operating expenses	\$10,342	\$ 9,633	\$ 9,010	7.4%	6.9%
Income before extraordinary loss	\$ 2,101	\$ 1,889	\$ 1,649	11.2%	14.6%
Extraordinary loss	-	\$ (2,819)	-	-	-
Net income (loss)	\$ 2,101	\$ (930)	\$ 1,649	-	-

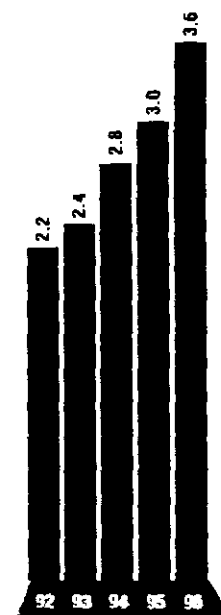
SBC recognized an extraordinary loss in 1995 from the discontinuance of regulatory accounting at the Telephone Company.

The primary factors contributing to the increase in income before extraordinary loss in 1996 were growth in demand for services and products at the Telephone Company and Southwestern Bell Mobile Systems, Inc. (Mobile Systems).

The primary factors contributing to the increase in income before extraordinary loss in 1995 were growth in demand for services

and products at the Telephone Company and Mobile Systems, and an after-tax gain of \$111 associated with the merger of SBC's United Kingdom cable television operations into TeleWest P.L.C. (TeleWest). These factors were partially offset by an after-tax charge of \$88 recorded in connection with SBC's strategic functional realignment.

Items affecting the comparison of the operating results between 1996 and 1995, and between 1995 and 1994, are discussed in the following sections.



Operating Income
(dollars in billions)

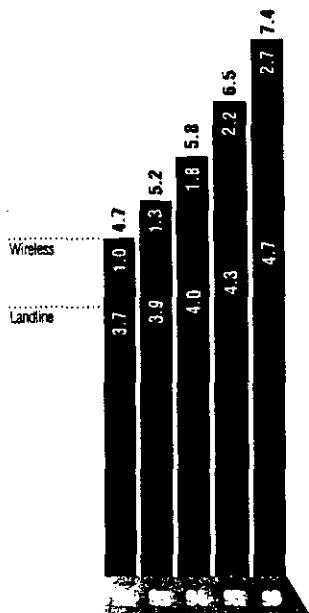
Operating income has grown by more than half since 1992.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

Operating Revenues Total operating revenues increased \$1,228, or 9.7%, in 1996 and \$898, or 7.6%, in 1995. Components of total operating revenues, including percentage changes from the prior year, are as follows:

	1996	1995	1994	Percent Change	
				1996 vs. 1995	1995 vs. 1994
Local service					
Landline	\$ 4,718	\$ 4,302	\$ 4,039	9.7%	6.5%
Wireless	2,678	2,247	1,749	19.1	28.5
Network access					
Interstate	2,145	2,035	1,912	5.4	6.4
Intrastate	1,099	1,032	945	6.5	9.2
Long-distance service	945	841	917	12.4	(8.3)
Directory advertising	914	953	947	(4.1)	0.6
Other	1,401	1,260	1,263	11.2	(0.2)
	\$13,898	\$12,670	\$11,772	9.7%	7.6%



Local Service
(dollars in billions)

Wireless local service revenues have nearly tripled in the last four years.

Local Service Landline revenues increased in 1996 and 1995 due to increases in demand, primarily increases in residential and business access lines and vertical services revenues. Total access lines increased 5.1% in 1996 and 4.5% in 1995. Nearly two-thirds of the access line growth occurred in Texas, which now has approximately 59% of the Telephone Company's access lines. Approximately 29% in 1996 and 25% in 1995 of access line growth was due to the sales of additional access lines to existing residential customers. Vertical services revenues, which include custom calling options, Caller ID and other enhanced services, increased by approximately 22% in 1996 and 17% in 1995.

Wireless revenues increased in 1996 and 1995 due primarily to the growth in the number of cellular customers of 20.2% and 22.3%. These increases were partially offset by slight declines in average revenue per customer. Market penetration at the end of 1996, 1995 and 1994 was 10.8, 9.0 and 7.4 customers per 100 residents in Mobile Systems' service areas.

Network Access Interstate network access revenues increased in 1996 and 1995 due largely to increases in demand for access services by interexchange carriers. Growth in revenues from end user charges, attributable to an increasing access line base, also contributed to the increases in both years. Net rate reductions under the FCC's revised price cap plan, which was

effective August 1, 1995, partially offset these increases by approximately \$65 in both 1996 and 1995.

Intrastate network access revenues increased in 1996 and 1995 due primarily to increases in demand, including usage by alternative intraLATA toll carriers.

Long-Distance Service revenues increased in 1996 due principally to growth in Mobile Systems' wireless revenues including interLATA service that began in February 1996, and the inclusion in 1995 of the Telephone Company's intraLATA toll pool settlement payments and accruals for rate reductions relating to an appealed 1992 rate order in Oklahoma. The settlement of the appeals in October 1995 eliminated the need to continue these accruals. Absent these accruals and settlements, the Telephone Company's long-distance service revenues in 1996 would have decreased slightly due to the continuing impact of price competition from alternative intraLATA toll carriers. Competition had less impact on message volumes in 1996 due to the Telephone Company's deployment and promotion of optional long-distance calling plans, which generally result in higher message volumes but lower average revenue per message. This message volume trend is not expected to continue, because the Telephone Company plans to emphasize promotions of extended area local service plans. Long-distance service revenues decreased in 1995, reflecting competition-related decreases in

residential message volumes and the impact of optional calling plans and extended area service plans.

Directory Advertising revenues decreased in 1996 as increased yellow pages revenues from Southwestern Bell Yellow Pages, Inc. were more than offset by the decrease resulting from the January 1996 sale of SBC's publishing contracts for GTE Corporation's service areas to GTE Directories. Excluding the impact of this sale, revenues increased 6.7% in 1996. Revenues in 1995 were relatively

unchanged from 1994, reflecting the impact of increased competition.

Other operating revenues in 1996 and 1995 reflect the increased demand for the Telephone Company's non-regulated services and products, including Caller ID equipment, computer network services, contract programming and videoconferencing services. The increase in 1995 was offset by the decrease in equipment sales revenues at Mobile Systems resulting primarily from declining equipment prices.

Operating Expenses Total operating expenses increased \$709, or 7.4%, in 1996 and \$623, or 6.9%, in 1995. Components of total operating expenses, including percentage changes from the prior year, are as follows:

	1996	1995	1994	Percent Change	
				1996 vs. 1995	1995 vs. 1994
Cost of services and products	\$ 4,135	\$3,806	\$3,747	8.6%	1.6%
Selling, general and administrative	3,967	3,657	3,225	8.5	13.4
Depreciation and amortization	2,240	2,170	2,038	3.2	6.5
	\$10,342	\$9,633	\$9,010	7.4%	6.9%

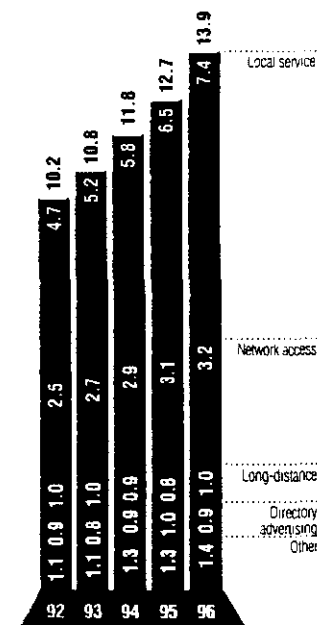
Cost of Services and Products increased in 1996 due to increases at the Telephone Company for network expansion and maintenance, employee compensation and demand-related increases, primarily increases in switching system software license fees. Other increases in 1996 related principally to growth at Mobile Systems. Similarly, in 1995, expenses increased primarily due to increases at the Telephone Company for network expansion and maintenance, employee compensation, and demand-related increases for enhanced services. These increases were mostly offset by decreased switching system software license fees at the Telephone Company, decreased equipment costs at Mobile Systems and the absence of expenses associated with SBC's United Kingdom cable television operations (discussed in Other Business Matters).

Selling, General and Administrative expenses increased in 1996 and 1995 primarily due to growth-related increases at Mobile Systems and the Telephone Company including increases in operating

taxes, which include the Texas Infrastructure Fund assessments, contracted services, employee compensation, advertising and uncollectibles. The increase in 1995 was also attributable to the \$139 charge for costs associated with the strategic realignment discussed in Other Business Matters.

Depreciation and Amortization increased in 1996 and 1995 due primarily to growth in plant levels and changes in plant composition, primarily at Mobile Systems and the Telephone Company. The increase in 1995 also reflects the effect of regulatory depreciation represcription at the Telephone Company.

Interest Expense decreased \$45, or 8.3%, in 1996 due to lower interest rates on short-term debt, lower long-term debt levels, and capitalization of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995. Under regulatory accounting, the Telephone Company accounted for a capitalization of both interest and equity costs during periods of construction as



Distribution of Revenues
(dollars in billions)

Local service revenue growth represents nearly three-fourths of the increase in operating revenues since 1992.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

other income. Interest expense increased \$35, or 7.3%, in 1995 due primarily to an increase in the average amount of debt outstanding to finance growth and acquisitions at Mobile Systems. Interest expense for 1995 also reflects debt issued for acquisitions in France and Chile.

Equity in Net Income of Affiliates increased \$88 in 1996 and decreased \$67 in 1995. The 1996 increase reflects increased income from Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company, due to the relative stabilization of the peso, net gains on international affiliate transactions and improved results from SBC's investment in French cellular operations. Results for 1995 include losses on SBC's United Kingdom cable television operations, which were accounted for under the equity method prior to October 1995, and exchange losses on the non-peso denominated debt of Telmex. Results for 1996 and 1995 also reflect reductions in the translated amount of U.S. dollar earnings from Telmex's operations. Operational growth at Telmex in both years somewhat offsets these declines. The 1995 decrease is also attributable to SBC's investment in French cellular operations.

SBC's future earnings from Telmex will continue to be sensitive to changes in the value of the peso. SBC's investment in Telmex has been recorded under U.S. generally accepted accounting principles (GAAP), which exclude inflation adjustments and include adjustments for the purchase method of accounting. Beginning in 1997, SBC will use the U.S. dollar, instead of the peso, as the functional currency for its investment in Telmex due to the Mexican economy becoming highly inflationary as defined by GAAP. Earnings in 1997 will reflect SBC's reduced ownership percentage in Telmex as discussed in Note 5 to the financial statements. These changes are each expected to have a slightly negative impact on equity in net income from Telmex.

Other Income (Expense) - Net In 1995, SBC recognized a gain from the merger of SBC's United Kingdom cable television operations into TeleWest (see Note 12 to the

financial statements). The gain was somewhat offset by expenses associated with the refinancing of long-term debt by the Telephone Company (see Note 6 to the financial statements).

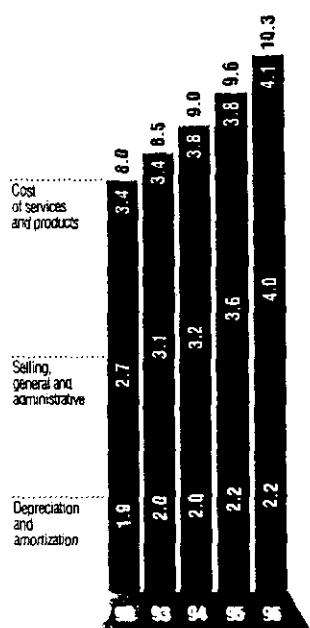
Federal Income Tax expense increased \$233, or 28.3%, in 1996 and \$140, or 20.5%, in 1995, primarily due to higher income before income taxes. The elimination of excess deferred taxes and the reduction in the amortization of investment tax credits resulting from the discontinuance of regulatory accounting, as described in Note 2 to the financial statements, also contributed to the increases in both years.

Extraordinary Loss In 1995, SBC recorded an extraordinary loss of \$2.8 billion from the discontinuance of regulatory accounting. The loss included a reduction in the net carrying value of telephone plant partially offset by the elimination of net regulatory liabilities of the Telephone Company (see Note 2 to the financial statements).

Operating Environment and Trends of the Business

Regulatory Environment The Telephone Company's telecommunications operations are subject to regulation by each of the five states in which it operates for intrastate services and by the FCC for interstate services. Through the end of 1996, the Telephone Company operated under incentive regulation or price caps for various services provided by the Telephone Company. In early 1997, Arkansas enacted legislation establishing incentive regulation for electing companies, replacing a settlement which had expired on December 31, 1996. Under price cap regulation, the Telephone Company is permitted to establish and modify prices, not to exceed the price caps, subject to expedited approval by the governing jurisdiction. Prices for some other services not specifically covered by price caps are also subject to regulatory approval.

The states set intrastate price caps for various periods, depending upon the state. Price caps set by the FCC are adjusted annually for inflation, a productivity offset and certain other changes in costs.



Distribution of Expenses
(dollars in billions)

Expenses as a percentage of operating revenues decreased for the fourth consecutive year.

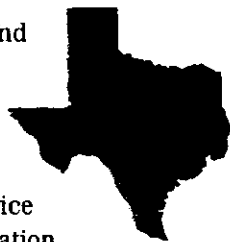
The productivity offset is a fixed percentage used to reduce price caps and is designed to encourage increased productivity.

Under the original FCC plan adopted in 1991, the Telephone Company applied a productivity offset of 3.5%, with sharing at various rates of return on investment. The FCC adopted revised price cap rules effective August 1, 1995. The new rules allowed a choice of three new productivity offsets, two of which provide for a sharing of profits with consumers above certain earnings levels. The Telephone Company elected a 3.5% productivity offset with no sharing.

The revised FCC price cap plan was intended to be an interim plan that would be revised in 1996. However, with the passage of the Telecommunications Act of 1996 (the Telecom Act), the FCC is conducting further proceedings to address various pricing and productivity issues, and is performing a broader review of price cap regulation in a competitive environment. Additionally, the FCC will also examine universal service and access charge rules during 1997. The Telecom Act and FCC actions taken to implement provisions of the Telecom Act are discussed further under the heading "Competition."

Following is a summary of significant state regulatory developments.

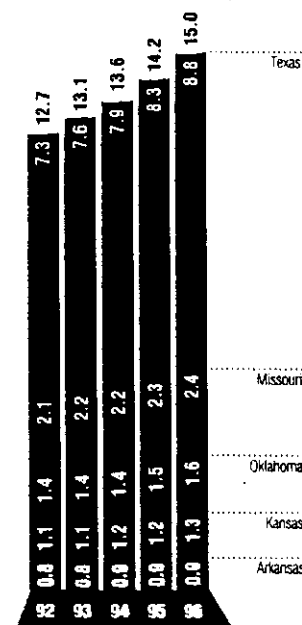
Texas The Public Utility Regulatory Act, which became effective in May 1995 (PURA), allows the Telephone Company and other Local Exchange Carriers (LECs) to elect to move from rate of return regulation to price regulation with elimination of earnings sharing. In September 1995, the Telephone Company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



LECs electing price regulation must commit to network and infrastructure improvement goals, including expansion of digital switching and advanced high-speed services to qualifying public institutions, such as schools, libraries and hospitals, requesting the services. PURA also established an infrastructure grant fund for use by public institutions in upgrading their communications and computer technology. PURA provided for a total fund assessment of \$150 annually on all telecommunications providers in Texas for a ten-year period, half of which would be paid by the cellular and wireless industry. The provisions establishing different assessment rates for landline and cellular and wireless service providers were ruled unconstitutional under the Texas constitution in January 1996, and the lower rate was ordered to be applied to both categories of service providers, resulting in less than a \$150 annual assessment. Based on this order, SBC's total annual payment is estimated to be approximately \$35 to \$45. The 1997 Texas legislative session is considering this issue with the goal of restoring the assessment to its original \$150 annual amount. As a result, SBC's annual payment could increase.

PURA establishes local exchange competition by allowing other companies who desire to provide local exchange services to apply for certification by the TPUC, subject to certain build-out requirements, resale restrictions and minimum service requirements. PURA provides that the Telephone Company will remain the default carrier of "1 plus" intraLATA toll traffic until all LECs are allowed to carry interLATA long-distance.

In 1996, MCI Communications Corporation (MCI) and AT&T Corp. (AT&T) sued the state of Texas, alleging that PURA violates the Texas state constitution, claiming PURA establishes anticompetitive barriers designed to prevent MCI, AT&T and Sprint Corporation (Sprint) from providing local services within Texas. SBC is unable to predict the outcome of this proceeding.

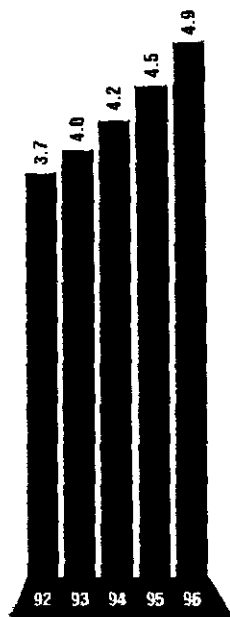


Access Lines
(in millions)

Texas accounts for nearly two-thirds of access line growth since 1992.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts



Business Access Lines
(in millions)

Business access lines have grown nearly one-third since 1992.

