d. Public Policy Does Not Support Imputation

In Feist Publications, Inc. v. Rural Telephone Service Co., Inc., 499 U.S. 340, 111 S. Ct. 1282 (1991), the United States Supreme Court eliminated telephone companies' copyright in directory listings. The Court's ruling foreclosed telephone companies from negotiating high payments from directory publishers and promoted directory competition. In Section 202(e) of the Telecommunications Act of 1996, 47 U.S.C § 202(e), Congress prohibited discrimination among directory publishers in the price, quality and format of listing information, and the FCC subsequently established maximum rates for directory listings. These actions were taken to prevent telephone companies from making sweetheart deals with preferred publishers, to prevent unreasonable charges for directory listings, and to promote directory competition.

The overall purpose of TA96 was to promote telecommunications competition, in part by eliminating subsidies enjoyed by the dominant provider. Section 263(a) provides that:

> "No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." 47 U.S.C. §263(a).

Staff's and GCI's proposed directory imputation runs counter to all of these public policy goals. GCI would have Ameritech Illinois sell the Ameritech name and endorsement to the highest bidder to the competitive disadvantage of all other directory publishers.[42] This is exactly opposite to what Congress and the Courts intended. Staff and GCI seek to use imputation to perpetuate the substantial subsidies to local exchange rates that existed under the expired Directory Agreement. These subsidies allowed services to be priced below their full costs (even if individual services were priced above marginal cost), thereby, impeding competition and

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[42] This assumes that Ameritech Illinois had any rights in the Ameritech name to sell, which is does not, and that a telephone company's name and endorsement have any value to a directory publisher, which, as shown previously, they do not.

depriving customers of competitive choice. Perpetuation of these subsidies would be directly contrary to the intent of Congress. An equally perverse consequence of the proposed imputation would be that it would deprive Ameritech Illinois of funds needed to maintain service quality and upgrade the network since Ameritech Illinois would not actually receive the imputed revenues. None of these are positive outcomes.

The Commission should carefully consider these public policy objectives, along with the lack of any probative evidence or legal rationale to support imputation, and should reject Staff's and GCI's proposed imputation.

3. Incentive Compensation Expense

The Commission should reject Staff witness Everson's proposal to eliminate actual management incentive compensation expense in the amount of $16.117 million. (Staff Ex. 21.0, Sch. 21.02). Incentive compensation represents a normal and prudent operating expense necessary to provide service (Am. Ill. Ex. 7.1, p. 11), a fact which Ms. Everson does not dispute. (Tr. 823-24). Incentive compensation is a standard part of employee compensation packages in most businesses, including Ameritech, and is one component of the overall level of compensation necessary to attract and retain capable management employees. (Am. Ill. Ex. 7.1, p. 11). If incentive compensation expense were eliminated, base salaries would need to be increased commensurately. (Am. Ill. Ex. 7.2, p. 23). To ignore a portion of the expense incurred to compensate employees, as Ms. Everson proposes, is improper and would overstate the Company's 1999 earnings. (Am. Ill. Ex. 7.1, p. 12).

Ms. Everson argued that incentive compensation expense does not "benefit ratepayers" because it involves a "circular reasoning," i.e., incentive compensation leads to an achievement of financial goals (such as revenue growth and return on assets) which leads to increases in "base rates" which leads to increased incentive compensation. (Staff Ex. 7.0, p. 5; Staff Ex. 21.0, pp. 4-5). The "circular reasoning" argument does not, however, logically apply to a price-cap regulated company, such as Ameritech Illinois, because the financial goals of return on assets and revenue growth are not achieved by requesting the Commission to grant increases in "base rates." (Am. Ill. Ex. 7.1, p. 12; 7.2, pp. 24-25). To the contrary, such goals are achieved primarily through improved efficiencies, cost control, growth in the number of sales and customers and development of new and improved products and services. (Id.). Accordingly, even if the Commission were to determine that rates should be "reinitialized" (and they should not be), it would be improper to disallow incentive compensation on the false assumption that the level of such expense has been or will be influenced by factors inapplicable to a price-cap regulated company.

In any event, an adjustment to disallow incentive compensation expense would be inappropriate even if Ameritech Illinois were subject to traditional rate base/rate-of-return regulation. The Commission has allowed the recovery of incentive compensation expense in a number of cases, including the two most recent proceedings involving a review of Ameritech Illinois' revenue requirements, Docket 89-0033 and Docket 92-0448/93-0239. (Am. Ill. Ex. 7.1, p. 13).[43] Moreover, as Ms. Everson acknowledged, the financial performance goals of return on assets and revenue growth can be met through efficiencies, customer and sales growth and/or new services and products, all of which benefit customers. (Tr. 811-12). Finally, Staff does not challenge the prudence of the Company incentive compensation plan or the reasonableness of the

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[43] In Consumers Illinois Water Company, Docket 97-0351 (June 19, 1998), Staff made the same "circular reasoning" argument made by Ms. Everson in this case as the basis for of a proposal to disallow incentive compensation tied, in part, to the utility's parent company financial performance. Amendatory Order, Docket 97-0351, p. 15. The Commission rejected Staff's argument, recognizing that such compensation provides incentives to contain costs, thereby benefiting customers. Id., pp. 16-17. (Am. Ill. Ex. 7.1, p. 13). See also, Northern Illinois Gas Company, Docket 95-0219 (April 3, 1995). (Id.).

amount of the incentive compensation expense incurred in 1999. (Tr. 823-24). Accordingly, under traditional ratemaking principles, such costs should be fully recognized in rates. See, 220 ILCS 5/1-102(a)(iv) (providing that rates should be set to "allow utilities to recover the total costs prudently and reasonably incurred.").

4. External Relations Expense

Ms. Everson proposed an adjustment to eliminate the 1999 level of expenses recorded in Account 6722, External Relations, on the grounds that such expenses include non-product specific "goodwill or institutional advertising costs" (also referred to as "brand" advertising). (Staff Ex. 7, pp. 9-10). Ms. Everson suggested that the inclusion of such expenses in the determination of a "public utility's revenue requirement" is prohibited by Section 9-255 of the Act and 83 Ill. Admin. Code 295.10(a). (Staff Ex. 7.0, pp. 9-10). On their face, however, those provisions apply only in the case of a "general rate increase request by any gas or electric utility." 220 ILCS 59-255(2); 83 Ill. Admin. Code Section 295.10. Ameritech Illinois is not a gas or electric utility, and this case does not involve a general rate increase request. For the reasons discussed in Section V.A.5., below, "brand" advertising expenses are legitimate and reasonable costs of doing business. There is no basis for disregarding such costs in a review of a telephone company's earnings under an alternative regulation plan.