During 1996, the TPUC approved the application of Sprint to be granted a certificate of authority to provide local service, waiving the build-out requirements specified under state law for facilities-based certificates of authority. AT&T and MCI have also filed petitions with the FCC arguing the build-out requirements should be preempted; they have also requested TPUC grant them similar treatment as Sprint. TPUC has also requested the FCC issue an expedited ruling on whether PURA's build-out requirements are lawful under the Telecom Act.

More than 80 applications to provide competitive local service certification have been approved by the TPUC, with over 30 more applications pending approval. As a result, the Telephone Company expects competition to continue to develop for local service, but the specific financial impacts of this competition cannot be reasonably estimated until all required tariff filings are approved by the TPUC for the Telephone Company and other companies intending to provide local service.

Missouri During 1996, the 1995 Cole County Circuit Court ruling which overturned the August 1994 settlement agreement reached among the Telephone Company, the Missouri Public Service Commission (MPSC) and the Office of Public Counsel (OPC) was upheld on appeal. The practical effect of this decision is

to eliminate the prospective commitments under the settlement agreement, including a rate review moratorium and capital investment commitments. The decision has no immediate impact on the Telephone Company's current rates because they were approved by the MPSC in separate proceedings, which were not appealed.

Oklahoma On October 30, 1995, the Oklahoma Corporation Commission (OCC) approved a settlement that resolved pending court appeals of a 1992 rate order. Under the terms of the settlement, the Telephone Company paid a cash settlement of \$170 to business and residential customers, and

offered discounts with a retail value of \$268 for certain Telephone Company services. Previously ordered rate reductions of \$100 were lowered to \$84, of which \$57 had already been implemented. The settlement allowed the remaining \$27 in rate reductions to be deferred, with approximately \$9 becoming effective in 1996 and the remainder during 1997. The settlement also provides that no overearnings complaint can be filed against the Telephone Company until January 1, 1998. The Telephone Company began accruing for the order in 1992, and the settlement and associated costs had been fully accrued as of the end of the third quarter of 1995.

Competition Competition continues to expand in the telecommunications industry. Legislation and regulation have increased the opportunities for alternative service providers offering telecommunications services. Technological advances have expanded the types and uses of services and products available. Accordingly, SBC faces increasing competition in significant portions of its business.

Domestic On February 8, 1996, the Telecom Act was enacted into law. The Telecom Act is intended to address various aspects of competition within, and regulation of, the telecommunications industry. The Telecom Act provides that all post-enactment conduct or activities which were subject to the consent decree, referred to as the Modification of Final Judgment (MFI), issued at the time of AT&T's divestiture of the Regional Holding Companies (RHCs) are now subject to the provisions of the Telecom Act. Among other things, the Telecom Act also defines conditions SBC must comply with before being permitted to offer interLATA long-distance service within the five-state area and establishes certain terms and conditions intended to promote competition for the Telephone Company's local exchange services. Under terms of the Telecom Act, SBC may immediately offer interLATA long-distance outside the five-

state area and over its wireless network both inside and outside the five-state area. Before being permitted to offer landline interLATA long-distance service in any state within the Telephone Company's five-state region, SBC must apply for and obtain state-specific approval from the FCC. The FCC's approval, which involves consultation with the United States Department of Justice, requires favorable determinations that the Telephone Company has entered into interconnection agreement(s) that satisfy a 14-point "competitive checklist" with predominantly facilities based carrier(s) that serve residential and business customers or, alternatively, that the Telephone Company has a statement of terms and conditions effective in that state under which it offers the "competitive checklist" items. The FCC must also make favorable public interest and structural separation determinations. The Telecom Act directed the FCC to establish rules and regulations to implement the Telecom Act, and to preempt specific state law provisions under certain circumstances. The Telecom Act also allows RHCs to provide cable services over their own networks, but sets limits on RHCs acquiring interests in cable television operations in their telephone service areas.

In April 1996, the United States District Court for the District of Columbia issued its Opinion and Order terminating the MFJ and dismissing all pending motions related to the MFJ as moot. This ruling effectively ended 15 years of RHC regulation under the MFJ.

In August 1996, the FCC issued rules by which competitors could connect with LECs' networks, including those of the Telephone Company. Among other things, the rules addressed unbundling of network elements, pricing for interconnection and unbundled elements (Pricing Provisions), and resale of network services. The FCC rules were appealed by numerous parties, including SBC, other LECs, various state regulatory commissions and the National Association of Regulatory Utility Commissioners.

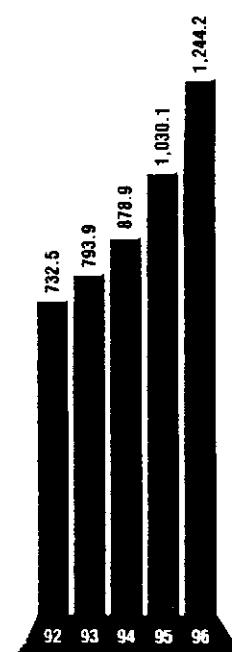
On October 15, 1996, the United States Court of Appeals for the Eighth Circuit (Eighth Circuit) issued an order to stay the

FCC's Pricing Provisions and its rules permitting new entrants to "pick and choose" among the terms and conditions of approved interconnection agreements. The stay provides that it will remain in effect while the Eighth Circuit considers the validity of the rules. Other provisions of rules adopted by the FCC to implement the Telecom Act remain in effect.

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

Recently enacted and pending state laws and regulations also allow increased competition for local exchange services. Companies wishing to provide competitive local service have filed numerous applications with state commissions throughout the Telephone Company's five-state area, and the commissions of each state have begun approving these applications. Under the Telecom Act, companies seeking to interconnect to the Telephone Company's network and exchange local calls must enter into interconnection agreements with the Telephone Company, which are then subject to approval by the appropriate state commission. Numerous interconnection agreements have been entered into and approved in the Telephone Company's five-state area. Several companies who have failed to agree on all interconnection terms have filed for arbitration before the state commissions.

In October 1996, the TPUC announced its ruling in a consolidated arbitration hearing between the Telephone Company and AT&T, MCI, MFS Communications Company, Inc. (MFS), Teleport Communications Group, and American Communications Services, Inc. The TPUC approved interim interconnection rates to be charged by the Telephone Company as well as certain other terms of interconnec-



Additional Lines
(in thousands)

Additional lines growth represents nearly one-fourth of the increase in access lines since 1992.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

tion between the parties. Some agreements containing the arbitrated rates and terms have been approved by the TPUC. The Telephone Company also filed revised cost support for the establishment of permanent rates with the TPUC, with an anticipated effective date of April 1997. The Telephone Company has filed suit in state and federal court maintaining that, for various reasons, the arbitration award is unlawful.

In Missouri, the MPSC issued orders on a consolidated arbitration hearing with AT&T and MCI and on selected items with MFS. Among other terms, the orders established discount rates for resale of Telephone Company services and prices for unbundled network elements. The Telephone Company has filed suit in federal court appealing the orders as unlawful.

As a result of the Telecom Act and conforming interconnection agreements, the Telephone Company expects in 1997 it will experience local exchange competition from multiple providers in various markets. SBC intends to use approved agreements in support of its application to the FCC to provide interLATA long-distance service in the Telephone Company's five-state area.

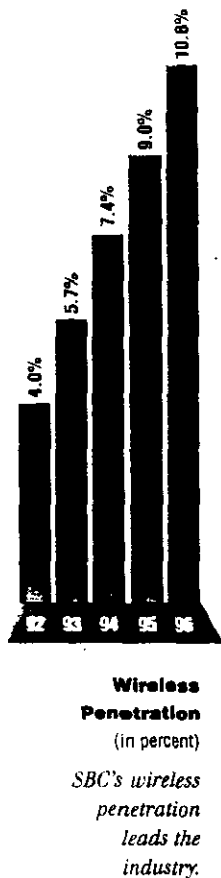
The Telephone Company also faces competition from various local service providers that bypass the local exchange network. Some of these providers have built fiber optic "rings" throughout large metropolitan areas to provide transport services (generally high-speed data) for large business customers and interexchange carriers. Others provide high-usage customers, particularly large businesses, alternative telecommunications links for voice and data, such as private network systems, shared tenant services or private branch exchange (PBX) systems (which are customer-owned and provide internal switching functions without using Telephone Company central office facilities). The extent of the economic incentive to bypass the local exchange network depends upon local exchange prices, access charges, regulatory policy and other factors. End user charges ordered by the FCC are designed in part to mitigate the effect of system bypass.

Competition continues to intensify in the Telephone Company's intraLATA toll markets. Principal competitors are inter-exchange carriers, which are assigned an access code (e.g., "10XXX") used by their customers to route intraLATA calls through the interexchange carrier's network, and resellers, which sell toll services obtained at bulk rates.

In 1993, the FCC adopted an order allocating radio spectrum and outlining the development of licenses for new personal communications services (PCS). PCS utilizes wireless telecommunications digital technology at a higher frequency radio spectrum than cellular. Like cellular, it is designed to permit access to a variety of communications services regardless of subscriber location. In an FCC auction, which concluded in March 1995, PCS licenses were awarded in 51 major markets. SBC acquired PCS licenses in the Major Trading Areas (MTAs) of Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma. SBC is currently in the build out phase of PCS in Tulsa, Oklahoma. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis, Tennessee and Little Rock, Arkansas and other consideration. In an FCC auction concluded January 1997, SBC acquired eight additional PCS licenses for Basic Trading Areas (BTAs) that are within its five-state area. SBC plans to build out the new BTAs as part of its strategy to be a full service telecommunications provider. Including these new BTAs, SBC will be able to offer approximately 85% of its landline local service customers wireless service as well.

Companies granted licenses in MTAs and BTAs where SBC also provides service include subsidiaries and affiliates of AT&T, Sprint and other RHCs. The degree of competition which SBC will encounter from PCS providers will depend on the timing and extent of the build out of PCS services.

In the future, it is likely that additional competitors will emerge in the telecommunications industry. Cable television companies and electric utilities have expressed an interest in, or already are, providing



telecommunications services. As a result of recent and prospective mergers and acquisitions within the industry, SBC may face competition from entities offering both cable TV and telephone services in the Telephone Company's operating territory. Interexchange carriers have been certified to provide local service, and a number of other major carriers have publicly announced their intent to provide local service in certain markets, some of which are in the Telephone Company's five-state area.

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

International Telmex was granted a concession in 1990 which expired in August 1996, as the sole provider of long-distance services in Mexico. In 1995, the Mexican Senate and Chamber of Deputies passed legislation encompassing a series of rules for the introduction of competition into the Mexican long-distance market previously issued by the Mexican Secretary of Communication and Transportation. Those

rules specified that there would be an unlimited number of long-distance concessions and that Telmex was required to provide

60 interconnection points by January 1, 1997, and more than 200 interconnection points by the year 2000. Several large competitors have announced their intention to compete with Telmex and have filed for licenses, including a joint venture between AT&T and Alfa, a Mexican consortium, and Avantel, S.A., a joint venture between MCI and Grupo Financiero Banamex-Accival, Mexico's largest financial group. Balloting for presubscription of long-distance service has begun among Telmex's customers in selected areas.

Other Business Matters

Merger Agreement On April 1, 1996, SBC and Pacific Telesis Group (PAC) jointly announced a definitive agreement to merge an SBC subsidiary with PAC, in a transaction in which each share of PAC common stock will be exchanged for 0.733 of a share of SBC common stock, subject to adjustment as described in the merger agreement based upon an allocation of the costs, fees and expenses and other financial effects incurred or sustained in connection with obtaining state regulatory approvals. After the merger, PAC will be a wholly-owned subsidiary of SBC. The transaction is intended to be accounted for as a pooling of interests and to be a tax-free reorganization. On July 31, 1996, the shareowners of SBC and PAC each approved the transaction, which had previously been approved by the board of directors of each company. On November 5, 1996, the United States Department of Justice announced it would not initiate action on the merger under the Hart-Scott-Rodino antitrust law. The Public Service Commission of Nevada approved the merger on December 31, 1996. The FCC approved the transfer of licenses from PAC to SBC on January 31, 1997. The merger agreement is subject to certain other regulatory approvals, including approval by the California Public Utilities Commission, which has established a schedule for review of the transaction with approval expected before the end of the first quarter of 1997. If approvals are granted, the transaction is expected to close in the first half of 1997 (see Note 3 to the financial statements for more information).

Acquisitions and Dispositions SBC made several acquisitions and dispositions in 1996, 1995 and 1994.

SBC's acquisitions of two cable television systems located in Montgomery County, Maryland, and Arlington County, Virginia, the domestic wireless business of Associated Communications Corporation, adjacent properties in New York state and an indirect

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

10% ownership of a nationwide cellular company in France are described in Note 12 to the financial statements. In addition, the merger of SBC's United Kingdom cable television operations into TeleWest is described in Note 12 to the financial statements.

In October 1994, SBC sold an additional 25% of its United Kingdom cable television operations to Cox Cable Communications. From October 1994 until the merger into TeleWest in 1995, SBC's United Kingdom cable television investment was accounted for under the equity method. In December 1996, SBC made an additional investment to maintain its indirect 10% ownership in the French cellular company to offset dilution of its interest resulting from other equity sales.

During 1995, SBC also purchased a wireless system serving Watertown, New York, and, as previously discussed, obtained at auction PCS licenses in Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis, Tennessee and Little Rock, Arkansas and other consideration.

In 1995, SBC made an equity investment in Chile, purchasing 40% of VTR S.A. (VTR), a privately owned telecommunications holding company, for \$317. VTR provides local, long-distance, wireless and cable television services in Chile and is 51% owned by Grupo Luksic, a large Chilean conglomerate. During 1996, SBC increased its holding in VTR to 49% through the purchase of shares from another minority shareowner. Also, in 1995, SBC made an equity investment in a South African wireless company.

Except as discussed in Note 12 to the financial statements, none of these transactions had a material effect on SBC's financial results in 1996, 1995 or 1994, nor does management expect them to have a material effect on SBC's financial position or results of operations in 1997.

Strategic Realignment In July 1995, SBC announced a strategic realignment which positions the company to be a single-

source provider of telecommunications services. All of SBC's operations within the five state area report to one management group, while international operations and domestic operations outside the five-state area report to a separate management group.

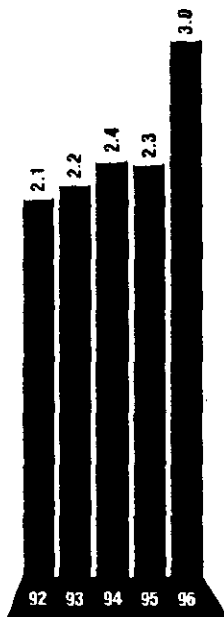
In connection with this realignment of functions, in 1995 SBC recognized \$139 in selling, general and administrative expenses. These expenses include postemployment benefits for approximately 2,400 employees arising from the future consolidation of operations within the five-state area, streamlining support and administrative functions and integrating financial systems. Implementation of the realignment has been delayed due to the pending merger with PAC. The charge reduced net income for 1995 by approximately \$88.

Liquidity and Capital Resources

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

SBC's capital expenditures totaled \$3,027, \$2,336 and \$2,350 for 1996, 1995 and 1994. In 1996, Telephone Company and Mobile Systems expenditures increased 33% and 10%. The Telephone Company's increase in capital expenditures was due primarily to demand-related growth, network upgrades, customer-contracted requirements, regulatory commitments and ISDN projects. Mobile Systems expenditures increased due primarily to continued growth.

SBC's total reported 1995 capital expenditures were relatively unchanged compared to 1994. Reported decreases in SBC's capital expenditures related to the change in accounting for its United Kingdom cable television operations were offset by capital expenditures increases of 5% at the Telephone Company and 6% at Mobile Systems.



Capital Expenditures
(dollars in billions)

Capital expenditures have increased for growth and network modernization.

In 1997, management expects total capital spending to increase from 1996, to between \$3,300 and \$3,500. Capital expenditures in 1997 will relate primarily to the continued evolution of the Telephone Company's network, including amounts agreed to under regulation plans, and continued build out of Mobile Systems' markets. SBC expects to fund ongoing capital expenditures with cash provided by operations.

The Telephone Company continues to make additional network and infrastructure improvements over periods ranging through 2001 to satisfy regulatory commitments. Total capital expenditures under these commitments can vary based on actual demand of potential end users. The Telephone Company anticipates spending approximately \$150 to \$200 in 1997 associated with these commitments.

Over the next few years, SBC is expecting to incur significant software expenditures for interconnection and customer number portability. The extent and timing of these expenditures will vary depending on the timing and nature of regulatory actions and corresponding or compensating network improvements.

Dividends Declared Dividends declared by SBC totaled \$1,042 (\$1.72 per share) in 1996, \$1,004 (\$1.65 per share) in 1995 and \$954 (\$1.58 per share) in 1994.

Management's dividend policy considers both the expectations and requirements of shareowners, internal requirements of SBC and long-term growth opportunities.

Cash, Lines of Credit and Cash Flows SBC had \$242 of cash and cash equivalents available at December 31, 1996.

Commercial paper borrowings as of December 31, 1996, totaled \$1,318. SBC has entered into agreements with several banks for lines of credit totaling \$750, all of which may be used to support commercial paper borrowings. SBC had no borrowings outstanding under these lines of credit as of December 31, 1996.

During 1996, as in 1995 and 1994, SBC's primary source of funds continued to be cash generated from operations, as shown

in the Consolidated Statements of Cash Flows. In 1996, 1995 and 1994, cash provided by operating activities was reduced by the contribution of \$57, \$151 and \$134 to the collectively bargained Voluntary Employee Beneficiary Association trusts for the future payment of postretirement benefits. Net cash provided by operating activities exceeded SBC's construction and capital expenditures during 1996, as in 1995 and 1994; this excess is referred to as free cash flow, a supplemental measure of liquidity. SBC generated free cash flow of \$1,797, \$1,685 and \$1,618 in 1996, 1995 and 1994.

During 1995, the Telephone Company refinanced long-term debt with an aggregate principal amount of \$450. Since June 1991, the Telephone Company has refinanced \$3,652 in long-term debt.

Total Capital SBC's total capital consists of debt (long-term debt and debt maturing within one year) and shareowners' equity. Total capital increased \$454 in 1996 and decreased \$2,265 in 1995. The increase in 1996 was due to the reinvestment of earnings, partially offset by the acquisition of treasury shares. The decrease in 1995 was due to the effects of the discontinuance of regulatory accounting. Absent this extraordinary charge, total capital increased by \$554 in 1995 due primarily to the reinvestment of earnings, partially offset by foreign currency translation adjustments resulting from the decline in the value of the Mexican peso.

Debt Ratio SBC's debt ratio (long-term debt and debt maturing within one year, as a percentage of total capital) was 51.4%, 54.0% and 47.4% at December 31, 1996, 1995 and 1994. The debt ratio is affected by the same factors that affect total capital. For 1995, the decrease in equity caused by the discontinuance of regulatory accounting increased the debt ratio by 9.2 percentage points.

Share Repurchases See Note 11 to the financial statements.

Employee Stock Ownership Plans See Note 9 to the financial statements.

Consolidated Statements of Income

Dollars in millions except per share amounts

	1996	1995	1994
Operating Revenues			
Local service	\$ 7,394	\$ 6,549	\$ 5,788
Network access	3,244	3,067	2,857
Long-distance service	945	841	917
Directory advertising	914	953	947
Other	1,401	1,260	1,263
Total operating revenues	13,898	12,670	11,772
Operating Expenses			
Cost of services and products	4,135	3,806	3,747
Selling, general and administrative	3,967	3,657	3,225
Depreciation and amortization	2,240	2,170	2,038
Total operating expenses	10,342	9,633	9,010
Operating Income	3,556	3,037	2,762
Other Income (Expense)			
Interest expense	(472)	(515)	(480)
Equity in net income of affiliates	244	156	223
Other income (expense) - net	(61)	114	(71)
Total other income (expense)	(289)	(245)	(328)
Income Before Income Taxes and Extraordinary Loss	3,267	2,792	2,434
Income Taxes			
Federal	1,057	824	684
State and local	109	79	101
Total income taxes	1,166	903	785
Income Before Extraordinary Loss	2,101	1,889	1,649
Extraordinary Loss from Discontinuance of Regulatory Accounting, net of tax	-	(2,819)	-
Net Income (Loss)	\$ 2,101	\$ (930)	\$ 1,649
Earnings Per Common Share:			
Income Before Extraordinary Loss	\$ 3.46	\$ 3.10	\$ 2.74
Extraordinary Loss	-	(4.63)	-
Net Income (Loss)	\$ 3.46	\$ (1.53)	\$ 2.74
Weighted Average Number of Common Shares Outstanding (in millions)	607	609	601

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

Consolidated Balance Sheets

Dollars in millions except per share amounts

	December 31,	
	1996	1995
Assets		
Current Assets		
Cash and cash equivalents	\$ 242	\$ 490
Short-term cash investments and other current assets	513	310
Accounts receivable - net of allowances for uncollectibles of \$148 and \$134	2,575	2,389
Material and supplies	116	131
Prepaid expenses	261	157
Deferred charges	205	202
Total current assets	3,912	3,679
Property, Plant and Equipment - Net	14,007	12,988
Intangible Assets - Net of Accumulated Amortization of \$607 and \$548	2,485	2,679
Investments in Equity Affiliates	1,955	1,586
Other Assets	1,090	1,070
Total Assets	\$23,449	\$22,002
Liabilities and Shareowners' Equity		
Current Liabilities		
Debt maturing within one year	\$ 1,722	\$ 1,680
Accounts payable and accrued liabilities	3,839	3,125
Dividends payable	259	251
Total current liabilities	5,820	5,056
Long-Term Debt	5,505	5,672
Deferred Credits and Other Noncurrent Liabilities		
Deferred income taxes	784	723
Postemployment benefit obligation	2,720	2,736
Unamortized investment tax credits	255	287
Other noncurrent liabilities	1,530	1,272
Total deferred credits and other noncurrent liabilities	5,289	5,018
Shareowners' Equity		
Preferred shares (\$1 par value, 10,000,000 authorized: none issued)	-	-
Common shares (\$1 par value, 2,200,000,000 authorized: issued 620,483,301 at December 31, 1996 and 1995)	620	620
Capital in excess of par value	6,322	6,298
Retained earnings	1,739	672
Guaranteed obligations of employee stock ownership plans	(229)	(272)
Foreign currency translation adjustment	(633)	(581)
Treasury shares (20,616,939 at December 31, 1996 and 11,122,981 at December 31, 1995, at cost)	(984)	(481)
Total shareowners' equity	6,835	6,256
Total Liabilities and Shareowners' Equity	\$23,449	\$22,002

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

Consolidated Statements of Cash Flows

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

	1996	1995	1994
Operating Activities			
Net income (loss)	\$ 2,101	\$ (930)	\$ 1,649
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	2,240	2,170	2,038
Undistributed earnings from investments in equity affiliates	(174)	(94)	(134)
Provision for uncollectible accounts	226	178	153
Amortization of investment tax credits	(32)	(42)	(61)
Pensions and other postemployment expenses	221	138	202
Deferred income tax expense	165	463	(124)
Extraordinary loss, net of tax	-	2,819	-
Changes in operating assets and liabilities:			
Accounts receivable	(412)	(363)	(303)
Other current assets	(106)	33	(90)
Accounts payable and accrued liabilities	660	(186)	430
Other - net	(65)	(165)	208
Total adjustments	2,723	4,951	2,319
Net Cash Provided by Operating Activities	4,824	4,021	3,968
Investing Activities			
Construction and capital expenditures	(3,027)	(2,336)	(2,350)
Investments in affiliates	(29)	(16)	(22)
Purchase of short-term investments	(1,005)	(704)	(325)
Proceeds from short-term investments	816	587	390
Dispositions	67	-	141
Acquisitions	(264)	(538)	(1,182)
Net Cash Used in Investing Activities	(3,442)	(3,007)	(3,348)
Financing Activities			
Net change in short-term borrowings with original maturities of three months or less	5	(111)	463
Issuance of other short-term borrowings	209	91	36
Repayment of other short-term borrowings	(134)	(91)	(41)
Issuance of long-term debt	209	981	345
Repayment of long-term debt	(393)	(272)	(450)
Early extinguishment of debt and related call premiums	-	(465)	-
Issuance of common shares	-	-	40
Purchase of treasury shares	(650)	(216)	(447)
Issuance of treasury shares	52	82	18
Dividends paid	(928)	(888)	(837)
Net Cash Used in Financing Activities	(1,630)	(889)	(873)
Net increase (decrease) in cash and cash equivalents	(248)	125	(253)
Cash and cash equivalents beginning of year	490	365	618
Cash and Cash Equivalents End of Year	\$ 242	\$ 490	\$ 365

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

Consolidated Statements of Shareowners' Equity

Dollars in millions except per share amounts

	Common Shares		Capital in		Guaranteed		Foreign	Treasury Shares		
	Shares	Amount	Excess of	Retained	Employee	Stock	Currency	Shares	Amount	Total
			Par Value	Earnings	Ownership	Plans	Translation			
							Adjustment			
Balance, December 31, 1993	602,744,484	\$603	\$5,577	\$1,891	\$(353)		\$ (40)	(2,510,404)	\$(110)	\$7,568
Net income for the year										
(\$2.74 per share)	-	-	-	1,649	-	-	-	-	-	
Dividends to shareowners										
(\$1.58 per share)	-	-	-	(954)	-	-	-	-	-	
Reduction of debt associated with										
Employee Stock Ownership Plans	-	-	-	-	38	-	-	-	-	
Foreign currency translation										
adjustment, net of income tax										
benefit of \$197	-	-	-	-	-	-	(326)	-	-	
Issuance of common shares:										
Dividend Reinvestment Plan	3,334,668	3	134	-	-	-	-	-	-	
Other issuances	14,404,149	14	571	-	-	-	-	-	-	
Purchase of treasury shares	-	-	-	-	-	-	-	(11,301,550)	(447)	
Issuance of treasury shares	-	-	4	-	-	-	-	2,410,326	94	
Other	-	-	-	7	-	-	-	-	-	
Balance, December 31, 1994	620,483,301	620	6,286	2,593	(315)		(366)	(11,401,628)	(463)	8,355
Net income (loss) for the year										
\$(1.53) per share)	-	-	-	(930)	-	-	-	-	-	
Dividends to shareowners										
(\$1.65 per share)	-	-	-	(1,004)	-	-	-	-	-	
Reduction of debt associated with										
Employee Stock Ownership Plans	-	-	-	-	43	-	-	-	-	
Foreign currency translation										
adjustment, net of income tax										
benefit of \$116	-	-	-	-	-	-	(215)	-	-	
Purchase of treasury shares	-	-	-	-	-	-	-	(4,610,713)	(216)	
Issuance of treasury shares:										
Dividend Reinvestment Plan	-	-	19	-	-	-	-	2,730,666	111	
Other issuances	-	-	(7)	-	-	-	-	2,158,694	87	
Other	-	-	-	13	-	-	-	-	-	
Balance, December 31, 1995	620,483,301	620	6,298	672	(272)		(581)	(11,122,981)	(481)	6,256
Net income for the year										
(\$3.46 per share)	-	-	-	2,101	-	-	-	-	-	
Dividends to shareowners										
(\$1.72 per share)	-	-	-	(1,042)	-	-	-	-	-	
Reduction of debt associated with										
Employee Stock Ownership Plans	-	-	-	-	43	-	-	-	-	
Foreign currency translation										
adjustment, net of income tax										
benefit of \$28	-	-	-	-	-	-	(52)	-	-	
Purchase of treasury shares	-	-	-	-	-	-	-	(13,099,709)	(650)	
Issuance of treasury shares:										
Dividend Reinvestment Plan	-	-	26	-	-	-	-	2,667,752	109	
Other issuances	-	-	(5)	-	-	-	-	937,999	38	
Other	-	-	3	8	-	-	-	-	-	
Balance, December 31, 1996	620,483,301	\$620	\$6,322	\$1,739	\$(229)		\$(633)	(20,616,939)	\$(984)	\$6,835

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

Notes to Consolidated Financial Statements

Dollars in millions except per share amounts

1. Summary of Significant Accounting Policies

Basis of Presentation The consolidated financial statements include the accounts of SBC Communications Inc. and its majority-owned subsidiaries (SBC). SBC's subsidiaries and affiliates operate predominantly in the communications services industry, providing landline and wireless telecommunications services and equipment, directory advertising and cable television services both domestically and worldwide. Southwestern Bell Telephone Company (Telephone Company) is SBC's largest subsidiary, providing telecommunications services in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area).

All significant intercompany transactions are eliminated in the consolidation process. Investments in partnerships, joint ventures and less than majority-owned subsidiaries are principally accounted for under the equity method. Earnings from certain foreign investments accounted for under the equity method are included for periods ended within three months of SBC's year end.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Income Taxes Deferred income taxes are provided for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes.

Investment tax credits resulted from federal tax law provisions that allowed for a reduction in income tax liability based on certain construction and capital expenditures. Corresponding income tax expense reductions were deferred and are being amortized as reductions in income tax expense over the life of the property, plant and equipment that gave rise to the credits.

Cash Equivalents Cash equivalents include all highly liquid investments with original maturities of three months or less.

Deferred Charges Certain sales commissions are deferred and amortized over 12 months. Directory advertising costs are deferred until the directory is published and advertising revenues related to these costs are recognized.

Material and Supplies New and reusable materials are carried principally at average original cost. Specific costs are used for large individual items. Nonreusable material is carried at estimated salvage value.

Property, Plant and Equipment Property, plant and equipment is stated at cost. The cost of additions and substantial betterments of property, plant and equipment is capitalized. The cost of maintenance and repairs of property, plant and equipment is charged to operating expenses.

Property, plant and equipment is depreciated using straight-line methods over their estimated useful lives, generally ranging from 3 to 50 years. Prior to September 1995, the Telephone Company computed depreciation using certain straight-line methods and rates as prescribed by regulators. In accordance with composite group depreciation methodology, when a portion of the Telephone Company's depreciable property, plant and equipment is retired in the ordinary course of business, the gross book value is charged to accumulated depreciation.

Intangible Assets Intangible assets consist primarily of wireless and cable television licenses, customer lists and the excess of consideration paid over net assets acquired in business combinations. These assets are being amortized using the straight-line method, over periods generally ranging from 5 to 40 years. At December 31, 1996 and 1995, amounts included in net intangible assets for licenses were \$1,838 and \$1,798. Management periodically reviews the carrying value and lives of all intangible assets based on expected future cash flows.

Foreign Currency Translation Local currencies are generally considered the functional currency for SBC's share of foreign operations, except in countries considered highly inflationary. SBC translates its share of foreign assets and liabilities at current exchange rates. Revenues and expenses are translated using average rates during the year. The ensuing foreign currency translation adjustments are recorded as a separate component of Shareowners' Equity. Other transaction gains and losses resulting from exchange rate changes on transactions denominated in a currency other than the local currency are included in earnings as incurred.

Earnings Per Common Share The earnings per common share computation uses the weighted average number of common shares outstanding, including shares held by employee stock ownership plans. Common stock equivalents outstanding are not considered dilutive

2. Discontinuance of Regulatory Accounting

In September 1995, the Telephone Company discontinued its application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (FAS 71). FAS 71 requires depreciation of telephone plant using lives set by regulators which are generally longer than those established by unregulated companies, and deferral of certain costs and obligations based on regulatory actions (regulatory assets and liabilities). As a result of the adoption of price-based regulation for most of the Telephone Company's revenues and the acceleration of competition in the telecommunications market, management determined that the Telephone Company no longer met the criteria for application of FAS 71.

Upon discontinuance of FAS 71, the Telephone Company recorded a non-cash, extraordinary charge to net income of \$2,819 (after a net deferred tax benefit of \$1,764). This charge is comprised of an after-tax charge of \$2,897 to reduce the net carrying value of telephone plant, partially offset by an after-tax benefit of \$78 for the elimination of net regulatory liabilities. The components of the charge are as follows:

	Pre-tax	After-tax
Increase telephone plant accumulated depreciation	\$4,657	\$2,897
Adjust unamortized investment tax credits	(41)	(25)
Eliminate tax-related regulatory assets and liabilities	(88)	(88)
Eliminate other regulatory assets	55	35
Total	\$4,583	\$2,819

The increase in accumulated depreciation of \$4,657 reflects the effects of adopting depreciable lives for many of the Telephone Company's plant categories which more closely reflect the economic and technological lives of the plant. The adjustment was supported by a discounted cash flow analysis which estimated amounts of telephone plant that may not be recoverable from future discounted cash flows. This analysis included consideration of the effects of anticipated competition and technological changes on plant lives and revenues. The adjustment also included elimination of accumulated depreciation deficiencies recognized by regulators and amortized as part of depreciation expense.

Following is a comparison of new lives to those prescribed by regulators for selected plant categories:

	Average Lives (in Years)	
	Regulator-Prescribed	Estimated Economic
Digital switch	17	11
Digital circuit	12	7
Copper cable	24	18
Fiber cable	27	20
Conduit	57	50

The increase in accumulated depreciation also includes an adjustment of approximately \$450 to fully depreciate analog switching equipment scheduled for replacement. Remaining analog switching equipment is being depreciated using an average remaining life of four years.

Investment tax credits have historically been deferred and amortized over the estimated lives of the related plant. The adjustment to unamortized investment tax credits reflects the shortening of those plant lives discussed above. Regulatory assets and liabilities are related primarily to accounting policies used by regulators in the ratemaking process which are different from those used by non-regulated companies, predominantly in the accounting for income taxes and deferred compensated absences. These items are required to be eliminated with the discontinuance of accounting under FAS 71.

Additionally, in September 1995, the Telephone Company began accounting for interest on funds borrowed to finance construction as an increase in property, plant and equipment and a reduction of interest expense. Under the provisions of FAS 71, the Telephone Company accounted for a capitalization of both interest and equity costs allowed by regulators during periods of construction as other income and as an addition to the cost of plant constructed.

Notes to Consolidated Financial Statements, continued

Dollars in millions except per share amounts

3. Merger Agreement

On April 1, 1996, SBC and Pacific Telesis Group (PAC) jointly announced a definitive agreement to merge an SBC subsidiary with PAC, in a transaction in which each share of PAC common stock will be exchanged for 0.755 of a share of SBC common stock (equivalent to approximately 314 million shares), subject to adjustment as described in the merger agreement based upon an allocation of the costs, fees and expenses and other financial effects incurred or sustained in connection with obtaining state regulatory approvals. After the merger, PAC will be a wholly-owned subsidiary of SBC. The transaction is intended to be accounted for as a pooling of interests and to be a tax-free reorganization. On July 31, 1996, the shareowners of SBC and PAC each approved the transaction, which had previously been approved by the board of directors of each company. On November 5, 1996, the United States Department of Justice announced it would not initiate action on the merger under the Hart-Scott-Rodino antitrust law. The Public Service Commission of Nevada approved the merger on December 31, 1996. The FCC approved the transfer of licenses from PAC to SBC on January 31, 1997. The merger agreement is subject to certain other regulatory approvals, including approval by the California Public Utilities Commission, which has established a schedule for review of the transaction with approval expected before the end of the first quarter of 1997. If approvals are granted, the transaction is expected to close in the first half of 1997.