Moreover, of the $20.413 million in intrastate external relations expenses incurred during 1999, only $6.807 million represents "brand" advertising expense. The remaining portion represents costs associated with other activities, including (a) preparing and presenting information for regulatory purposes, including tariff and service cost filings; (b) administering relations, including contracts, with telecommunications carriers, utilities, and other businesses; (c) administering investor relations; and (d) reviewing existing or pending legislation. (Am. Ill.

Ex. 7.1, p. 23; Am. Ill. Ex. 7.2, p. 27). These are reasonable costs necessary for doing business as a regulated telecommunications carrier and have consistently been allowed in prior cases. (Am. Ill. Ex. 7.1, pp. 23-24).

In support of her proposal, Ms. Everson asserted that the Company had failed to provide a breakdown of the costs recorded in Account 6722 by each "descriptive activity," as described in the instructions for that account set forth in the FCC Part 32 Uniform System of Accounts ("USOA"). The Company does not, however, track its costs in that manner; nor is there any requirement that it do so. (Am. Ill. Ex. 7.2, p. 28).[44] In any event, because all of the "descriptive activities" are reasonable and necessary for doing business in Illinois, the alleged failure to provide a breakdown of costs by each such activity does not logically support Ms. Everson's proposed adjustment. (Id.).

5. Non-Product Specific Brand Advertising

GCI witness Smith proposed an adjustment to eliminate the $6.807 million of non-product specific "brand" advertising expense included in Account 6722, External Relations. Mr. Smith asserted that the purpose of such advertising is solely to "promote the image of Ameritech" and "not to attempt to sell specific products to ratepayers, which would increase regulated revenue in Illinois." (GCI Ex. 6.0, p. 35). In fact, while "brand" advertising does not focus directly on the promotion of a specific product, it is intended to create positive images of the Company in the mind of consumers, thereby promoting sales of all of the Company's products and services. (Am. Ill. Ex. 7.1, pp. 22-23; Am. Ill. Ex. 7.2, pp. 32-36). For the reasons fully discussed by Mr. Dominak, "brand" advertising is an integral part of Ameritech Illinois'

[44] Mr. Dominak presented a schedule which contains a breakdown of the amounts recorded in Account 6722 in 1999 by the expense categories maintained by Ameritech Illinois. (Am. Ill. Ex. 7.2, p. 2, Sch. 5).

efforts to successfully promote its products and services and, in particular, to successfully bid on communications solutions for large business and institutional customers. As a result, "brand" advertising helps to generate revenue and retain traffic on Ameritech Illinois' network and is a necessary cost of doing business in an increasingly competitive environment. (Id.).

6. Revenues Related to Service Quality Standards

Mr. Smith proposed an adjustment to impute revenues of $29.579 million, an amount equal to the cumulative reduction in revenues which the Company was required to make in its annual price cap filings during the years 1996 through 1999 for not meeting one of eight service quality standards. (GCI Ex. 6.5, Sch. E-8 Rev.). Mr. Smith's proposed adjustment should be rejected because it imputes to the Company revenues it did not actually receive during 1999 and, therefore, does not result in an accurate presentation of 1999 financial results. (Am. Ill. Ex. 7.1, p. 31). Furthermore, customers have already received the benefit of the cumulative reductions. (Am. Ill. Ex. 7.1, p. 31; Am. Ill. Ex. 7.2, pp. 34-35). If rates were reinitialized in the manner proposed by Mr. Smith, customers would receive the same rate reductions again, and an annual "penalty" of $29.579 million would be indefinitely locked into Ameritech Illinois' rates without regard to the level of service quality. Not only is such an approach arbitrary and unfair, it is inconsistent with the concept of "reinitializing" rates. (Id.).

Moreover, Mr. Smith incorrectly calculated his proposed adjustment. Mr. Smith purported to compute the amount of the revenues which Ameritech Illinois actually lost during one year (1999) as a result of service quality penalties. That amount would be $11,919,886, equal to the total of the annual amounts of revenue reductions required in the years 1996, 1997, and 1998, plus one-half of the annual reduction required July 1, 1999. The annual amounts are identified in the column labeled "Annual Amount" shown on GCI Exhibit 6-3, Schedule E-8

Revised. The cumulative revenue reduction of $29.579 million (which is also shown on Schedule E-8 Revised) reflects the total amount of revenue lost over a number of years and, therefore, overstates the amount of revenue lost during 1999. For example, the $29.579 million figure includes $14 million, equal to 3.5 years worth of the $4 million annual penalty imposed through the price cap formula in 1996 for failure to meet a service quality standard in 1995. (Am. Ill. Ex. 7.1, p. 31). The revenue foregone during 1999 would reflect the annual effect of the $4 million penalty imposed in 1996, <u>not</u> the cumulative effect of $14 million. Accordingly, if the Commission deems it appropriate to impute revenues lost during 1999 as a result of service quality penalties (and it should not, for the reasons previously discussed), the correct amount of the adjustment is $11,919,886.

7. Pension Settlement Gains

The Company made an adjustment to its 1999 Operating Income Statement to remove the impact of a $98.6 million net pension settlement gain recorded on the books during 1999. The intrastate regulated portion of this gain is $66.189 million. The effect of the Company's adjustment is to eliminate a credit to pension expense in the amount of $66.189 million, thereby increasing 1999 operating expense by the same amount. (Am. Ill. Ex. 7.1, p. 32; Am. Ill. Ex. 7.3, Sch. 1). The Company made a similar adjustment to remove Ameritech Illinois' allocable share of the 1999 net pension settlement gains charged from Ameritech Services, Inc. ("ASI"). (Am. Ill. Ex. 7.1, pp. 2-3). Staff witness Hathhorn proposed an adjustment to add back a "normal" level of pension settlement gains and to amortize over five years the amount by which the actual 1999 gain exceeded the normal level. The effect of her adjustment is to reduce Corporate Operations Expense for 1999 by $16.855 million. (Staff Ex. 20.0, Sch. 20.01). Ms. Hathhorn proposed a similar adjustment, in the amount of $6.795 million, with respect to the Company's allocable share of ASI's net pension settlement gains. (Id.). The total amount of Ms. Hathhorn's adjustment is $23.65 million. Mr. Smith proposed similar adjustments for the 1999 Ameritech Illinois and ASI pension settlement gains of $13.238 million and $3.7 million, respectively, calculated by amortizing the total Illinois intrastate amounts of those gains over five years. (GCI Ex. 9.2, p. 23; GCI Ex. 9.5, Sch. E-3 Rev.).

The proposals of Ms. Hathhorn and Mr. Smith should be rejected. As Ms. Hathhorn expressly acknowledged, it is not appropriate to consider the pension settlement gains as a current period (1999) gain. (Staff Ex. 20.0, p. 3). Pension actuarial gains and losses occur when (i) actual pension plan experience turns out different than what was assumed in developing annual expense levels; and (ii) actuarial assumptions are changed.[45] FAS 87 allows such types of gains (or losses) to be deferred for financial reporting purposes in order to reduce the volatility that would otherwise occur with immediate recognition. When the pension plan makes lump sum pension payments to its participants, a full or partial settlement of the plan liability occurs. If the total lump sum pension payments in a particular year exceed a certain threshold, recognition of deferred actuarial gains (losses) and the unamortized balance of any transition assets are accelerated. This accelerated recognition is what is referred to as a settlement gain or loss. (Am. Ill. Ex. 7.1, pp. 32-33; Am. Ill. Ex. 7.2, pp. 11-12).