The pro forma effect on SBC's consolidated statements of income had the merger occurred on January 1, 1994 is as follows:

Pro Forma (unaudited):	1996	1995	1994
Operating revenues	\$23,486	\$21,712	\$21,007
Income before extraordinary loss and cumulative effect of accounting changes	\$ 3,158	\$ 2,937	\$ 2,808
Net income (loss)	\$ 3,243	\$ (3,242)	\$ 2,808
Income before extraordinary loss and cumulative effect of accounting changes per common share	\$ 3.43	\$ 3.19	\$ 3.08
Net income (loss) per common share	\$ 3.52	\$ (3.52)	\$ 3.08

This pro forma information does not include the effect of changes, which will be applied retroactively, to conform accounting methodologies between PAC and SBC for, among other items, pensions, postretirement benefits, sales commissions or merger transaction costs and certain deferred tax adjustments resulting from the merger. Based on information currently available, management estimates these changes will not materially affect the pro forma operating revenues or income before extraordinary loss and cumulative effect of accounting changes, and estimates the changes will reduce the pro forma 1995 extraordinary loss from discontinuance of regulatory accounting by between \$100 and \$200.

4. Property, Plant and Equipment

Property, plant and equipment is summarized as follows at December 31:

	1996	1995
Telephone Company plant		
In service	\$ 29,035	\$ 27,764
Under construction	312	245
	29,347	28,009
Accumulated depreciation and amortization	(17,588)	(16,882)
Total Telephone Company	11,759	11,127
Other	3,407	2,781
Accumulated depreciation and amortization	(1,159)	(900)
Total other	2,248	1,881
Property, plant and equipment—net	\$ 14,007	\$ 12,988

SBC's depreciation expense as a percentage of average depreciable plant was 6.8% for 1996 and 6.9% for 1995 and 1994.

Certain facilities and equipment used in operations are under operating or capital leases. Rental expenses under operating leases for 1996, 1995 and 1994 were \$171, \$138 and \$126. At December 31, 1996, the future minimum rental payments under noncancelable operating leases for the years 1997 through 2001 were \$105, \$91, \$94, \$51 and \$30 and \$167 thereafter. Capital leases were not significant.

5. Equity Investments

Investments in affiliates accounted for under the equity method consist principally of SBC's investment in Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company. SBC is a member of a consortium that holds all of the Class AA shares of Telmex stock, representing voting control of the company. The consortium is controlled by a group of Mexican investors led by an affiliate of Grupo Carso, S.A. de C.V. SBC also owns Class L shares which have limited voting rights. In January 1997, SBC sold a portion of its Class L shares so that its total equity investment was below 10% of Telmex's total equity capitalization.

In December 1994 SBC made an equity investment in French cellular operations (see Note 12). Other equity investments held by SBC include interests in Australian and Israeli operations which provide directory, cable television and other services, minority ownership of several domestic wireless properties and 1995 investments in Chilean telecommunications and South African wireless operations.

The following table is a reconciliation of SBC's investments in equity affiliates:

	1996	1995	1994
Beginning of year	\$1,586	\$1,748	\$1,421
Additional investments	292	409	626
Equity in net income	244	156	223
Dividends received	(70)	(62)	(89)
Currency translation adjustment	(94)	(268)	(560)
Reclassifications and other adjustments	(3)	(397)	127
End of year	\$1,955	\$1,586	\$1,748

Currency translation adjustments for 1995 and 1994 primarily reflect the effect on SBC's investment in Telmex resulting from the decline in the value of the Mexican peso relative to the U.S. dollar during those years. Beginning in 1997, SBC will use the U.S. dollar, instead of the peso, as the functional currency for its investment in Telmex due to the Mexican economy becoming highly inflationary.

Other adjustments for 1995 reflect the change to the cost method of accounting in October 1995 for SBC's United Kingdom cable television operations (see Note 12) and the reclassification of a credit deferred in 1994 pending completion of the French cellular investment in 1995. Other adjustments for 1994 reflect the change to the equity method of accounting for SBC's previously consolidated United Kingdom cable television operations.

Undistributed earnings from equity affiliates were \$837 and \$663 at December 31, 1996 and 1995.

6. Debt

Long-term debt, including interest rates and maturities, is summarized as follows at December 31:

	1996	1995
Telephone Company debentures		
4.50%-5.88% 1997-2006	\$ 600	\$ 600
6.12%-6.88% 2000-2024	1,200	1,200
7.00%-7.75% 2009-2026	1,500	1,500
8.30% 1996	-	200
	3,300	3,500
Unamortized discount—net of premium	(29)	(31)
Total Telephone Company debentures	3,271	3,469
Telephone Company notes		
5.04%-7.67% 1997-2010	1,118	950
Unamortized discount	(8)	(5)
Total Telephone Company notes	1,112	945
Other notes		
5.70%-6.98% 1996-2007	299	306
7.00%-8.81% 1996-2020	1,021	1,129
	1,320	1,435
Unamortized discount	(14)	(21)
Total other notes	1,306	1,414
Guaranteed obligations of employee stock ownership plans ⁽¹⁾		
8.41%-9.40% 1996-2000	208	260
Capitalized leases	12	26
Total long-term debt, including current maturities	5,909	6,114
Current maturities	(404)	(442)
Total long-term debt	\$5,505	\$5,672

(1) See Note 9.

During 1995, SBC refinanced long-term debentures of the Telephone Company. Costs of \$18 associated with refinancing are included in other income (expense) - net, with related income tax benefits of \$7 included in income taxes in SBC's Consolidated Statements of Income.

At December 31, 1996, the aggregate principal amounts of long-term debt scheduled for repayment for the years 1997 through 2001 were \$404, \$302, \$447, \$323 and \$270. As of December 31, 1996, SBC was in compliance with all covenants and conditions of instruments governing its debt.

Notes to Consolidated Financial Statements, continued

Dollars in millions except per share amounts

Debt maturing within one year consists of the following at December 31:

	1996	1995
Commercial paper	\$1,318	\$1,238
Current maturities of long-term debt	404	442
Total	\$1,722	\$1,680

The weighted average interest rate on commercial paper debt at December 31, 1996 and 1995 was 5.5% and 5.7%. SBC has entered into agreements with several banks for lines of credit totaling \$750. All of these agreements may be used to support commercial paper borrowings and are on a negotiated fee basis with interest rates negotiable at time of borrowing. There were no borrowings outstanding under these lines of credit at December 31, 1996.

7. Financial Instruments

The carrying amounts and estimated fair values of SBC's long-term debt, including current maturities, are summarized as follows at December 31:

	1996		1995	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Telephone Company debentures	\$3,271	\$3,208	\$3,469	\$3,553
Telephone Company notes	1,112	1,115	945	965
Other notes	1,308	1,338	1,414	1,468
Guaranteed obligations of employee stock ownership plans	208	219	260	280

The fair values of SBC's long-term debt were estimated based on quoted market prices, where available, or on discounted future cash flows using current interest rates. The carrying amounts of commercial paper debt approximate fair values.

SBC does not hold or issue any financial instruments for trading purposes. SBC's cash equivalents and short-term investments are recorded at amortized cost. Short-term investments were \$432 and \$243 at December 31, 1996 and 1995. The carrying amounts of cash and cash equivalents and short-term investments approximate fair values.

8. Income Taxes

Significant components of SBC's deferred tax liabilities and assets are as follows at December 31:

	1996	1995
Depreciation and amortization	\$2,313	\$2,166
Other	598	556
Gross deferred tax liabilities	2,911	2,722
Employee benefits	1,485	1,373
Unamortized investment tax credits	96	108
Other	563	604
Gross deferred tax assets	2,144	2,085
Deferred tax assets valuation allowance	96	110
Net deferred tax liabilities	\$ 863	\$ 747

As a result of implementing Financial Accounting Standards No. 109, "Accounting for Income Taxes," in 1993, the Telephone Company recorded a net reduction in its deferred tax liability. This reduction was substantially offset by the establishment of a net regulatory liability, which was eliminated with the discontinued application of FAS 71 in September 1995 (see Note 2).

The decrease in the valuation allowance is the result of an evaluation of the uncertainty associated with the realization of certain deferred tax assets. The valuation allowance is maintained in deferred tax assets for certain unused federal and state loss carryforwards.

The components of income tax expense are as follows:

	1996	1995	1994
Federal			
Current	\$ 940	\$421	\$ 86
Deferred—net	149	445	(122)
Amortization of investment tax credits	(32)	(42)	(61)
	1,057	824	61
State and local			
Current	92	61	103
Deferred—net	17	18	—
	109	79	103
Total	\$1,166	\$903	\$ 785

A reconciliation of income tax expense and the amount computed by applying the statutory federal income tax rate (35%) to income before income taxes and extraordinary loss is as follows:

	1996	1995	1994
Taxes computed at federal statutory rate	\$1,143	\$977	\$852
Increases (decreases) in taxes resulting from:			
Amortization of investment tax credits over the life of the plant that gave rise to the credits—1996 and 1995, net of deferred tax	(21)	(39)	(61)
Excess deferred taxes due to rate change	-	(24)	(35)
Depreciation of telephone plant construction costs previously deducted for tax purposes—net	-	14	18
State and local income taxes—net of federal tax benefit	71	51	66
Other—net	(27)	(76)	(55)
Total	\$1,166	\$903	\$785

9. Employee Benefits

Pensions Substantially all employees of SBC are covered by noncontributory pension and death benefit plans. The pension benefit formula used in the determination of pension cost is based on a flat dollar amount per year of service according to job classification for non-management employees and a stated percentage of adjusted career income for management employees.

SBC's objective in funding the plans, in combination with the standards of the Employee Retirement Income Security Act of 1974 (as amended), is to accumulate funds sufficient to meet its benefit obligations to employees upon their retirement. Contributions to the plans are made to a trust for the benefit of plan participants. Plan assets consist primarily of stocks, U.S. government and domestic corporate bonds and real estate.

Net pension cost is composed of the following:

	1996	1995	1994
Service cost—benefits earned during the period	\$ 182	\$ 163	\$ 157
Interest cost on projected benefit obligation	514	486	464
Actual return on plan assets	(1,209)	(2,017)	149
Other—net	642	1,495	(670)
Net pension cost	\$ 129	\$ 127	\$ 100

The following table sets forth the pension plans' funded status and the amounts included in SBC's Consolidated Balance Sheets at December 31:

	1996	1995
Fair value of plan assets	\$ 9,293	\$ 8,529
Less: Actuarial present value of projected benefit obligation	7,376	7,276
Plan assets in excess of projected benefit obligation	1,917	1,253
Unrecognized prior service cost	842	950
Unrecognized net gain	(2,447)	(1,608)
Unamortized transition asset	(605)	(686)
Accrued pension cost	\$ (293)	\$ (91)

Significant assumptions used in developing pension information include:

	1996	1995	1994
Discount rate for determining projected benefit obligation	7.5%	7.25%	7.5%
Long-term rate of return on plan assets	8.0%	8.0%	8.0%
Composite rate of compensation increase	4.6%	4.6%	4.6%

The projected benefit obligation is the actuarial present value of all benefits attributed by the pension benefit formula to previously rendered employee service. It is measured based on assumptions concerning future interest rates and employee compensation levels. Should actual experience differ from the actuarial assumptions, the benefit obligation will be affected.

The actuarial estimate of the accumulated benefit obligation does not include assumptions about future compensation levels. The accumulated benefit obligation as of December 31, 1996, was \$6,562, of which \$5,512 was vested. At December 31, 1995, these amounts were \$6,350 and \$5,607.

In December 1996, under the provisions of Section 420 of the Internal Revenue Code, SBC transferred \$73 in pension assets to a health care benefit account for the reimbursement of retiree health care benefits paid by SBC.

Supplemental Retirement Plans SBC also provides senior and middle management employees with nonqualified, unfunded supplemental retirement and savings plans. The plans allow employees to defer and invest portions of their current compensation for later payment, and SBC matches a percentage of the compensation deferral according to thresholds specified in the plans. Expenses related to these plans were \$69, \$68 and \$68 in 1996, 1995 and 1994. Liabilities of \$626 and \$584 related to these plans have been included in other noncurrent liabilities in SBC's Consolidated Balance Sheets at December 31, 1996 and 1995.

Notes to Consolidated Financial Statements, continued

Dollars in millions except per share amounts

Postretirement Benefits SBC provides certain medical, dental and life insurance benefits to substantially all retired employees and accrues actuarially determined postretirement benefit costs as active employees earn these benefits.

Postretirement benefit cost is composed of the following:

	1996	1995	1994
Service cost—benefits earned during the period	\$ 55	\$ 48	\$ 49
Interest cost on accumulated postretirement benefit obligation (APBO)	230	228	225
Actual return on assets	(188)	(202)	(16)
Other—net	126	144	(24)
Postretirement benefit cost	\$ 223	\$ 218	\$234

SBC maintains collectively bargained Voluntary Employee Beneficiary Association (CBVEBA) trusts to fund postretirement benefits. During 1996 and 1995, SBC contributed \$57 and \$151 into the CBVEBA trusts to be ultimately used for the payment of postretirement benefits. Assets consist principally of stocks and U.S. government and corporate bonds.

The following table sets forth the plans' funded status and the amount included in SBC's Consolidated Balance Sheets at December 31:

	1996	1995
Retirees	\$1,743	\$1,828
Fully eligible active plan participants	438	353
Other active plan participants	1,025	1,063
Total APBO	3,206	3,244
Less: Fair value of plan assets	1,155	923
APBO in excess of plan assets	2,051	2,321
Unrecognized prior service cost	(68)	(77)
Unrecognized net gain	752	459
Accrued postretirement benefit obligation	\$2,735	\$2,703

In December 1995, the life insurance benefit plan and the medical plan were merged. Also in December 1995, \$109 of postretirement life insurance assets were transferred to the CBVEBA trusts. The fair value of plan assets restricted to the payment of life insurance benefits only were \$265 and \$245 at December 31, 1996 and 1995. At December 31, 1996 and 1995, the accrued life insurance benefits included in the accrued postretirement benefit obligation were \$107 and \$91.

The assumed medical cost trend rate in 1997 is 8%, decreasing gradually to 5.5% in 2002, prior to adjustment for cost-sharing provisions of the plan for active and certain recently retired employees. The assumed dental cost trend rate in 1997 is 6.25%, reducing to 5.0% in 2002. Raising the annual medical and dental cost trend rates by one percentage point increases the APBO as of December 31, 1996 by \$135 and increases the aggregate service and interest cost components of the net periodic postretirement benefit cost for the year ended December 31, 1996 by approximately \$16. Significant assumptions for the discount rate, long-term rate of return on plan assets and composite rate of compensation increase used in developing the APBO were the same as those used in developing the pension information.

Employee Stock Ownership Plans SBC maintains contributory savings plans which cover substantially all employees. Under the savings plans, SBC matches a stated percentage of eligible employee contributions, subject to a specified ceiling.

SBC has two leveraged Employee Stock Ownership Plans (ESOPs) as part of the existing savings plans. The ESOPs were funded with notes issued by the savings plans, the proceeds of which were used to purchase shares of SBC's common stock in the open market. The notes are unconditionally guaranteed by SBC and will be repaid with SBC contributions to the savings plans, dividends paid on SBC shares and interest earned on funds held by the ESOPs.

SBC's match of employee contributions to the savings plans is fulfilled with shares of stock allocated from the ESOPs and with purchases of SBC's stock in the open market. Benefit cost is based on a combination of the contributions to the savings plans and the cost of shares allocated to participating employees' accounts. Both benefit cost and interest expense on the notes are reduced by dividends on SBC's shares held by the ESOPs and interest earned on the ESOPs' funds.

Information related to the ESOPs and the savings plans is summarized below:

	1996	1995
Benefit expense—net of dividends and interest income	\$23	\$23
Interest expense—net of dividends and interest income	11	14
Net ESOP expense	34	37
Additional savings plans stock purchases	—	—
Total expense	\$34	\$37
Company contributions for ESOPs	\$37	\$40
Dividends and interest income for debt service	\$29	\$21

SBC shares held by the ESOPs are summarized as follows at December 31:

	1996	1995
Unallocated	6,401,613	7,922,909
Committed to be allocated	13,554	25,353
Allocated to participants	11,350,052	10,183,433
Total	17,765,219	18,131,695

10. Stock Option Plans

Various SBC plans authorize the issuance of stock options to senior and other management employees to purchase up to 69 million shares of SBC common stock, of which 32 million have been issued. Options issued through December 31, 1996 carry exercise prices equal to the market price of the stock at the date of grant and have maximum terms ranging from five to ten years. Depending upon the plan, vesting of options occurs one to three years from the date of grant.