Thus, settlement gains and losses recorded on the Ameritech Illinois' books in 1999 represent the recognition of gains and losses that occurred in prior periods. Furthermore, the pension settlement gains recorded in 1999 were abnormally high due to the retirements of an unusually large number of employees who elected to receive their pensions in a lump sum

[45] For example, when developing annual pension expense, an assumption must be made about the investment return on pension fund assets. The expected investment return is a component of annual expense. If the fund is assumed to earn 8.5% per year and the actual return for the period is 15%, an actuarial gain has occurred.

payment. (Am. Ill. Ex. 7.2, p. 11).[46] For these reasons, to accurately present a normalized view of 1999 financial results, pension settlement gains and losses should be removed in their entirety from the 1999 operating income statement developed for regulatory financial reporting purposes. (Am. Ill. Ex. 7.1, pp. 32-33; 7.2, pp. 11-12).

Even if it were appropriate to "normalize" the level of pension settlement gains, as Ms. Hathhorn and Mr. Smith suggested (Staff Ex. 20.0, p. 3; GCI Ex. 6.2, p. 30), their proposed adjustments are overstated. For the period from 1991 through 1998, the average annual pension settlement gain recorded by Ameritech Illinois was $5.010 million per year and Ameritech Illinois' average allocable share of ASI's pension settlement gains was $4.560 million. (Staff Ex. 20.0, Sch. 20.01, p. 4.1). These are the amounts which Ms. Hathhorn considers to be "normal" on a total Company basis. (Tr. 871). The regulated, intrastate portions of those amounts are $3.712 million and $3.379 million, respectively. (Am. Ill. Ex. 7.2, p. 10). Thus, the Staff adjustment of $23.650 million exceeds by over $16.56 million the "normal" level of annual pension settlement gains. (Am. Ill. Ex. 7.2, pp. 10-11). GCI's total adjustment of $16.938 million ($13.238 million + $3.7 million) exceeds the "normal" level by $9.847 million.

As the basis for her proposal to amortize the "abnormal" portion of the 1999 pension settlement gain, Ms. Hathhorn argued that "by including the entire amount" of pension expense in the revenue requirement established in the 1994 Order, "ratepayers have previously funded 100% of the Company's pension expense" and, therefore, "deserve full recovery of any gains

46 Mr. Smith alleged that, in light of the significant amount of pension settlement gains recorded during the first half of 2000, the gains recorded in 1999 "were not a one-time occurrence." (GCI Ex. 6.2, p. 27). For reasons explained by Mr. Dominak, however, the gain recorded in the first half of 2000 reflects a carryover effect of the same unusual set of circumstances which led to an abnormal amount of gains in 1999. (Am. Ill. Ex. 7.2, p. 12). Mr. Smith also argued that the abnormal level of pension settlement gains experienced in 1999 are related to the SBC/Ameritech merger. (GCI Ex. 6.2, p. 16). As Mr. Dominak explained, and Mr. Smith acknowledged during cross-examination (Tr. 1583-84), however, the pension settlement gains do not represent merger-related savings. (Am. Ill. Ex. 7.2, pp. 16-17).

reflected in the Company's pension fund." (Staff Ex. 6.0, pp. 7-8; Tr. 876-77; Am. Ill. Ex. 7.1, p. 34). As Mr. Dominak testified, and Ms. Hathhorn acknowledged, however, the revenue requirement used to establish the "going-in" rates approved in the 1994 Order did not contain an allowance for pension expense. (Am. Ill. Ex. 7.1, p. 34; Am. Ill. Ex. 7.2, p. 13; Staff Ex. 20.0, p. 4).[47] Furthermore, as a result of the price cap formula (which contains no factor for inclusion of pension expense or any other specific expense item), the overall rates charged for non-competitive service declined every year since issuance of the 1994 Order. Accordingly, there is no basis for Ms. Hathhorn's premise that customers have been paying for pension expense and, consequently, no basis for her assertion that ratepayers "deserve" credit for the abnormal pension settlement gain. (Am. Ill. Ex. 7.1, pp. 34-35; Am. Ill. Ex. 7.2, p. 14).

Finally, the use of a five-year amortization period is arbitrary. As Mr. Dominak testified, if an amortized level of pension settlement gains were to be reflected in the 1999 data (and it should not be), the appropriate amortization period would be 11.4 years for management and 16 years for non-management employees. These figures represent the average future working lifetime calculation from the most recent actuarial valuations and is used to amortize the deferred pension plan unrecognized gains and losses. (Am. Ill. Ex. 7.2, p. 13).

In addition to his proposed adjustments related to 1999 pension settlement gains, Mr. Smith proposed an adjustment to reduce 1999 operating expense by including an amortization of pension settlement gains recorded in the year 2000. (GCI Ex. 6.2, p. 17). Mr. Smith, however, did not purport to justify his adjustment (and there would be no basis to justify his adjustment) as necessary to reflect a known and measurable change in the level of a 1999 expense or revenue item. To the contrary, Mr. Smith is attempting to "double-count" an income statement item by

[47] In fact, the test year level of operating expenses approved in the 1994 Order reflected a $37 million credit for negative pension expense. (Am. Ill. Ex. 7.1, p. 34).

including adjustments for both the 1999 and 2000 pension settlement gains credits. (Am. Ill. Ex. 7.2, p. 17). Ms. Hathhorn also opposed Mr. Smith's adjustment on the grounds that the 2000 pension settlement gains are outside the test year. (Staff Ex. 31.0, p. 4). For these reasons, as well as the other reasons discussed above with respect to 1999 pension settlement gains, Mr. Smith's proposed adjustment for the 2000 gains should be rejected.

8. Asset Disposition Accrual Credit

Mr. Smith proposed an adjustment to reduce 1999 Operating Expense in the amount of $741,000 to reflect a five year amortization of the jurisdictional portion of an asset disposition accrual credit in the amount of $5.518 million. (GCI Ex. 6.5, Sch. E-5 (Revised)). The accruals were made for costs associated with property sales which occurred in 1994. (Am. Ill. Ex. 7.1, p. 37). In 1999, the Company made a reconciling adjustment on its books for financial reporting purposes in the amount of $5.518 million as a credit to Corporate Operations Expense to remove the balance of the accrual. (Id., pp. 37-38). Because the transaction which gave rise to the accrual had nothing to do with 1999 operations, however, the Company eliminated the credit entirely from its presentation of a normalized level of expenses. (Id.; Am. Ill. Ex. 7.2, p. 33). Mr. Smith's adjustment would reduce expenses by one-fifth of the amount of the credit, thereby improperly reflecting prior period activities in the results for 1999. (Id.).