In 1996 SBC elected to continue measuring compensation cost for these plans using the intrinsic value based method of accounting prescribed in the Statement of Financial Accounting Standards No. 123, "Accounting for Stock Based Compensation" (FAS 123). Accordingly, no compensation cost has been recognized for the stock option plans. Had compensation cost for stock option plans been recognized using the fair value based method of accounting at the date of grant for awards in 1996 and 1995 as defined by FAS 123, SBC's net income (loss) would have been \$2,075 and \$(939) and net income (loss) per share would have been \$5.42 and \$(1.54).

For purposes of these pro forma disclosures, the estimated fair value of the options granted after 1994 is amortized to expense over the options' vesting period. Because most employee options vest over a two to three year period, these disclosures will not be indicative of future pro forma amounts until the FAS 123 rules are applied to all outstanding non-vested awards. The fair value for these options was estimated at the date of grant, using a Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1996 and 1995: risk-free interest rate of 6.37% and 6.31%; dividend yield of 3.45% and 3.45%; expected volatility factor of 16% and 18%; and expected option life of 4.5 and 4.6 years.

Information related to options is summarized below:

	Number of Options	Weighted Average Exercise Price Per Option
Outstanding at December 31, 1993 (2,297,538 exercisable)	9,794,665	\$36.30
Granted	5,226,551	41.71
Exercised	(386,331)	31.34
Forfeited/Expired	(498,315)	38.09
Outstanding at December 31, 1994 (5,352,273 exercisable)	14,136,570	38.37
Granted	8,101,794	47.19
Exercised	(1,413,276)	34.79
Forfeited/Expired	(362,691)	42.11
Outstanding at December 31, 1995 (8,539,081 exercisable)	20,462,397	42.04
Granted	8,287,849	50.09
Exercised	(816,179)	37.26
Forfeited/Expired	(445,448)	45.89
Outstanding at December 31, 1996 (11,962,332 exercisable)	27,488,619	\$44.55

Information related to options outstanding at December 31, 1996:

Exercise Price Range	\$27.00-39.99	\$40.00-44.99	\$45.00-57.38
Number of options:			
Outstanding	3,283,091	8,500,278	15,705,250
Exercisable	3,280,699	7,166,462	1,515,171
Weighted average exercise price:			
Outstanding	\$ 32.73	\$ 41.23	\$ 48.81
Exercisable	\$ 32.72	\$ 41.12	\$ 47.36
Weighted average remaining contractual life	5.6 years	7.2 years	6.2 years

The weighted-average grant-date fair value of each option granted during the year was \$8.32 for 1996 and \$8.45 for 1995.

11. Shareowners' Equity

Share Repurchases From time to time, SBC has repurchased shares of common stock for distribution, to offset shares distributed through its employee benefit plans and SBC's Dividend Reinvestment Plan, in connection with certain acquisitions or for general purposes. In January 1997, the Board of Directors of SBC (Board) rescinded all authorizations to repurchase common stock.

Guaranteed Obligations of Employee Stock Ownership Plans SBC's guarantee of the ESOPs' notes issued by the savings plans (see Note 9) is presented as a reduction to shareowners' equity and an increase in long-term debt. The amount of debt guaranteed decreases as the notes are repaid.

Shareowners' Rights Plan The Shareowners' Rights Plan (Plan) becomes operative in certain events involving the acquisition of 20% or more of SBC's common stock by any person or group in a transaction not approved by the Board, or the designation by the Board of a person or

Notes to Consolidated Financial Statements, continued

Dollars in millions except per share amounts

group owning more than 10% of the outstanding stock as an adverse person, as provided in the Plan. Upon the occurrence of these events, each right, unless redeemed by the Board, generally entitles the holder (other than the holder triggering the right) to purchase an amount of common stock of SBC (or, in certain circumstances, of the potential acquiror) having a value equal to two times the exercise price of \$160. The rights expire in January 1999. After giving effect to a stock split in May 1993, effected in the form of a stock dividend, each share of common stock represents one-half of a right.

The rights have certain antitakeover effects. The rights will cause substantial dilution to a person or group that attempts to acquire SBC on terms not approved by the Board.

The rights should not interfere with any merger or other business combination approved by the Board since the rights may be redeemed.

12. Acquisitions and Dispositions

In October 1995, SBC combined its United Kingdom cable television operations with those of TeleWest Communications, P.L.C., a publicly held joint venture between Telecommunications, Inc. and U S WEST, Inc. The resulting entity, TeleWest P.L.C. (TeleWest), is the largest cable television operator in the United Kingdom. SBC owns approximately 15% of the new entity and accounts for its investment using the cost method of accounting. Restrictions expiring over the next four years exist on the sale of SBC's interest in TeleWest. SBC recorded an after-tax gain of \$111 associated with the combination.

During 1994, SBC purchased two cable television systems located in Montgomery County, Maryland, and Arlington County, Virginia, for \$650. Also in 1994, SBC acquired the domestic wireless business of Associated Communications Corporation (Associated) for \$705, including wireless systems in Buffalo, Rochester, Albany and Glens Falls, New York, and in two separate transactions purchased smaller wireless systems in Syracuse, Utica and Ithaca, New York, which are adjacent to the Associated properties.

In October 1994, SBC formed a strategic alliance with Compagnie Générale des Eaux (CGE), a French diversified public company. Through this alliance, SBC acquired an indirect 10% ownership of Société Française du Radiotéléphone S.A. (SFR), a nationwide cellular company in France, and minority ownership interests in other communications businesses controlled by CGE, and CGE obtained an effective 10% interest in SBC's wireless operations in Washington, D.C.-Baltimore and surrounding

rural markets. SBC and CGE both made contributions to the alliance. SBC's effective contribution was \$376. This investment is accounted for under the equity method of accounting.

In addition to payments shown in the Consolidated Statements of Cash Flows, the 1994 acquisitions were also financed through the issuance of 16 million new and treasury shares, valued at approximately \$660, and the issuance of approximately \$360 of long-term debt. All of the acquisitions were accounted for under the purchase method of accounting. The purchase prices in excess of the underlying fair value of identifiable net assets acquired are being amortized over periods not to exceed 40 years. Results of operations of the properties acquired have been included in the consolidated financial statements from their respective dates of acquisition.

The above developments did not have a significant impact on consolidated results of operations for 1995 and 1994, nor would they had they occurred on January 1 of the respective periods.

13. Additional Financial Information

	December 31,	
	1996	1995
Balance Sheets		
Accounts payable and accrued liabilities		
Accounts payable	\$1,118	\$1,118
Accrued taxes	799	438
Advance billing and customer deposits	351	333
Compensated future absences	211	199
Accrued interest	144	141
Accrued payroll	163	117
Other	1,053	868
Total	\$3,839	\$3,125
Statements of Income	1996	1995
Interest expense incurred	\$493	\$520
Capitalized interest	(21)	(5)
Total interest expense	\$472	\$515
Allowance for funds used during construction	-	\$ 11
Statements of Cash Flows	1996	1995
Cash paid during the year for:		
Interest	\$469	\$504
Income taxes	\$830	\$690

No customer accounted for more than 10% of consolidated revenues in 1996 or 1995. Approximately 10% of SBC's consolidated revenues in 1994 were from services provided to AT&T Corp. No other customer accounted for more than 10% of consolidated revenues in 1994.

Three subsidiaries of SBC have negotiated contracts with the Communications Workers of America (CWA), none of which is subject to renegotiation in 1997. Approximately 67% of SBC's employees are represented by the CWA.

14. Quarterly Financial Information (Unaudited)

Calendar Quarter	Total Operating Revenues	Operating Income	Net Income (Loss)	Earnings per Common Share	Stock Price		
	High				Low	Close	
1996							
First	\$ 3,197	\$ 800	\$ 464	\$ 0.76	\$60.250	\$49.750	\$52.625
Second	3,333	845	501	0.82	50.750	46.250	49.250
Third	3,600	980	593	0.97	51.000	46.000	48.125
Fourth	3,768	931	543	0.90	55.250	47.000	51.875
Annual	\$13,898	\$3,556	\$ 2,101	\$ 3.46			
1995							
First	\$ 2,910	\$ 708	\$ 395	\$ 0.65	\$43.875	\$39.625	\$42.000
Second	3,025	754	442	0.73	47.875	41.625	47.625
Third ⁽¹⁾	3,292	883	(2,285)	(3.75)	55.125	45.500	55.000
Fourth ⁽²⁾	3,443	692	518	0.85	58.500	53.125	57.250
Annual ⁽¹⁾	\$12,670	\$3,037	\$ (930)	\$ (1.53)			

(1) Net Loss and Earnings per Common Share reflect an extraordinary loss of \$2,819, or \$4.63 per share, from discontinuance of regulatory accounting.

(2) Operating Income reflects \$139 in selling, general and administrative expenses associated with a strategic realignment of functions. These expenses include postemployment benefits for approximately 2,400 employees arising from the consolidation of operations within the five-state area, streamlining support and administrative functions and integrating financial systems.

Net Income and Earnings per Common Share reflect after-tax charges of \$88 for the strategic realignment of functions and \$11 for refinancing of debt and an after-tax gain of \$111 from the merger of SBC's United Kingdom cable television operations into TeleWest. The net of these transactions was \$12, or \$0.02 per share.

Report of Management

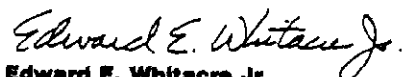
The consolidated financial statements have been prepared in conformity with generally accepted accounting principles. The integrity and objectivity of the data in these financial statements, including estimates and judgments relating to matters not concluded by year end, are the responsibility of management, as is all other information included in the Annual Report, unless otherwise indicated.

The financial statements of SBC Communications Inc. (SBC) have been audited by Ernst & Young LLP, independent auditors. Management has made available to Ernst & Young LLP all of SBC's financial records and related data, as well as the minutes of shareowners' and directors' meetings. Furthermore, management believes that all representations made to Ernst & Young LLP during its audit were valid and appropriate.

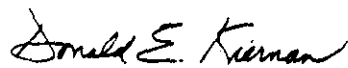
Management has established and maintains a system of internal accounting controls that provides reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition and the prevention and detection of fraudulent financial reporting. The concept of reasonable assurance recognizes that the costs of an internal accounting controls system should not exceed, in management's judgment, the benefits to be derived.

Management also seeks to ensure 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 communication programs aimed at ensuring that its policies, standards and managerial authorities are understood throughout the organization. Management continually monitors the system of internal accounting controls for compliance. SBC maintains an internal auditing program that independently assesses the effectiveness of the internal accounting controls and recommends improvements thereto.

The Audit Committee of the Board of Directors, which consists of six 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 access to the Audit Committee at any time.


Edward E. Whitacre Jr.

Chairman of the Board and Chief Executive Officer


Donald E. Kiernan

Senior Vice President, Treasurer and Chief Financial Officer

Report of Independent Auditors

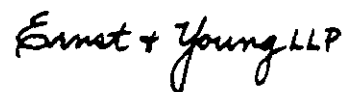
The Board of Directors and Shareowners
SBC Communications Inc.

We have audited the accompanying consolidated balance sheets of SBC Communications Inc. (SBC) as of December 31, 1996 and 1995, and the related consolidated statements of income, shareowners' equity and cash flows for each of the three years in the period ended December 31, 1996. These financial statements are the responsibility of SBC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SBC Communications Inc. at December 31, 1996 and 1995, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, SBC discontinued its application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" in 1995.



San Antonio, Texas
February 14, 1997

Executives of SBC and its Subsidiaries

SBC Senior Executives

Edward E. Whitacre Jr., 55, chairman of the board and chief executive officer.

Royce S. Caldwell, 58, president, Southwestern Bell Operations.

James W. Callaway, 50, senior vice president-strategic planning.

Cassandra C. Carr, 52, senior vice president-human resources.

William E. Dreyer, 59, senior executive vice president-external affairs.

James D. Ellis, 53, senior executive vice president and general counsel.

Charles E. Foster, 60, president, SBC Operations.

James S. Kahan, 49, senior vice president-corporate development.

Donald E. Kiernan, 56, senior vice president, treasurer and chief financial officer.

Linda S. Mills, 45, senior vice president-corporate communications.

Other Executives

Thomas M. Barry, 52, senior vice president-federal relations, SBC Telecommunications.

Liam S. Coonan, 61, senior vice president and assistant general counsel.

Patricia Diaz Dennis, 50, senior vice president and assistant general counsel-regulation and law.

Pat F. Parker, 49, president, SBC Center for Learning.

Alfred G. Richter Jr., 46, senior vice president and assistant general counsel.

A. Dale Robertson, 48, senior vice president-FCC, SBC Telecommunications.

Charles J. Roesslein, 48, vice president-strategic planning.

Judith M. Sahm, 51, vice president and secretary of the Corporation.

Van H. Taylor, 48, president and chief executive officer, Southwestern Bell Technology Resources and Southwestern Bell Communications Services.

SBC's Five-state Businesses

Stephen M. Carter, 43, vice president-general manager (special markets), Southwestern Bell Telephone.

Lea Ann Champion, 38, vice president-general manager (St. Louis), Southwestern Bell Telephone.

David A. Cole, 48, president (Texas), Southwestern Bell Telephone.

Durward D. Dupre, 53, vice president and associate general counsel-federal external affairs, Southwestern Bell Telephone.

J. Cliff Eason, 49, president and chief executive officer, Southwestern Bell Communications.

Melanie S. Fannin, 46, president (Kansas), Southwestern Bell Telephone.

James D. Gallemore, 45, vice president-marketing, Southwestern Bell Communications.

R. McRae Geschwind, 55, president and chief executive officer, Southwestern Bell Yellow Pages.

Michael N. Gilliam, 44, vice president-general manager (Arkansas), Southwestern Bell Telephone.

Edward L. Glotzbach, 48, president and chief executive officer, SBC Services.

Karen Jennings, 46, president (Missouri), Southwestern Bell Telephone.

Ronald M. Jennings, 55, vice president-general manager-operator services & public communications, Southwestern Bell Telephone.

Michael Kaufman, 51, vice president-general manager (Central/West Texas), Southwestern Bell Telephone.

Richard G. Lindner, 42, vice president and chief financial officer, Southwestern Bell Telephone.

David R. Lopez, 45, president (Oklahoma), Southwestern Bell Telephone.

Robert M. Lynch, 46, vice president and general counsel-external affairs, Southwestern Bell Telephone.

Mary T. Manning, 46, president and chief executive officer, Southwestern Bell Wireless.

Norma Martinez, 40, vice president-diversity marketing, Southwestern Bell Communications.

Wayne Masters, 51, vice president-customer services, Southwestern Bell Telephone.

Tom E. Morgan, 50, vice president-general manager (Dallas/Fort Worth), Southwestern Bell Telephone.

Edward A. Mueller, 49, president and chief executive officer, Southwestern Bell Telephone.

T. Michael Payne, 46, vice president, general counsel-operations and secretary, Southwestern Bell Telephone.

James B. Shelley, 43, president (Arkansas), Southwestern Bell Telephone.

J. Michael Turner, 47, vice president-general manager (Houston/Southeast Texas), Southwestern Bell Telephone.

Richard J. Vehige, 51, vice president-procurement services, Southwestern Bell Telephone.

Joe W. Walkowiak, 49, senior vice president-network, Southwestern Bell Communications.

Horace Wilkins Jr., 46, vice president-general manager (South Texas), Southwestern Bell Telephone.

Rayford Wilkins Jr., 45, vice president-general manager (Kansas City), Southwestern Bell Telephone.

SBC's National and International Businesses

Wayne Alexander, 48, president, SBC International (Chile).

John H. Atterbury III, 48, president and chief executive officer, SBC International Operations.

Richard C. Dietz, 50, president, SBCI Mexico, SBC International.

Drew A. Roy, 50, executive vice president and chief operating officer, Southwestern Bell Mobile Systems.

Stanley T. Sigman, 49, president and chief executive officer, Southwestern Bell Mobile Systems.