9. Interest Synchronization

Staff witness Voss and GCI witness Smith each proposed an adjustment to "synchronize" interest expense for purposes of calculating 1999 income tax expense. As Mr. Dominak explained, an interest synchronization adjustment is inappropriate for purposes of determining the Company's actual earnings under the Plan. The interest synchronization methodology does not allow for fluctuation in interest rates, particularly the short-term interest rates on balances outstanding. (Am. Ill. Ex. 7.1, p. 10). As a result, the effect of Staff's and GCI's proposed adjustments is to reflect interest payments the Company never made in 1999, thereby understating income tax expense and overstating earnings. (Id.).

10. Social and Service Club Dues

The Commission should reject Ms. Everson's proposal to eliminate actual Social and Service Club dues expense in the amount of $266,994. A portion of the expense ($29,500) represents dues paid to Chambers of Commerce, organizations which benefit customers by promoting business and development. (Am. Ill. Ex. 7.1, p. 15; Am. Ill. Ex. 7.2, p. 25). The remaining portion of the costs represent dues paid to various business and industry organizations, primarily the Illinois Telecommunications Association ("ITA"), an organization which provides a forum for examining issues of importance to the telecommunications industry, such as 9-1-1 Emergency Service, labor relations and right-of-way matters. (Am. Ill. Ex. 7.1, p. 15; Am. Ill. Ex. 7.2, p. 26). Dues paid to these organizations represent normal and prudent costs of providing service and have been recognized as appropriate in prior cases involving Ameritech Illinois, including Dockets 89-0033 and 92-0448. (Am. Ill. Ex. 7.1, p. 15).

11. Revised Non-Regulated Allocation Factor

In his Rebuttal Testimony, Mr. Dominak revised the non-regulated allocation factor applied to "prior period" expense adjustments from 0.1301 to 0.0464. (Am. Ill. Ex. 7.1, pp. 2-3). Mr. Smith took issue with that revision. (GCI Ex. 9.2, pp. 13-14). The revision was made in accordance with the FCC's Joint Cost Rules, which specify that costs are to be allocated based upon a direct analysis of the origin of cost. (See C.F.R. Section 64.901 Allocation of Costs).

The costs related to the prior period activities at issue were all booked to account 6728, Other General and Administrative Expense, for which the specifically applicable factor is 0.0464. This is a more precise, and, therefore, more appropriate factor to use than the general allocator (0.1303) associated with the Corporate Operations Expense summary of accounts. (Am. Ill. Ex. 7.2, p. 30).

B. RATE BASE

1. Accumulated Reserve For Depreciation

As previously discussed, Staff and GCI proposed to eliminate the FAS 71 amortization from expenses in their revenue requirements analyses. If the Commission were to adopt this proposal (and it should not), the December 31, 1999 accumulated reserve for depreciation should be reduced by $539.530 million (and accumulated deferral taxes should be increased by $214.020 million) to reflect restoral to rate base of the written-down assets as if the FAS 71 write-down had not taken place. Staff witness Voss correctly made such an adjustment in his direct and rebuttal testimony. (Staff Ex. 5.0, Sch. 5.04; Staff Ex. 19.0, Sch. 19.04). In her surrebuttal testimony, however, Staff witness Marshall proposed that the write-down be treated as a one-time event and eliminated from rate base. Based on Ms. Marshall's position, Mr. Voss, in his surrebuttal exhibits, added back $539.530 million to the accumulated depreciation reserve, thereby reducing Staff's proposed rate base.

The proposals of Staff and GCI to both eliminate the FAS 71 amortization from expenses <u>and</u> remove the written down assets from rate base is inappropriate. The depreciation freedom granted by the Commission was a balanced trade-off: Ameritech Illinois assumed the risk of full capital recovery -- <u>i.e.,</u> it would forego its legal right to increase subscriber rates needed to guarantee full recovery of its assets -- in return for the right to set its own depreciation rates and to recover those investments as best it could within the constraints of the price index. Ameritech Illinois proceeded to do precisely that. It wrote down its assets in conformance with financial reporting requirements, but it is continuing to attempt to recover its investments as long as the marketplace permits. If the Commission were to treat the write-down as a one-time event in calculating Ameritech Illinois' earnings, it would wildly overstate Ameritech Illinois' profitability. If rates were then reduced based on these fictitiously high earnings, the Commission would be foreclosing absolutely Ameritech Illinois' ability to recover the projected capital recovery shortfall. This would deny Ameritech Illinois the benefit of the capital recovery bargain that was explicit in the Plan and would deny shareholders returns to which they are entitled. (Am. Ill. Ex. 1.3, pp. 101-102).

GCI's position with respect to the FAS 71 write-down is internally inconsistent with its position regarding "revenue requirements." GCI has argued that the purpose of performing a "revenue requirement" analysis is to assess the Company's financial performance under the Plan as compared to what that performance would have been under traditional rate of return regulation. The discontinuance of FAS 71, and the resulting write-down of assets, however, occurred as a direct result of the replacement of traditional rate of return regulation with price cap regulation. Thus, the write-down would not have occurred if the Plan had not been adopted. Under GCI's theory of the case, therefore, the value of the written-down assets should be restored to rate base in order to accurately portray what the Company's performance would have been under traditional rate of return regulation.

Staff's position, like GCI's, is also internally inconsistent. As previously discussed, Ms. Marshall's principal criticism of the FAS 71 amortization is that it is a "second attempt to recover costs previously disallowed for rate making purposes" because the Commission did not allow amortization of the reserve deficiency in 1994. If Ms. Marshall's theory is correct, then the only appropriate treatment of depreciation expense in this proceeding is to calculate it on a basis that is consistent with the Commission's 1994 Order. That is, the rate base must be restated as if the write-down did not take place. That is what Mr. Voss did in his direct and rebuttal testimony. Staff's proposal on surrebuttal to treat the FAS 71 adjustment as a one-time event occurring outside of the test year is completely inconsistent with that theory. If the Company was not "allowed" to treat this shortfall as a reserve deficiency for ratemaking purposes in 1994, then the flip side is that the Commission should not be "allowed" to recognize the write-down for ratemaking purposes now. (Am. Ill. Ex. 1.5, pp. 17-18). In effect, Staff wants to have it both ways. Staff -- and the Commission -- did not want ratepayers to have to pay for any reserve deficiency through rates in 1994. Now, when the Company has voluntarily written down its assets to reflect the shortfall the Commission did not want to recognize, Staff wants to flow through to ratepayers the entire beneficial effect of that write-down for ratemaking purposes. Such a one-sided and unfair approach to depreciation policy should be rejected. (Id.).