SBC Board of Directors



Edward E. Whitacre Jr., 55^(2, 4, 5)
Chairman of the Board
and Chief Executive Officer
SBC Communications Inc.
San Antonio, Texas
SBC Director since October 1986
Background: Telecommunications



August A. Busch III, 59^(2, 4, 6)
Chairman of the Board and President
Anheuser-Busch Companies, Inc.
St. Louis, Missouri
SBC Director since October 1983
SWBT Director 1980-1983
Background: Brewing, family
entertainment, transportation,
manufacturer of aluminum
beverage containers



Jess T. Hay, 66^(1, 6)
Chairman
Texas Foundation for Higher
Education
HCB Enterprises Inc
Dallas, Texas
SBC Director since April 1986
Background: Financial services



Ing. Carlos Slim Helu, 57^(3, 5)
Chairman of the Board
Grupo Carso, S.A. de C.V.
Mexico City, Mexico
SBC Director since September 1993
Background: Telecommunications,
consumer goods, automobile parts,
construction, retailing



Clarence C. Barksdale, 64^(1, 3)
Vice Chairman, Board of Trustees
Washington University
St. Louis, Missouri
SBC Director since October 1983
SWBT Director 1982-1983
Background: Banking



Ruben R. Cardenas, 66^(1, 3)
Partner
Cardenas, Whitis & Stephen, L.L.P.
McAllen, Texas
SBC Director since October 1983
SWBT Director 1975-1983
Background: Law



Admiral Bobby R. Inman, 65^(5, 6)
United States Navy, Retired
Austin, Texas
SBC Director since March 1985
Background: Private investment



Patricia P. Upton, 58^(1, 3)
President and Chief Executive Officer
Aromatique, Inc.
Heber Springs, Arkansas
SBC Director since June 1993
Background: Decorative home
fragrances



James E. Barnes, 63^(1, 2)
Chairman of the Board, President
and Chief Executive Officer
MAPCO Inc.
Tulsa, Oklahoma
SBC Director since November 1990
Background: Diversified energy



Martin K. Eby Jr., 62^(1, 5)
Chairman of the Board and
Chief Executive Officer and
President
The Eby Corporation
Wichita, Kansas
SBC Director since June 1992
Background: General building
construction



Charles F. Knight, 61^(2, 4, 5)
Chairman, President and
Chief Executive Officer
Emerson Electric Co.
St. Louis, Missouri
SBC Director since October 1983
SWBT Director 1974-1983
Background: Electrical
manufacturing

Committees of the Board:

- (1) Audit
- (2) Corporate Development
- (3) Corporate Public Policy
and Environmental Affairs
- (4) Executive
- (5) Finance/Pension
- (6) Human Resources



Jack S. Blanton, 69^(4, 6)
Chairman
Houston Endowment, Inc.
President and Chief Executive Officer
Eddy Refining Company
Houston, Texas
SBC Director since October 1983
SWBT Director 1977-1983
Background: Petroleum products



Tom C. Frost, 69^(2, 4, 5)
Senior Chairman of the Board
and Chief Executive Officer
Cullen/Frost Bankers, Inc.
San Antonio, Texas
SBC Director since October 1983
SWBT Director 1974-1983
Background: Banking



Dr. Haskell M. Monroe Jr., 65^(3, 5)
Professor of History
The University of Missouri-Columbia
Columbia, Missouri
SBC Director since October 1983
SWBT Director 1982-1983
Background: Education,
administration

Shareowner Information

Toll-Free Shareowner Hotline

Call us at 1-800-351-7221, toll-free, from 8 a.m. and 5 p.m. Central Time. TDD 1-888-296-5221.

We can help with:

- account inquiries;
- requests for assistance including stock transfers and
- information on the Dividend Reinvestment Plan.

Written Requests

Please mail check and requests for transfer, transfers of stock transfers or account changes and other requests for assistance with regard to your stock ownership to:

SBC Communications Inc.
c/o The Bank of New York
60 Wall Street, Suite 100
P.O. Box 11272
New York, New York
10286-1272

Or, if you cannot mail your request, please write to:

Dividend Reinvestment Plan

The SBC Dividend Reinvestment Plan (DRP) allows shareowners to purchase SBC stock when a dividend is paid. One share is enrolled in the plan. Optional cash investments and automatic monthly deductions into an Individual Retirement Account are available.

To request a prospectus, correspond about your DRP account or send optional cash investments, write:
SBC Communications Inc., DRP
c/o The Bank of New York
P.O. Box 239
Newark, New Jersey
07101-0239

Stock Trading Information

Trading: SBC is traded on the New York, Chicago, and Pacific stock exchanges, as well as The London Stock Exchange and The Stock Exchange.

Ticker symbol: NYSE: SBC

Delisting: stock listed on SBC Common: SBC

Information on the Internet

Information about SBC is available on the Internet. To find out more, please visit: <http://www.sbc.com>

Annual Meeting

The 1997 Annual Meeting of Shareowners will be held at 10:00 a.m. on Friday, May 1, 1997, at:

Grand Hyatt Hotel
800 Lexington Avenue
New York, New York 10017

Independent Auditors

Ernst & Young
1300 Peachtree Street, N.E.
Atlanta, Georgia 30309
SBC Atlanta Office: 404-525-4000

Requests for 10-K or Audiocassette

For a copy of our 10-K or an audiocassette of our 1996 annual report, please write or call: To request, and of price, call:
Superior Shareowner Communications
210-351-2000

Investor Relations

Security and Shareholder member of the professional financial community. Investor Relations:
210-351-2000

Product Information

For information on SBC and services, please call:

Southwestern Bell Telephone
1-800-221-1111
For Yellow Pages:
Admission: 1-800-221-1111

Southwestern Bell Yellow Pages
1-800-221-1111

To order telephone directories, call: 1-800-221-1111

Messaging services
1-800-221-1111

Cellular Service

For information on cellular service, please call:
Southwestern Bell Cellular
1-800-221-1111

For more information, call:
1-800-221-1111

For more information, call:
1-800-221-1111

For more information, call:
1-800-221-1111

For more information, call:
1-800-221-1111

General Information — Corporate Offices

SBC Communications Inc.
1000 R
P.O. Box 11272
New York, New York 10286-1272
212-621-3333

For help with your shareowner account and information on SBC's stock price or dividends, please call our toll-free number —

1-800-351-7221.
TDD 1-888-296-5221



100% recycled paper, including the cover, with 10% recycled content, including 10% post consumer waste. Printed on recycled paper.

SBC Communications Inc.
175 E. Houston
P.O. Box 2933
San Antonio, Texas 78299-2933
210-821-4105



Markets



Excellent Position.

SBC has access to more than 90 million customers in seven of the top 10 U.S. markets and more than 300 million customers internationally.

Great

Businesses



Strong Core Businesses.

Between 1993 and 1997, SBC increased its total number of access lines and wireless customers nearly 29%.

Execution



Outstanding Return.

SBC's total annual compounded shareowner return since divestiture is one of the strongest in the industry.

*assumes quarterly reinvestment of dividends

Dramatic Industry Growth.*Expanding opportunities.Page 6***Dynamic Domestic Markets.***Positioning ourselves in top U.S. markets.....Page 7***International Growth Opportunities.***Building our global base.Page 8***Powerful Network.***Strengthening our backbone.Page 11***Vertical Services Goals.***Growing revenues with proven products.Page 12***Wireless Strength.***Building customers in key markets.Page 13***The Long Distance Potential.***Ready to seize the opportunity.Page 13***Merger Value.***Gaining real benefits.Page 15***Customer Service.***Setting us apart.Page 16***Local Competition.***Meet us in the marketplace. Now.Page 17*

SBC, which operates under some of the industry's strongest brands, is ranked by a survey held in the October 21, 1987 issue of Fortune as the world's most admired telecommunications company.

Gr 1

THE SBC VALUE EQUATION



and Business 8.

Financial Information (dollars in millions)	1997	1996	Change
Reported earnings	\$ 1,474	\$ 3,189	(53.8)%
1997 Special charges	\$ 1,890	\$ —	—
Adjusted earnings	\$ 3,364	\$ 3,189	5.5%

Adjusted earnings exclude \$1.9 billion of one-time charges principally for strategic decisions related to the merger of SBC and Pacific Telesis, as described on Page 19.

Per Basic Share of Common Stock	1997	1996	Change
Adjusted earnings	\$ 1.84	\$ 1.73	6.4%
Dividend	\$.895	\$.86	4.1%
Year-end stock price	\$ 36.625	\$ 25.938	41.2%

Per basic share amounts restated for the two-for-one stock split, as described on Page 44.

DEAR FELLOW INVESTOR:

The principle that guides our business

more than any other is a commitment to creating

shareowner value. This guiding principle served us well in navigating

the most eventful — and perhaps the most important — year in SBC Communications' history as a publicly traded company. Nineteen-ninety-seven provided more challenges than some companies face in a decade. But through it all, SBC delivered superior results for our owners. Moreover, SBC's commitment to shareowner value enabled us to make 1997 a solid foundation for success in 1998 and for many years to come. In the process, we validated our simple but effective formula for creating Great Value for our shareowners. For SBC, Great Value is the sum of Great Markets, Great Businesses and Great Execution.

As expected, our merger with Pacific Telesis slowed net income growth, interrupting a five-year pattern of double-digit earnings increases. But thanks to swift integration of the merged companies and investments in key markets and businesses, we target a return to double-digit earnings growth by 1998.

This report will detail that formula, and how we have followed it to deliver the best value to you as an owner of the company. Others have noticed. Your company is now ranked as the world's "most admired" telecommunications company in *Fortune* magazine's survey of our industry's executives, directors and financial analysts. Not bad for a company that is only beginning to seize some of its most promising opportunities. Viewed from that perspective, 1997 was just a warm-up for some great years ahead. We did not digress from our strategy of growth in networked businesses, growth in wireless businesses and growth through participation in high-potential international markets. On the contrary, we positioned SBC even more strongly to deliver on that strategy.

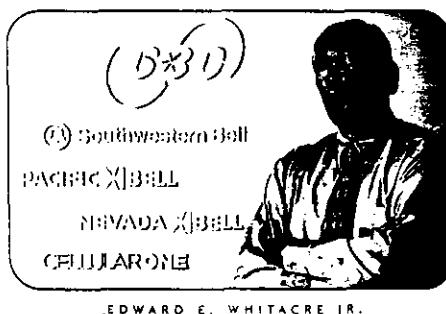
Our strategy now is more important than ever. Increased competition and deregulation worldwide create a tough environment for those unfamiliar with how to compete successfully. But the telecommunications industry offers tremendous potential for companies, such as SBC, that know how to identify and seize opportunities.

There's much room for optimism at SBC, and that optimism comes from the way SBC and its people met the challenges of 1997.

Completing the Pacific Telesis Merger: This is the first comprehensive report to shareowners since our merger with Pacific Telesis, and it will show that SBC smoothly and successfully completed one of the largest mergers in history. We moved quickly to develop some 250 initiatives focused on value creation — identifying new revenue opportunities, achieving economies of scale, eliminating duplication and adopting best practices. Today's SBC has the opportunity to realize significant benefits created by the merger. Those potential benefits include \$1.2 billion in annual expense savings and \$500 million in incremental annual revenue by the year 2000.

We now have the plans and assets in place to capture the full benefits of the new SBC's increased marketing strength; of its greater access to Mexican and Asian markets; of the huge untapped potential we see in California for sales of vertical services, such as Caller ID; and of the dynamic growth we expect in our two largest markets in the United States — California and Texas. These two states are expected to add 8.5 million new residents and 4.4 million new jobs over the next decade, and account for 37 percent of all U.S. population growth over the

next three decades. They already account for a quarter of all high-tech jobs in the United States, and California alone can lay claim to 35 percent of worldwide Internet traffic. Clearly, we are going forward from a position of great strength. A similar strategy drives our proposed merger with Southern New England Telecommunications, announced in early January: Seize the tremendous opportunities in wireline and wireless businesses.



EDWARD E. WHITACRE JR.

Growing Wireless: Although launching wireless Personal Communications Services (PCS) in California and Nevada incurred heavy expenses, it also generated outstanding results. The original goal was to end the year with 250,000 subscribers. A very strong customer response led us to push that goal to 325,000, and by year's end we had nearly 340,000 subscribers.

A similarly strong push in Southwestern Bell's five states and in our Cellular One markets brought the net total of new wireless subscribers during 1997 to more than 1 million. SBC's total wireless customers now number 5.5 million, and we are among the leaders in the industry with a 12.2 percent penetration in our non-PCS network-based markets. We expanded our subscriber base by offering the services customers have told us they want, such as prepaid wireless and digital service, and by continuing to emphasize our larger calling areas, superior distribution network and unmatched customer service. We are under increasing pressure from competitors, but in the wireless market competition really seems to drive overall demand.

Pursuing Long Distance. Providing long distance service within our seven-state territory continues to be a primary objective. Through our wireless subsidiaries, we already serve 3.6 million long distance customers. They clearly want to buy all their service from one company, and we want to give them that choice. Getting there, however, has proven more difficult and costly than anyone reasonably expected.

Last year in Oklahoma, SBC became the first Bell company to complete the entire process of applying to the FCC for permission to offer interstate long distance service. That application, like every Bell company application to follow, was rejected by federal regulators. Nevertheless, SBC believes we have met our obligations under the 1996 Telecommunications Act and moved aggressively to open our local markets. We are meeting new competitors in the marketplace; by year's end, SBC had processed more than a million service orders for competitors who are reselling our local service or using our network to provide service to their customers.

Additionally, SBC pursued — and continues to pursue — every opportunity to win regulatory relief and create a level playing field for all competitors. We have challenged in federal court the FCC's interpretation of the law, and the courts have upheld our position on some key issues. We have contested as unconstitutional that portion of the Telecommunications Act which bars SBC from offering long distance service. We will keep knocking on the long distance door until it opens. And when it does, we will finally see the significant new competition that will generate new business opportunities and customer benefits.

Given these and other challenges we faced in 1997, it is fair to ask, how did we do on behalf of our shareowners?

Earnings. As expected, the merger with Pacific Telesis slowed net income growth, interrupting a five-year pattern of double-digit increases. Thanks to our swift implementation of the merger, we intend it to be a brief interruption. Overall it was a solid year for earnings considering the costs of completing the merger and rolling out PCS wireless service. We incurred \$1.9 billion in special charges during 1997, including the effects of strategic decisions resulting from a comprehensive operations review of the merged company. By 2000, the benefits of the merger should add \$1 billion a year in additional net income, providing the flexibility to seize opportunities as they arise. Our goal is to return to double-digit earnings growth in 1998.

Revenues. Our revenue growth in 1997 was attributable to very strong performance in our core businesses, reflecting solid growth in access lines, vertical services, data services and wireless subscribers, including PCS. With a focus on growing vertical services and Caller ID in California, we're targeting substantial revenue growth.

Total Return on investment. We realized a one-year total return of 45.49 percent. Since divestiture in 1984, SBC's total annual compounded return has been 21.22 percent, versus a combined 18.92 percent by our telecommunications peers.

As I said at the outset, our ability to extend that kind of performance well into the future is based on a simple formula ...three elements that add up to **Great Value** for our shareowners.

Our Markets: However you define "market" — by geography, by customer group, or any other way — SBC is in the right places at precisely the right time. Worldwide demand for telecommunications services continues to grow at a record pace. Here and abroad, SBC is positioned to meet that demand...with a potential domestic customer base of 90 million and the ability to serve more than three times that many customers through fast-growing overseas operations in countries such as South Africa, France and Mexico.

Our Businesses: SBC operates strong, growing businesses under some of the most respected brand names in our industry — Southwestern Bell, Pacific Bell, Nevada Bell and Cellular One. Across all of those brands, we continue to see growth in access lines, vertical services, wireless and data services. And as the nation moves closer to a fully competitive marketplace, we see more and more potential to expand into exciting new businesses.

Our Execution: The best markets and businesses in the world are not worth much without managers who develop clear, workable plans, then work with a talented team of dedicated employees to execute those plans. I believe SBC has the finest people in the industry today, and they work tirelessly — one day at a time, one customer at a time — to ensure that our markets and businesses really do add up to great shareowner value.

Creating that value is where SBC's success begins and ends. Your investment in SBC is a vote of confidence and we — managers, employees and the Board of Directors — are obligated to respond with a healthy return. We know you look to SBC for solid growth and entrust us with helping you meet important goals, like funding education or retirement plans. We took significant steps to earn that confidence and trust in 1997. You have my absolute commitment that we will strive to continue to earn your support in the years ahead.

Edward E. Whitacre Jr.

Edward E. Whitacre Jr., Chairman and Chief Executive Officer
February 20, 1998

THE SBC EQUATION

*We explore on the
following pages our
simple but effective
formula for creating
value for our
shareowners. —*

→ The telecommunications industry is

exploding, and SBC is prepared to take advantage of the opportunities

this growing marketplace presents. Our merger with Pacific Telesis provides tremendous access

to some of the hottest markets in the industry. → Nearly a quarter of the Fortune 500

companies are headquartered in our seven states of Arkansas, California, Kansas, Missouri,

Nevada, Oklahoma and Texas. And we're in key wireless markets outside our seven states,

including Boston, Chicago, central Illinois, upstate New York and Washington, D.C. →

Domestically and internationally, our operations are in large and growing markets with

increasing demand for telecommunications services. We are proud to be in markets where our

customer relationships span decades.

Markets



UNITED STATES

Los Angeles

Chicago

Baltimore/Washington, D.C.

San Francisco/Oakland/San Jose

Boston

Dallas/Ft. Worth

Houston

National Reach.

*Serving seven
of the top 10
U.S. markets*



CHILE



CHINA



FRANCE



ISRAEL



MEXICO



SOUTH AFRICA



SOUTH KOREA



SWITZERLAND



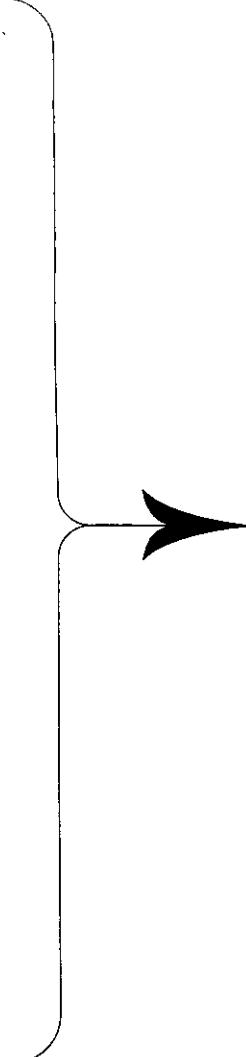
TAIWAN



UNITED KINGDOM

Global Reach.

*Serving areas
with more than
300 million
customers
internationally*



SBC is positioned in
the *right places* at the
right time to take
advantage of this growth.