Moreover, the proposals of Staff and GCI would be unlawful under rate-of-return regulation. The Commission is legally obligated to allow regulated companies to recover their investments in regulated plant assets through depreciation expense that is reflected in customer rates. Thus, the Commission could not have required Ameritech Illinois to write down its assets in 1994. If the Commission is going to conduct an earnings analysis now based on rate-of-return principles, it cannot assume a write-down that would never have taken place. (Am. Ill. Ex. 1.5, p. 18).

Ms. Marshall and Mr. Dunkel argued that elimination of the write-down from rate base is consistent with the FCC's ordered treatment in the interstate jurisdiction. (Staff Ex. 29.0, p. 3;

GCI Ex. 9.0, p. 46). As discussed above, however, the condition that the FCC adopted with respect to changes in depreciation expense is the same as adopted by the Commission as part of the Plan, i.e., increases in depreciation expense resulting from the exercise of depreciation freedom are not to be recovered through increases in customer rates. There is nothing in the FCC's order which would support the "have your cake and eat it too" approach being taken by GCI and Staff, which is to (i) reflect in rate base the result of the Company having exercised its depreciation freedom, by reflecting the full effect of the FAS 71 write-down, while simultaneously (ii) removing the amortization of the write-down from expenses, thereby effectively pretending that the Company had not been granted the freedom to amortize the write-down over eight years. (Am. Ill. Ex. 1.5, p. 20).[48]

As previously discussed, GCI's proposed level of depreciation expense reflects not only the impact of eliminating the FAS 71 amortization, but also Mr. Dunkel's proposal to recalculate depreciation expense based on FCC remaining life parameters prescribed in 1995, thereby effectively negating the depreciation freedom granted in the 1994 Order. For the reasons discussed above with respect to FAS 71, if GCI's position is adopted (and it should not be), consistency would require that the depreciation reserve be reduced by the amount by which the depreciation expense accrued since 1994 exceeded the depreciation expense that would have been accrued if the Company had not been granted depreciation freedom. (Am. Ill. Ex. 1.5, p. 31). Specifically, the December 31, 1999 intrastate reserve balance (as reflected in Schedule 2 of Ameritech Illinois Exhibit 7.1) would need to be reduced by $1,708,302,000, and the associated

[48] In support of her position, Ms. Marshall cited the Order in the TELRIC proceeding (Docket 96-0486), a case which has nothing to do with the issues here. In the language from that Order quoted by Ms. Marshall, the Commission referred to its decision in the 1994 Order not to incorporate an adjustment for recovery of a depreciation reserve deficiency into the price cap formula. In this case, the Company is not proposing to incorporate such an adjustment into the price cap formula. (Am. Ill. Ex. 1.5, p. 19).

adjustment to increase the deferred income tax balance would be $677.632 million. (Am. Ill. Ex. 7.1, p. 39).

2. Telephone Plant Under Construction and Telephone In Plant Service

The December 31, 1999 Statement of Net Original Cost of Property initially presented by the Company included a Telephone Plant Under Construction ("TPUC") balance of $59.034 million. (Am. Ill. Ex. 7.0, Sch. 1). Use of a year-end balance of TPUC is consistent with the 1994 Order. (Am. Ill. Ex. 7.1, p. 36). GCI witness Smith proposed an adjustment to reduce that balance to $45.883 million, to reflect a 36 month average balance of TPUC. (GCI Ex. 6.5, Sch. E-13). Upon further review, Mr. Dominak determined that a plug-in circuit board equipment accrual in the amount of $26.8 million which was included in the year-end TPUC balance should properly be transferred to the year-end balance of Telephone Plant In Service ("TPIS") because it represents the cost of equipment received and actually placed in service during December of 1999. (Am. Ill. Ex. 7.2, p. 31). Accordingly, the Company made offsetting adjustments to reduce TPUC and increase TPIS by $26.8 million. (Id.; Am. Ill. Ex. 7.2, Sch. 2). The adjusted intrastate balance of TPUC is $39.137 million, less than the 36 month average used by Mr. Smith. (Id.).

Staff witness Hathhorn proposed an adjustment to remove from rate base investment in TPUC on which an allowance for funds used during construction ("AFUDC") is accrued, in order to prevent "double 'recovery'" of AFUDC. (Staff Ex. 20, p. 5). The Company, however, made an income statement adjustment of $1.929 million for AFUDC as an offset to the inclusion of TPUC in the 1999 Statement of Net Original Cost of Property. (Am. Ill. Ex. 7.2, pp. 18-22; Am. Ill.. Ex. 7.3, p. 5, Sch. 7). This adjustment eliminates Ms. Hathhorn's "double recovery" concern. (Am. Ill. Ex. 7.2, p. 18). Moreover, as Ms. Hathhorn acknowledged, Section 9-214(e) of the Act allows for rate base inclusion of TPUC for which construction will be completed and placed in service within 12 months after the rate determination. (Tr. 880-81). 220 ILCS 5/9-214(e). That provision contains no exception for TPUC on which AFUDC is accrued.

3. Accumulated Deferred Income Taxes/Uncollectibles

GCI witness Smith correctly noted that an adjustment should be made to the balance of Accumulated Deferred Income Taxes ("ADIT") to reflect an adjustment of the uncollectible expense of $18.685 which Staff and GCI proposed, and which the Company accepted. (Am. Ill. Ex. 7.1, p. 7; Am. Ill. Ex. 7.2, p. 3). The amount of the ADIT adjustment proposed by Mr. Smith ($19 million) is, however, not correct. It is only the tax effect of the $18.675 million adjustment to uncollectible expense which would impact the ADIT balance. (Am. Ill. Ex. 7.2, p. 3). The correct adjustment to ADIT is, therefore, $7.412 million. (Id.; Am. Ill. Ex. 7.2, Sch. 2).

C. Cost of Capital

Two witnesses provided direct testimony on cost of capital, Alan S. Pregozen, CFA, on behalf of Staff and Dr. Roger G. Ibbotson on behalf of Ameritech Illinois. (Staff Ex. 11.0; Am. Ill. Ex. 6.0).

Dr. Ibbotson and Mr. Pregozen are finance professionals with recognized experience in estimating cost of capital. They used the same methodologies to estimate the cost of equity: the DCF or discounted cash flow model and the CAPM or capital asset pricing model. While they implemented their models differently, they each used recognized and accepted procedures. Mr. Pregozen performed both a constant growth and non-constant growth DCF analysis, whereas, Dr. Ibbotson performed only a non-constant growth DCF analysis. Mr. Pregozen calculated the risk premium for the CAPM using forward-looking forecasted data, whereas, Dr. Ibbotson used historical data. Based on his analysis, Dr. Ibbotson recommended an overall cost of capital in a range from 10.58% to 11.21%. (Am. Ill. Ex. 6.0, p. 38). Mr. Pregozen recommended an overall cost of capital in a range from 9.74% to 11.30%. (Staff Ex. 11.0, p. 2). Mr. Pregozen recommended using the midpoint of his range (10.52%) for any revenue requirement determination. (Id.; Staff Ex. 25.0, pp. 2-3).