DYNAMIC DOMESTIC MARKETS

*With the Pacific Telesis merger,
SBC created one of the strongest market combinations in the industry.*

By 2000, the global telecommunications market is expected to produce revenues of \$1.3 trillion, more than double its value in 1995. In the United States, telecommunications now generates one dollar of every eight in the gross domestic product, more than the auto, food or construction industries create.

This dramatic growth can be attributed in part to high-quality, dependable telephone service that has inspired customers' trust. SBC has played a major role in building that trust, and today offers products and services under highly respected brand names — Southwestern Bell, Pacific Bell, Nevada Bell and Cellular One.

Customers are increasing their demand for fax and data transmission, more lines for convenience, wireless communications and

long distance, and they want to receive these services from one company.

We are positioned to seize this growth opportunity: Our seven-state region is one of the strongest market combinations in the industry.

Texas and California have the largest populations and some of the fastest growth in the country. Together, they are expected to add 8.5 million residents over the next decade and to account for 37 percent of all U.S. population growth in the next 30 years. Our markets are also opening to competition for services such as long distance. This combination is creating a much bigger opportunity — one that SBC is positioned to seize.

Because the economies in our markets are strong, customers have more disposable income to

buy telecommunications services. While the U.S. economy is expected to grow at a compounded annual rate of 2.0 percent over the next five years, California and Texas are anticipated to expand gross state product by 3.3 percent and 2.8 percent, respectively.

Job growth is also strong, which is a leading indicator of demand for telecommunications services, especially in markets receptive to new technology. Over the next 10 years, California and Texas are expected to add 4.4 million new jobs.

These states also are home to 25 percent of the nation's high-technology jobs. High-tech environments tend to be more open to data products, which are growing faster than voice products, and present impressive opportunities for SBC to increase vertical services and data product offerings.

We estimate the growth rate for Internet and data use at seven times the annual increase for voice transmissions. California alone is home to more than one-third of names registered on the worldwide web.

We are also well positioned in wireless operations. We provide service in some of the most attractive markets beyond our seven states, including Chicago, central Illinois, Boston, upstate New York, Baltimore and Washington, D.C.

Our proposed merger with Southern New England Telecommunications provides us an even stronger foothold in the Northeast as we enter Connecticut — our eighth state for wireline services — to take advantage of wireless and other businesses that geographically complement our operations there.



Borderless Service

Studies have shown that nearly 50 percent of U.S. calls to Mexico originate in SBC's seven-state region.

INTERNATIONAL OPPORTUNITIES

Over the past 10 years, we have built an international portfolio that includes operations in 10 countries on five continents.

We invest where we find the best prospects of building value for SBC shareowners. We look for strong partners, opportunities that allow us to emphasize our role in operations, and the potential to win long-term customers. In a little over a decade, SBC has built an international portfolio on initial investments of about \$3 billion, of which \$1 billion was invested in 1997 alone.

In addition to making direct investments, we also benefit from increasing international telecommunications traffic. Studies have shown that nearly 50 percent of U.S. calls to Mexico originate in SBC's seven-state region. Adding incoming calls, SBC market areas participate in 60 percent of the telephone traffic between the United States and Mexico. Where voice transmissions exist, data will follow, so opportunities build.

That growth complements two developments driving new opportunities worldwide: Privatization,

including the opening of European telecommunications markets, and the increasing demand for wireless services. Each offers opportunities for SBC.

Following are highlights of our international investments.

South Africa. Our initial investment in cellular service formed the springboard for greater involvement in South Africa's telecommunications market. We purchased an 18 percent stake in Telkom South Africa in early 1997, and it contributed positively to earnings in the first year. Only about 10 percent of South Africans have access to telephone service, so a high priority is to expand the number of lines by 75 percent in the first five years. We can help make that happen through a significant role in day-to-day management of the company's operations and an exclusive franchise for five years.

Europe/Middle East. France, with its high per capita income, offers long-term growth opportunities for SBC. Our involvement is through a consortium invested in Cegetel, a company that provides communications service nationwide, including cellular, long distance and local services. In our first two years, Cegetel more than quadrupled its cellular subscribers and doubled its market share to almost 40 percent. Although we don't know how rapidly the market will evolve, if the development of the French wireless market continues to parallel that of the United States, Cegetel could add more than 9 million customers in the next four years and achieve a market penetration of almost 15 percent.

Like most of Europe, France and Switzerland are opening their long distance markets to competition in 1998. As that happens, we expect to offer local, long distance, data and wireless services in both countries. In Switzerland we formed a consortium (diAx) with six Swiss electric utilities in which we have a management role. Switzerland has one of the world's highest ratios of telephones per capita, and revenues per access line are the highest of any country in the world — 50 percent higher than in the United States.

SBC also holds a 15 percent interest in TeleWest, the largest cable/telephony entity in the United Kingdom, and a 50 percent stake in AUREC Group, an Israeli cable television and publishing company.

Asia. Asia's telephone density is less than one-half the world average, and the number of wireless customers is only about the same as in the United States. Our goal is to provide telecommunications services where it makes business and economic sense.

In South Korea, we are part of a consortium designing, building and operating the country's second nationwide cellular network. Our investment there gave us a foothold in Asia, which we expanded in 1997 by winning a regional license for cellular service in Taiwan.

Finally, one of the most exciting and strategic Asian developments is the undersea fiber-optic cable project linking China and the United States. SBC is the only regional Bell company among 14 companies participating worldwide. The China-U.S. network is expected to be in service by 1999.

This investment secures significant future long distance capacity to and from Asia. With California's proximity to the Pacific Rim, we are well positioned to take advantage of this opportunity.

Latin America. SBC owns a stake in Teléfonos de México (Telmex), Mexico's national telecommunications company and the largest telecommunications provider in Latin America. Since 1990, when it was privatized, Telmex has spent more than \$12 billion modernizing its infrastructure. For example, it has increased digital exchanges from 29 percent to 90 percent.

Such quality improvements benefited Telmex as its domestic market opened to competition in 1997: Given a choice, most customers remained loyal.

Telmex is positioned to benefit from the improving Mexican economy and expanded demand for telecommunications services as well as its potential entry into the U.S. long distance market.

We also own over 44 percent of VTR, a Chilean company offering a wide range of telecommunications services.



Opportunity Calls

With half of the world's population having yet to make a telephone call, the opportunities abound for SBC to create long-term share-owner value.

— Strong markets become even more

valuable as we grow our businesses. — We carefully invest in products

and services that keep us competitive and those that produce the highest return for our shareowners. SBC's 1997 growth confirms that we are investing in the right businesses:

Access lines grew by 5 percent, additional lines increased 16 percent, wireless subscribers grew 24 percent and Integrated Service Digital Network (ISDN) lines grew 70 percent.

— Strong brands also make a difference. SBC operates under some of the most respected names in the industry — Southwestern Bell, Pacific Bell, Nevada Bell and Cellular One — which helps us compete for a greater share of the growing telecommunications market.

Businesses

NETWORK BACKBONE

Invested over \$23 billion in the network over the last five years

PCS

Invested in all-digital wireless network in California and Nevada

VERTICAL SERVICES

Targeting \$100 million in new revenue from California Caller ID effort by 2000

Growth Strategy.

Building businesses that keep us competitive

RELIABILITY

- Dependable dial tone 99.9 percent of the time

WIRELESS LEADERSHIP

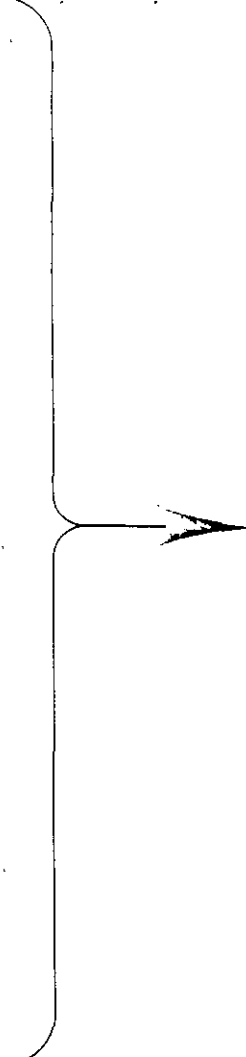
- Grew wireless subscribers 24 percent

REVENUE DRIVER

- Increased industry-leading Caller ID residential penetration to 47 percent in Southwestern Bell markets and grew it from 1.5 percent to 6.4 percent in California

Strategic Results.

Investing in products and services that have the highest return



In 1997, our *solid growth*
confirms that SBC is
investing in and developing
the right businesses.

THE SBC ADVANTAGE *Strong brand recognition and operating experience*

truly set us apart from competitors.

Our customers tell us they want one-stop shopping — all telecommunications services, including local, long distance, data and wireless services — from one provider. We are working to be their provider of choice.

The merger with Pacific Telesis brought together critical skills for successful growth in many areas. Southwestern Bell brings wireless expertise, industry-leading marketing abilities and financial discipline, while Pacific Bell offers extensive experience in data networks, Internet development and expense control.

Networks are key to our businesses, and over the past five years, SBC has invested more than

\$23 billion to keep our networks strong. More than 91 percent of our switches are digital; we have more than 1.8 million miles of fiber strands grouped into 42,000 miles of cable; and we have more than 2,700 SONET (Synchronous Optical Network) fiber rings for reliable transmission. This infrastructure enables us to deliver a high-quality, dependable dial tone 99.9 percent of the time.

A focus on building strong networks has allowed SBC to build value in core operations while setting the stage to extend that value through new revenue streams.

SBC balances the need to grow existing services with the desire to be among the first-to-market with new products.

Over the past year, SBC significantly increased sales of existing, high-speed data services such as Integrated Services Digital Network (ISDN) and frame relay through creative marketing.

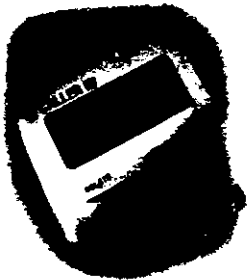
We created Turbo Access ISDN, which includes product installation and inside wiring so that all customers have to do is sign up. Frame Relay is another high-speed service that allows data to be exchanged very quickly. SBC developed FasTrak Managed Frame Relay Service for customers who want to outsource existing frame relay networks. We launched FasTrak DSL, based on Asymmetric Digital Subscriber Line technology (ADSL), in a limited number of cities, and we expect a broader launch in 1998. ADSL enables high-speed digital

data service over existing copper lines.

Also new is our Internet/Intranet Transport Service (IITS), designed to route Internet traffic from the voice network to a high-speed data network.

Our reputation for reliability is driving demand for our Internet service. In fact, *Business Week* magazine recently ranked Southwestern Bell and Pacific Bell Internet Services as No. 1 and No. 2, respectively, in percentage of successful connections.

As the demand for high-speed data services increases, SBC will continue to see a solid return on investment in this high-growth area.



Caller ID Growth

SBC has a goal of 50 percent Caller ID residential penetration in California and hopes to generate \$100 million in new revenue from this effort by 2000.

VERTICAL SERVICES OPPORTUNITIES

Our vertical services strategy is simple: create more value from existing assets.

The more services a customer has on one telephone line, the greater the revenue produced by that line. As we increase our access lines, we are selling more services on those lines.

In fact, Southwestern Bell leads the industry with an average of 2.27 vertical features per line. We are sharing the expertise gained in the Southwestern Bell markets at Pacific Bell, where the average is 0.73 features per line. The goal is to increase this average to 1.15 features by 2000 through a combination of promotion, sales skills training, packaging, third-party sales and strategic pricing changes. These efforts should produce \$100 million in new revenue by 2000.

In Caller ID, SBC has an industry-leading residential market penetration of 47 percent in its Southwestern Bell markets. Caller ID penetration in California increased from about 1.5 percent in 1996 to 6.4 percent in 1997. Pacific Bell is targeting 30 percent residential penetration and an additional \$100 million in new annual revenue by 2000 from this effort.

Key to our success is helping customers understand the benefits of Caller ID and reducing the number of lines that block Caller ID, a common problem in California. At the end of 1997, one million more customers chose to let their numbers show. We are continuing our customer education campaigns and adding features such as Caller Name to increase the value of Caller ID.

Diversity marketing practices will help; for example, Southwestern Bell and Pacific Bell employees communicate with customers in eight languages.

New products such as Call Waiting Deluxe, which will be introduced in 1998, help customers use their telephones more efficiently. At the same time, SBC gains more of the telecommunications dollar from high-volume customers. Call Waiting Deluxe displays the name and number of the person calling even when the customer is on another call. This new product will be part of a complete SBC call management system.

With 5.5 million wireless subscribers, SBC is one of the largest and strongest wireless providers in the world.

We have a 13-year record of successful wireless business strategies and a 12.2 percent wireless penetration rate, one of the highest in the industry, in our traditional, network-based cellular markets. In 1997 alone, SBC added 1 million wireless subscribers, including nearly 340,000 for Personal Communications Services (PCS) at Pacific Bell Mobile Services.

In California and Nevada, SBC offers PCS under the Pacific Bell and Nevada Bell brand names. In the southwest region and select markets throughout the country — including Chicago, central Illinois, Boston, upstate New York, Baltimore and Washington, D.C. — SBC offers wireless services under the Southwestern Bell and Cellular One brand

names — names customers have come to trust for reliable, dependable service.

The success of our PCS launch in California and Nevada exceeded our expectations and we are growing the business. We invested \$770 million to build out our all-digital PCS network that covers the major roadways to reach 90 percent of California and Nevada residents.

Among 35 million people living in both states, there are only an estimated 7 million wireless customers — a substantial growth opportunity for the new PCS services.

An all-digital PCS network, strong cellular markets and operational experience give us a strong competitive advantage.



THE LONG DISTANCE OPPORTUNITY

Providing long distance in our markets is a top priority.

The Telecommunications Act of 1996 offered hope that Bell companies would no longer be barred from the long distance business.

SBC challenged portions of the Act that unfairly singled us out, and we continue to open our markets to local competition as required by the Act, which we never contested. Our goal is to provide long distance service, and we are pursuing a dual-track process — through the application process in each state and through legal channels — to gain entry into this business. We want the support of and will continue to work with the FCC, the U.S. Department of Justice and state regulators to show that we have opened our markets.

Overall, long distance in our service territory is about a \$13 billion opportunity. Assuming a 15 percent to 20 percent penetration rate — which other companies have achieved — our revenue opportunity from long distance could be

\$1.5 billion to \$2 billion annually.

Long distance is a natural product extension of our existing telecommunications business. Through our wireless subsidiaries, we already serve 3.6 million long distance customers.

When we are allowed to do so, our strategy is to enter the market as a reseller of long distance service to all customers in our seven-state region.

Reselling has many advantages. It gives us a low entry cost and flexibility. We can better control costs during a phased rollout of the service by market as the FCC grants authority, and we can maintain appropriate margins.

Longer term, we plan to build or acquire network facilities that will allow us to offer service through our facilities when it makes economic and business sense.

PCS Strategy

Our PCS launch in California and Nevada shows the value of offering a high-quality product under strong brands.

→ *The ability to spot and seize*

opportunities has enabled us to build strong businesses in growing markets — and derive the maximum value from each opportunity. SBC has a solid track record of converting acquisitions to long-term shareowner value. Meanwhile, we divest ventures when they do not bring value to our shareowners, as demonstrated in scaling back our direct involvement in video services in 1997. → SBC's deliberate management style guided us through our merger with Pacific Telesis. It continues to provide the framework to address industry issues, such as local competition, and make sound, strategic investments here and abroad.

Execution

CUSTOMER FOCUS

- Making nearly 10 million customer contacts a month

SWISS OPPORTUNITIES

- Managing role in Switzerland consortium with plans to offer local, long distance, data and wireless services

GROWING FRENCH WIRELESS

- Doubled wireless market share to 40 percent in the first two years

Recognizing Potential.

Seeing the value in each opportunity

PACIFIC TELESIS

- Identified opportunities to add \$1 billion in net income by 2000

CELLULAR ONE

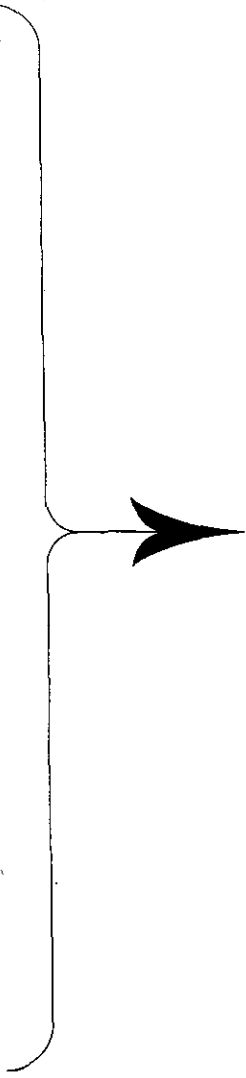
- Today boasts industry-leading wireless penetration

SOUTH AFRICA

- An 18 percent stake in Telkom South Africa that already has had a positive effect on earnings

Seizing Opportunities.

Converting acquisitions to shareowner value



Becoming the
world's *most admired*
telecommunications company
was no accident.

THE VALUE OF THE MERGER

SBC's recognition by Fortune magazine underscores the reputation and record of success resulting from our disciplined management approach and focus on creating long-term shareowner value.

SBC's merger with Pacific Telesis is a solid example of seizing an opportunity to generate greater returns as one company than either company could have achieved alone.

The key to unlocking the value of the merger has been the swift integration of the two companies. Within a week of completing the April 1, 1997, merger, we assembled more than 50 employee value-creation teams to evaluate all aspects of the combined business. The teams identified 250 initiatives, each with an associated business plan with direct ties to compensation for performance.