Ameritech Illinois' primary objection to Mr. Pregozen's analysis was his use of a book value-weighted capital structure to calculate the overall cost of capital. While the Commission has traditionally used this approach, it is incorrect under recognized financial theory. (Am. Ill. Ex. 6.0, p. 10). Investors estimate their expected returns based upon the market weights of debt and equity. Using a market cost of equity with a book value-weighted capital structure that contains a higher level of debt understates what the cost of equity would be for a capital structure with that higher level of debt and, therefore, understates the true market cost of capital. (Am. Ill. Ex. 1.1, p. 112). Dr. Avera testified that using a book value-weighted capital structure may have been reasonable in the past when rate of return regulation assured the utility an opportunity to earn a return on, and return of, the book value of equity invested. However, in today's more uncertain environment, where the Company's earnings and capital recovery are not assured, the general rule of financial theory should no longer be ignored, and the overall cost of capital should be determined using market weights. (Am. Ill. Ex. 8.1, p. 9).[49]

As previously discussed, the reasonableness of rates subject to price cap regulation should not be judged on the basis of a traditional earnings analysis. As Mr. Gebhardt testified,

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[49] Mr. Pregozen reduced his cost of equity estimate by 20 basis points to assure that it reflected only the risk of Ameritech Illinois and not the risks of SBC Corporation or his proxy firms. He based the reduction on the difference in bond yields between AA- rated firms (Ameritech Illinois) and A rated firms (the proxy companies). (Staff Ex. 11.0, p. 30). This reduction was unnecessary. Dr. Ibbotson testified that as a separate firm Ameritech Illinois' cost of capital would be at least as high, if not higher than that of SBC Corporation because of Ameritech Illinois' higher fixed costs and operating leverage, accelerating competition and the loss of the regulatory guarantee of capital recovery and a reasonable return under alternative regulation. (Am. Ill. Ex. 6.0, pp. 13-14).

however, if such an analysis is used, the yardstick by which reasonableness should be determined is whether the Company's revenues produce a rate of return which is within the range of reasonableness. Thus, it is the upper end of the capital cost range (in this case 11.30%) which the Commission should consider. See Illinois Bell Telephone Company v. Illinois Commerce Commission, 203 Ill. App. 2d 424, 433-433, 561 N.E.2d 426, 433 (2nd Dist. 1990). This is not a rate increase proceeding in which a point cost of capital is used to determine an appropriate increase in a company's revenue requirement. (Am. Ill. Ex. 1.3, p. 126).[50]

Although GCI presented no cost of capital testimony, GCI witness Smith used the low end of Staff's range (11.8% on equity and 9.74% overall) in his calculation of revenue requirement. (GCI Ex. 6.0, p. 14). In rebuttal, he defended his action on the basis that (i) his client asked him to use this return, (ii) 11.8% was within Staff's recommended range, and (iii) it was allegedly consistent with approved or stipulated equity returns in three other cases in which he had been involved. (GCI Ex. 6,2, p. 52).

Mr. Smith's use of the low end of Staff's range was inappropriate. First, Mr. Smith admitted that he had not made an independent estimate of Ameritech Illinois' cost of equity (GCI Ex. 6.2, p. 52), and use of the low end of Staff's range was not supported by the expert testimony of any witness. Second, the Commission has traditionally used the midpoint of Staff's range in rate of return determinations, and in his rebuttal, Mr. Pregozen reaffirmed his recommendation. (Staff Ex. 25.0, pp. 2-3). Third, Mr. Pregozen and Dr. Ibbotson explained that any method for estimating the cost of equity is subject to measurement error. Therefore, more reliable results are

[50] If this were a traditional rate increase proceeding (which it is not), the midpoint of Dr. Ibbotson's range (10.90%) would be the appropriate rate of return for purposes of calculating a revenue requirement since both witnesses have concluded that this would be a reasonable return. Because Staff's midpoint recommendation (10.52%) is so close to Dr. Ibbotson's recommended range, the Company acknowledges that use of that figure also would be reasonable.

obtained by using at least two methods of analysis and exercising informed judgment. (Staff Ex. 11, p. 29-30; Am. Ill. Ex. 6.0, p. 14). Mr. Pregozen's midpoint recommendation is based upon both of his analyses and his informed judgment. His low-end estimate is based only on the results of his DCF analysis; therefore, it is a less reliable indicator of the cost of equity than his midpoint estimate. Fourth, Staff's midpoint estimate is very close to Dr. Ibbotson's low-end estimate and is corroborated by Dr. Ibbotson's analysis. Staff's low end equity estimate is not. Fifth, using a particular return level because your client asks you to is not a legally supportable rationale for using a particular return.

Finally, the equity returns in the three cases from other jurisdictions cited by Mr. Smith were approved, or agreed to, in circumstances markedly different from those here. There is no evidence that telephone companies' cost of equity in the competitive hotbeds of North Dakota and Alaska are comparable to Ameritech Illinois' current equity costs. In this regard, the cost of equity approved in the North Dakota Order cited by Mr. Smith was based on an estimate of the market required return for the end of 1998 and, therefore, is already over two years out of date. (Tr. 1610). Moreover, contrary to this Commission's practice, the North Dakota commission relied exclusively on a DCF analysis and disregarded CAPM results. (Tr. 1613-14). The cost of equity approved by the Alaska commission for a small member-owned telephone cooperative was uncontested and was characterized by that commission as "rather conservative." (Tr. 1587). The cost of equity cited by Mr. Smith as having been "stipulated" in an Arizona proceeding was, in fact, a compromise included in a settlement agreement which has not yet been approved. (Tr. 1591-92; 1597-1601). In short, the cases cited by Mr. Smith are of absolutely no probative value in estimating Ameritech Illinois' cost of capital.

VI. THE COMPANY'S RATE REBALANCING PROPOSAL SHOULD BE ADOPTED AND NO OTHER RATE DESIGN CHANGES SHOULD BE MADE

A. AMERITECH ILLINOIS' RATE REBALANCING PROPOSAL SHOULD BE ADOPTED

In its rate rebalancing proposal, Ameritech Illinois proposed to increase the monthly charge for residence network access lines by $2 per month across all access areas, while reducing other service rates to make the plan revenue neutral. The new residence access line charges, including the end user common line charge ("EUCL"), would be $8.90 in access area A, $11.88 in access area B and $15.35 in access area C. (Am. Ill. Ex. 9.4P Corrected, Sch. 2). There has been no increase in network access line rates since 1990. Even with the proposed $2 increase in effect, the network access lines will have increased less than the inflation rate. Thus, even after the increase, the real cost of residence access lines would be lower than it was in 1990. (Am. Ill. Ex. 1.2, pp. 26-27).

The Company has requested these increases to bring rates more into line with costs and to narrow the difference between residence and business access line prices.[51] (Am. Ill. Ex. 9.0, pp. 5-7). At current rates, residence access lines are priced below LRSIC (long run service incremental cost)[52] in access areas B and C. (Am. Ill. Ex. 9.4P, Corrected Sch. 2). Although current rates cover LRSIC in access area A, when shared costs[53] and non-recurring costs[54] are included, the rate is below cost even in access area A. (Id.).

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51 After the increases, residence access line rates would be less than a dollar lower than their business access line equivalents. (Am. Ill. Ex. 9.4P (Corrected), Sch. 2).

52 The LRSICs that are referred to in this section of the brief are the costs presented by Mr. Palmer in Am. Ill. Ex. 10.0, Sch. 9 (rev). The evidence supporting those costs is discussed in the Cost of Service section of the brief and will not be repeated here.

53 Shared costs are LRSICs incurred to provide a category or group of services. A ratable portion of these costs needs to be allocated to each service that shares the facility.

54 Non-recurring costs are the incremental service ordering and installation costs incurred to provision access lines. These costs slightly exceed current service ordering and installation (non-recurring) charges. The shortfall needs to be recovered in the recurring rates for access lines.

Moreover, LRSIC, as calculated under the Commission's Cost of Service Rule (the "Rule"), 83 Ill. Admin. Code Part 791, understates the incremental costs of network access lines. Section 791.70(d) requires that LRSIC be calculated based upon the assumption that the entire useable capacity of network facilities is used to provide service. "Useable capacity" is the maximum physical capacity, less capacity required for maintenance, testing or administration. (83 Ill. Admin. Code, Section 791.20(n)). In the real world, facilities are almost never operated at their useable capacity for a variety of necessary reasons described by Mr. Palmer and Dr. Harris. (Am. Ill. Ex. 10.0, pp. 10-14; Am. Ill. Ex. 4.1, pp. 12-15).[55] Therefore, more facilities are required to meet the demand for residence access lines than are included in the cost study. The "spare capacity" costs of these necessary, additional facilities are treated as common costs[56] to be recovered from all services when, in reality, they should be considered part of the LRSIC costs of access lines. Spare capacity costs for residence network access lines are shown in Ameritech Illinois Exhibit 10.1, Schedule 9 (Rev.) and are significant. If spare capacity costs were included, the LRSIC of access lines, on average, would increase by 80.2%. (Am. Ill. Ex. 1.2, p. 10).[57]

When LRSICs (as calculated under the Rule) are considered in conjunction with shared, non-recurring and spare capacity costs, access line prices are significantly below cost in all access areas, even if those services are not asked to contribute to the recovery of common costs. However, the Commission has recognized that individual services should make a reasonable

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[55] When cables are installed, they are sized to meet the ultimate demand in the area, not just the immediate demand. This is less expensive than installing new cables each time someone orders service and allows the Company to provide service on demand. Also, cables are available only in certain sizes. To provide ten lines, the Company would use a 25 pair cable because that is the smallest size available. (Am. Ill. Ex. 10.0, pp. 10-14).

[56] Common costs are the overhead costs of the business that do not vary based upon the output of any service or group of services. (See 83 Ill. Admin. Code Section 791.20(h)). Since spare capacity costs vary based upon output, they are not true common costs.

[57] In calculating LRSICs under the Rule, the Company also is required to use outdated depreciation rates, which also cause the Company's studies to understate the LRSICs of access lines. (Am. Ill. Ex. 1.2, pp. 10-11).

contribution toward recovery of common costs in both the TELRIC proceeding (Docket 96-0486) and Phase II of the Access Charge reform proceeding (Dockets 97-0601/97-0602). (Am. Ill. Ex. 1.2, p. 11). Similarly, the FCC required LECs nationwide to develop forward-looking economic costs of service ("FLECs") that included an allocation of common overheads. These costs will be used by the FCC to determine eligibility for federal high cost funds. The Commission approved the Company's FLEC methodology in Docket No. 97-0515. (Id.).

The under-pricing of access lines has adverse consequences for both customers and competitors. Competitors have shared costs and spare capacity costs too. (Am. Ill. Ex. 1.2, p. 9; Am. Ill. Ex. 4.1, p. 17). When Ameritech Illinois' residence access lines are priced so low that they do not recover those costs, or at least a substantial portion of them, competitors are deterred from offering residence access line services and infrastructure investment suffers. (Am. Ill. Ex. 4.1, pp. 2-3). For consumers, the low prices stimulate inefficient and excessive demand, which the Company is reluctant to build new facilities to satisfy because the service is unprofitable. At the same time, efficient consumption of services such as usage and vertical features is discouraged because these services must be priced too high in relation to their costs in order to make up for the shortfall in residence access line revenues. (Id.).

Staff testified that residence access lines should be priced at least to recover LRSIC. Therefore, Staff supported access line increases in access areas B and C, but only up to the level of LRSIC and only if the LRSICs presented by Mr. Palmer are approved by the Commission. (Staff Ex. 14.0, pp. 14-15). Staff's proposal is too conservative. Staff ignores shared, non-recurring and spare capacity costs and would exempt residence access lines from any responsibility for recovery of common costs. In the long run, artificially low prices for access lines cannot be sustained. Services that are overpriced to compensate for low access line prices will face stiffer competition stimulated by the economically inefficient pricing of those services.

If Staff's concern is universal service, those concerns are more appropriately addressed through targeted support programs for the consumers who need them. Mr. Gebhardt explained the policy goal stated in Section 254 of TA96 that universal support mechanisms should be "specific," that is, targeted to the customers to need them. (Am. Ill. Ex. 1.2, pp. 22-23). He also described the federal and state lifeline programs available to Illinois consumers, including a new program which provides up to $10.20 per month to eligible consumers. (Am. Ill. Ex. 1.2, pp. 28-30).

GCI opposed any increase in the monthly rate for residence access lines. Instead, GCI recommended price reductions in both the one-time (non-recurring) charges for service ordering and installation and the (recurring) monthly line charges. The evidence, however, demonstrates that under virtually any reasoned view of network access lines, prices for that service must go up. (Am. Ill. Ex. 1.3, p. 147).[58] Furthermore, GCI did not contend that service ordering and installation charges exceed the LRSICs of those services. GCI ignored LRSIC. Because LRSICs exceed the current non-recurring charges, those charges should be reduced only if offsetting increases apply to monthly charges as proposed by the Company.