Based on these initiatives, SBC identified opportunities to add \$1 billion annually to net

income by 2000. This opportunity is the after-tax combination of \$500 million in revenue and \$1.2 billion in expense savings. In addition, more than \$300 million in annual capital savings are targeted by 2000.

Realizing the full value of the merger involves some initial costs. We expect to incur about one dollar of cost for each dollar of opportunity identified, so the full value of the merger will not be reflected in our operating results until 2000.

Our initiatives focus on identifying new revenue opportunities, taking advantage of scale, eliminating duplication and adopting best practices.

Revenue Opportunities: Reaching our \$500 million revenue goal by 2000 will depend largely on increasing our revenue per access line through efforts such as increasing the level of vertical services penetration and through products such as Caller ID (See Section on Great Businesses).

Taking Advantage of Scale: SBC's new combined buying power should help to save about 7 percent in procurement costs. We estimate saving \$500 million per year by 2000 — \$200 million in expense and \$300 million in capital — through these efforts.

Eliminating Duplication: About \$350 million in savings will come from combining similar services within each company without losing quality or our customer focus. After careful review,

we are consolidating our network operating centers from 48 to six; telemarketing centers from 10 to four; and collection centers from 24 to 13 without sacrificing quality or service.

Adopting Best Practices: We were fortunate to find outstanding practices in both companies and have been quick to use the best of each. Our goal is to save \$650 million in expenses through these initiatives by 2000.

Some of these practices include innovative ways to increase productivity while improving customer service. For example, we have adopted Global Positioning System (GPS) technology to help track and dispatch our thousands of trucks to service calls more quickly. Our pilot program in Dallas shows that GPS use reduces the time required to complete service calls.



Customer Care

In 1997, over 50 percent of the positions we added in California have customer contact — installation and repair technicians and customer service representatives — which increases our opportunities to build closer customer relationships.

CUSTOMER SERVICE STRENGTH

A true test of running our business well — and what sets us apart from our competitors — is service.

SBC makes about 10 million customer contacts each month. We know that good service every day is critical to retaining and winning business.

Our customers tell us we're doing things right. In the 1997 J.D. Power & Associates Wireline Customer Satisfaction Survey, Pacific Bell and Southwestern Bell ranked number two and number three, respectively, among the 13 largest U.S. telephone companies.

As demand for telecommunications services expands, the challenge is to manage growth while reducing expenses and improving customer service. In California, we hired about 2,000 people to meet demand and market our capabilities more effectively.

Through on-the-job training programs, such as our STAR (Service That Achieves Revenue) initiative,

we are ensuring that our people listen to customer needs to match them with a range of SBC products and services.

We have also created a "virtual" sales team through linked call centers to handle demand more efficiently and offer longer hours of operation. As a result, customers can reach us when they need us, strengthening our reputation for reliable and dependable service.

The employees of SBC represent an important competitive advantage, especially through efforts like our Ambassador Program, which involves hundreds of employees as personal advocates for customers.

We intervene on our customers' behalf to make sure the service they choose is not taken from them illegally.

We have instituted campaigns that help customers understand their rights and course of action if they have been slammed.

Slamming is the unauthorized and illegal switching of a customer's service from one carrier to another. We've found that most customers who have been slammed don't realize it until unauthorized charges appear on their bills.

A related problem, dubbed cramming, is also on the increase. Cramming occurs when companies bill customers for products and services they haven't ordered, and may not have received. These activities are increasing as the number of telecommunications competitors increases.

We have introduced education programs to help customers understand the problems of cramming and slamming and their rights should these fraudulent practices affect them. And when an unwanted change occurs in their service, we become our customers' advocate, helping them to continue receiving the high-quality service we provide, which is why they chose SBC in the first place.

LOCAL COMPETITION

We're ready to meet our competitors in the marketplace.

Local competition has been a tough issue for all major telecommunications providers. As soon as the FCC considers our local markets open to competition, SBC will be allowed to offer long distance service. The way we have handled this issue while focusing on customers and shareowners has set us apart from our competitors.

Our customers say they want one-stop shopping — telecommunications services, including local, wireless, data and long distance, from one company. Our goal is to provide these services.

However, since passage of the Telecommunications Act, issues on how we can proceed have been unclear. SBC has sought to clarify these issues, resulting in court filings to protect our shareowners and ensure a level playing field to benefit customers. We are not alone; every major Local Exchange Carrier (LEC), InterExchange Carrier (IXC) and most of the states also have sought court clarification.

SBC is committed to enabling local competition. We created a Special Business Unit of more than 3,000 employees to manage compliance efforts, and through the end of 1997

spent more than \$1.1 billion to open our network to competitors.

At the end of 1997, SBC had interconnection agreements with more than 270 competing companies. About half a million access lines have been converted to Competitive Local Exchange Carriers (CLECs) and IXCs for resale in our seven-state territory. Importantly, resold lines still generate wholesale revenues for SBC.

SBC, through our Southwestern Bell subsidiary, has set the industry standard for Operational Support Systems (OSS). These highly efficient electronic order processing systems handle orders from competitors who have agreements to connect into SBC's networks. OSS is a key requirement in opening markets to competition.

We are fully prepared to meet our competitors in the marketplace. We are committed to opening our markets and are focused on offering long distance service — an investment that will truly create long-term shareowner value.



Setting the Standard

SBC's Southwestern Bell subsidiary has set the industry standard for Operational Support Systems (OSS) which handles orders from competitors who have agreements to connect into SBC's networks.

SELECTED FINANCIAL AND OPERATING DATA

Dollars in millions except per share amounts

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

^{*} Restated to reflect two-for-one stock split declared January 30, 1998.^{*} Operating data may be periodically revised to reflect the most current information available.¹ As detailed in management's discussion and analysis of Results of Operations, 1997 results include charges for several items including strategic initiatives and ongoing merger integration costs, gain on the sale of SBC's interests in Bell Communications Research, Inc. and a first quarter after-tax settlement gain. Excluding these items, SBC reported an adjusted net income of \$3.364 for 1997.² As noted in management's discussion and analysis of Other Business Matters - Restructuring Reserve, 1993 results include restructuring costs at Pacific Telesis Group. Excluding these costs, SBC reported income from continuing operations before extraordinary loss and cumulative effect of accounting changes of \$2,450.³ 1996, Change in directory accounting; 1995, Discontinuance of Regulatory Accounting; 1994-1993, Income (loss) from spun-off operations; and 1993, Early Extinguishment of Debt and Cumulative Effect of Changes in Accounting Principles.⁴ Free cash flow is net cash provided by operating activities less construction and capital expenditures.⁵ Dividends declared by SBC's Board of Directors; these amounts do not include dividends declared and paid by Pacific Telesis Group prior to the merger.⁶ Shareowners' equity used in book value per common share and debt ratio calculations includes extraordinary loss and changes in accounting principles.⁷ Calculated using income before extraordinary loss and changes in accounting principles. These impacts are included in shareowners' equity.⁸ EBITDA is earnings before interest, taxes, depreciation and amortization (operating income plus depreciation and amortization). SBC considers EBITDA an important component in our economic value added systems as an indicator of the operational strength and performance of our businesses. It is provided as supplemental information and is not intended to be a substitute for operating income, net income or net cash provided by operating activities as a measure of financial performance or liquidity.

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

Dollars in millions except per share amounts

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

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

SBC's largest telephone subsidiaries are Southwestern Bell Telephone Company (SWBell), providing landline telecommunications and related services over approximately 16 million access lines in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area),

and PacBell, providing telecommunications and related services over approximately 17 million access lines in California. SBC also provides telecommunications and related services through its Nevada Bell subsidiary over approximately 300 thousand access lines in Nevada. (SWBell, PacBell and Nevada Bell are collectively referred to as the Telephone Companies.) The Telephone Companies are subject to regulation by each of the states in which they operate and by the Federal Communications Commission (FCC).

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

RESULTS OF OPERATIONS

Summary

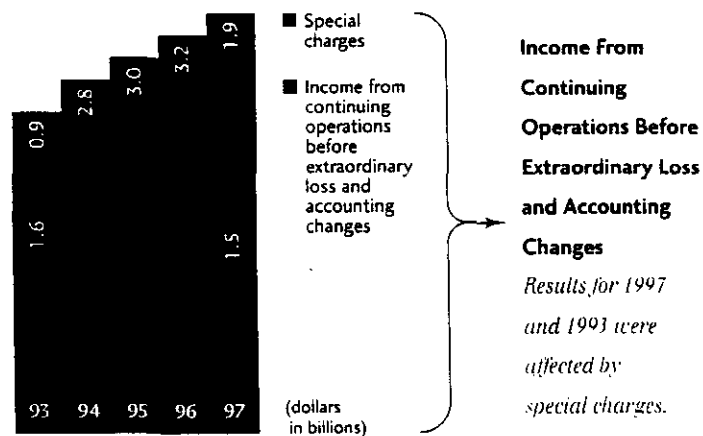
Financial results, including percentage changes from the prior year, are summarized as follows:

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

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

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

including expenses for the introduction of Personal Communications Services (PCS) operations in California and Nevada. The primary factors contributing to the increase in income before extraordinary loss and cumulative effect of accounting change in 1996 were growth in demand for services and products at the Telephone Companies and Mobile Systems.



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

MANAGEMENT'S DISCUSSION AND ANALYSIS, continued

Dollars in millions except per share amounts

Operating Revenues

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

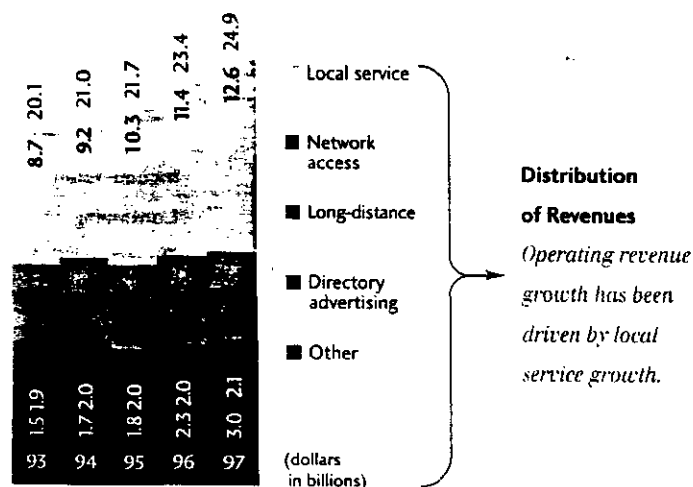
	1997	1996	1995	Percent Change	
				1997 vs. 1996	1996 vs. 1995
Local service					
Landline	\$ 9,568	\$ 8,754	\$ 8,118	9.3%	7.8%
Wireless	3,034	2,635	2,247	15.1	17.3
Network access					
Interstate	3,946	4,008	3,770	(1.5)	6.3
Intrastate	1,869	1,823	1,744	2.5	4.5
Long-distance service	2,115	2,240	2,072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

Local service Landline local service revenues increased in 1997 and 1996 due primarily to increases in demand, including increases in residential and business access lines and vertical services revenues. Total access lines increased by 5.0% in both years, of which approximately 50% was due to growth in California and over 30% was due to growth in Texas. Access lines in Texas and California account for approximately 80% of the Telephone Companies' access lines. Approximately 32% of access line growth in both years was due to sales of additional access lines to existing residential customers. Vertical services revenues, which include custom calling options, Caller ID and other enhanced services, increased by approximately 20% in 1997 and 29% in 1996. Local service revenues also reflect the implementation of the California High Cost Fund (CHCFB) that

from long-distance revenues of \$84 and intrastate network access revenues of \$26 to local service revenues in 1997. For further information on the operations of the CHCFB, see the discussion under the heading "Regulatory Environment - California." Additionally, Federal payphone deregulation in 1997 increased local service revenues and decreased long-distance service revenues and interstate network access revenues; the overall impact was a slight increase in total operating revenues. Rate reductions in 1997 due to CPUC price cap orders partially offset increases in landline local service revenues.

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

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



went into effect February 1, 1997. The California Public Utilities Commission (CPUC) has stated that the CHCFB is intended to directly subsidize the provision of service to high cost areas and allow PacBell to set competitive rates for other services. The rebalancing provisions of the CHCFB resulted in a shift

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

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

Long-Distance Service revenues decreased in 1997 due to the effect of the CHCFB discussed above, regulatory rate orders, price competition from alternative intralATA toll carriers and the introduction and deployment of extended area local service plans at SWBell. These decreases were somewhat offset by increases due to growth in wireless revenues and demand resulting from California's growing economy. Long-distance service revenues increased in 1996 due principally to increases in demand resulting from California's growing economy and to growth in Mobile Systems' long-distance revenues, including interLATA service that began in February 1996. Additionally, revenues in 1996 increased due to the reduction in 1995 from

SWBell intralATA toll pool settlement payments and accruals for rate reductions relating to an appealed 1992 rate order in Oklahoma. The settlement of the appeals in October 1995 eliminated the need to continue these accruals. These increases in 1996 revenues were somewhat offset by the impact of price competition from alternative intralATA toll carriers.

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

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

Operating Expenses

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

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

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

Selling, General and Administrative expense in 1997 reflects \$1,952 of charges relating to SBC's strategic initiatives, operational reviews and ongoing merger integration costs. As discussed in Note 3 to the Financial Statements, the most significant of these charges included shutdown of the Advanced Communications Network (ACN), regulatory costs related to the approval of the merger with SBC by California and Nevada regulators, and reorganization initiatives. Excluding these charges, expenses increased \$74, or 1.4%, in 1997. Significantly increasing expenses was the introduction of PCS operations during 1997. Other major factors contributing to the increase included growth at Mobile Systems, expenses related to new business initiatives, primarily voice messaging and Internet services, and increases in employee compensation, sales agent commissions and uncollectibles. These increases were partially offset by PAC's first quarter 1997 \$152 settlement gain

Dollars in millions except per share amounts

associated with lump-sum pension payments that exceeded the projected service and interest costs for 1996 retirements. Selling, general and administrative expense increased in 1996 due primarily to growth at Mobile Systems and increases in contracted services, employee compensation and software costs. Expenses incurred at PAC to prepare support systems for local competition and for new business initiatives also contributed to the increase in 1996.

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

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

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

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

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

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

Income Tax expense decreased \$1,097, or 56.0%, in 1997 and increased \$441, or 29.0%, in 1996. Income taxes for 1997 reflect the tax effect of charges for strategic initiatives resulting from SBC's comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997, costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these items, income taxes for 1997 were lower. Contributing to the decrease in income tax expense in 1997 was, among other items, realization of foreign tax credits. Income taxes paid, net of refunds, reflect the impact of reduced tax payments due to merger-related and integration costs.

incurred. The 1996 increase was due primarily to higher income before income taxes. Taxes also increased in 1996 reflecting a year's effects of the elimination of excess deferred taxes and a reduction in the amortization of investment tax credits resulting from the discontinuance of regulatory accounting, which occurred in the latter part of 1995.

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

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

RATING ENVIRONMENT AND TRENDS OF THE BUSINESS

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

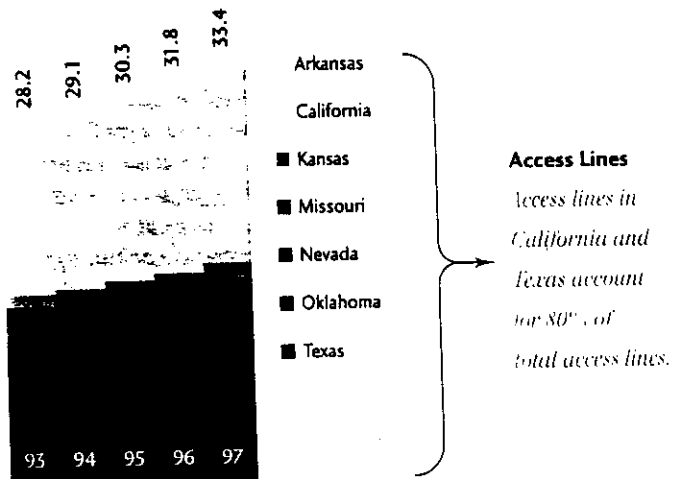
Federal Regulation During 1997, the FCC issued an Access Reform Order restructuring access charges paid for interexchange carrier access to the Telephone Companies' networks. The order raises the flat monthly end user charge for primary business lines, and additional residence and business lines, and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

The FCC's price cap plan for the LECs provides for changes to be made annually to the price caps for inflation, productivity and changes in other costs. In 1997 the Telephone Companies were ordered to begin using a 6.5% productivity offset, with no

sharing. Prior to 1997, there were three productivity offsets, two of which provided for a sharing of profits above a specified earnings level with the Telephone Companies' customers and a higher productivity offset which did not include sharing. The Telephone Companies had elected the higher 5.3% productivity offset without sharing.

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

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



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

California The California Public Utility Commission's (CPUC) form of price caps requires PacBell to submit an annual price cap filing to determine prices for categories of services for each new year. The productivity factor used in calculating price caps has been set equal to the inflation factor for the period 1996-1998. The price cap plan includes a sharing mechanism that requires PacBell to share its earnings with customers above certain earnings levels. In December 1997, the CPUC adopted a decision on PacBell's 1997 price cap filing resulting in a revenue reduction in 1998 of approximately \$86 effective January 1, 1998. The