GCI offered a number of rationales in an attempt to justify lower access line rates. Dr. Selwyn argued that rather than making the cost/price comparison on an individual service basis, the cost/price comparison should be made on an individual customer basis. Mr. Dunkel argued that network access lines should not be considered a service at all, but rather a shared component

[58] This conclusion is supported not only by the LRSIC cost analysis summarized above, but also by the fact that on a monthly statewide basis the embedded cost of a network access line is $19.12, compared to a statewide average price for network access line service of only $11.81. (Am. Ill. Ex. 1.3, p. 147).

of every other service that utilizes the access line. These contentions are inconsistent with sound economic theory, the Rule, and 20 years precedent at the FCC and this Commission. (Am. Ill. Ex. 1.3, pp. 128-134). Mr. Dunkel also "recalculated" the Company's LRSIC's to make them lower. His changes were not consistent with the Rule and economic theory and should be rejected. (See Section VII.C., infra). Lowering access line prices as proposed by GCI would erase two decades of progress by this Commission towards an economically efficient pricing structure that maximizes consumer welfare and encourages competition. (Am. Ill. Ex. 1.3, p. 139).

The Company has proposed to offset the residence access line price increases with price reductions in the following services: (1) carrier access charges, (2) residence access line service ordering and installation charges, (3) Band B usage additional minute charges, and (4) pay per use charges for popular calling features (Automatic Callback, Repeat Dialing and Three Way Calling).

The Company has reduced carrier access charges by approximately $33.3 million pursuant to Commission Orders in Docket No. 97-601/97-602/97-0516 (consol) and expects to reduce them by another $10.5 million when that docket is finalized for a total reduction of approximately $43.8 million.[59] The Commission rejected the Company's proposal to offset the access charge reductions with increases in network access line charges in that docket, stating that the issue was better addressed in the rate rebalancing proceeding. (Order, p. 52, Docket No. 97-

[59] If the ultimate reduction were less than $43.7 million, other rate reductions could be expanded to insure revenue neutrality in the rate rebalancing plan.

0601/97-0602/97-0516 (Consol.) (Mar. 29, 2000). Staff's principal economist Genio Staranczak acknowledged that the Company should be entitled to offsetting revenue increases under the Plan. (Tr. 1276-77).[60]

The Company is proposing to reduce one-time residence service ordering and installation charges by $21.6 million. Staff expressed reservations that these reductions would reduce one-time charges significantly below LRSIC. However, the Company pointed out that the lost revenues would be more than offset by the $84.1 million net increase in monthly residence access line revenues. It is appropriate to recover the residual service ordering and installation costs in monthly access line prices because the one-time costs are part of the overall incremental costs of access lines. (Am. Ill. Ex. 9.0, pp. 7-9; Am. Ill. Ex. 9.1, p. 7). Shifting a bigger portion of cost recovery to the monthly charges is reasonable because it is a common pricing model in competitive markets and has a beneficial impact on universal service. (Id.). Studies have shown that high levels of up-front service ordering and installation charges deter consumers from connecting to the network to a much greater extent than monthly recurring charges. The lower service ordering and installation charges will stimulate more network demand than the monthly price increases will deter[61], thereby, promoting universal service goals. (Am. Ill. Ex. 9.1, pp. 7-

[60] DOD/FEA witness Gildea proposed that IXCs be required to demonstrate "conclusively" that they are flowing through access charge reductions to their customers and that, if an IXC cannot demonstrate full flow through, Ameritech Illinois should be directed to suspend the access charge reduction for that carrier and reduce end user access line changes to pass through the reduction in access charges that were not passed through to customers by the IXC. (DOD Ex. 1, pp. 9-10; DOE Ex. 2, pp. 3-4). This "safeguard" is unnecessary. The Order in Docket Nos. 97-0601/97-0602/97-0516 (Consol.) requires IXCs to flow through access charge reductions to end users to the extent that actual access charge expenses decrease, and requires such carriers to submit documentation demonstrating flow through of the access charge reductions within the tariff filings necessitated by the Order. The Commission has the ability to monitor and enforce these provisions against the IXCs directly. Mr. Gildea's proposed "safeguard" is administratively complicated and burdensome and would improperly use Ameritech Illinois' rate structure as a means of enforcing IXC obligations. (Am. Ill. Ex. 9.2, p. 6).

[61] This is true even though the aggregate revenue increase from monthly rates will be much more than the aggregate revenue decrease for one-time charges. Consumers do not make their purchase decisions based upon the aggregate revenues of a service. They base them on the individual service price to them, and many consumers would rather come up with an extra $2 per month than an extra $63.55 all at one time. (Am. Ill. Ex. 9.1, pp. 7-8; Am. Ill. Ex. 9.3, pp. 2-6).

8). At the same time, the net revenue increase from the combined monthly increases and non-recurring charge decreases will improve the overall cost/price relationship of residence access lines, thereby, promoting economic efficiency goals. (Id.).

The Company is proposing to reduce Band B additional minute charges by approximately $12.7 million based upon the Company's perception that consumers would like to see the Band B rate structure move in the direction of the Band A per call rate structure. (Am. Ill. Ex. 9.0, p. 11; Am. Ill. Ex. 9.1, p. 12). Neither Staff nor GCI objected to this rate design change.

Finally, the Company is proposing to reduce pay per use charges for three popular calling features: automatic callback, repeat dialing and three way calling, by about $5.1 million. Mr. Sorenson testified that these pay per use charges were priced too high in relation to the monthly subscription rates for these services. Lowering the pay per use charges would give customers more reasonable break points to choose between the monthly and pay per use rates. (Am. Ill. Ex. 9.0, pp. 12-13).

In his direct testimony, Staff witness Hanson criticized the Company for not taking into account the demand effects of the proposed price changes, thereby overstating the amount of the actual revenue reductions that would result. In his rebuttal testimony, Mr. Sorenson provided the demand analysis and demonstrated the effects on overall net revenues. (Am. Ill. Ex. 9.1, pp. 3-6). He also factored into his analysis the changes in total incremental costs incurred that would result from the price changes. (Id.). The end result was that the price changes would increase overall revenues, net of the increase in incremental costs, by less than $1 million. (Am. Ill. Ex. 9.1, p. 6 and Prop. Sch. 1).

Staff criticized the rate rebalancing plan on the ground that it lacked sufficient customer equity. That is, the customers who would be experiencing the access line price increases were not necessarily the same customers who would benefit from the offsetting price reductions. Mr. Hanson overlooks that the purpose of rate rebalancing is to increase prices to customers who are underpaying for the services they use and to reduce prices for customers who are overpaying for other services to make up the shortfall. It is not the goal of rate rebalancing to insure that customers who are paying less than their fair share continue to do so. (Am. Ill. Ex. 1.2, p. 18). Nevertheless, Mr. Hanson's concerns are overstated. As Mr. Gebhardt testified, all residential customers who make long distance calls have already benefited from carrier access charge reductions, and customers will also benefit from the lower Band B usage rates, reduced calling feature charges, and lower service order and installation charges. (Am. Ill. Ex. 1.2, pp. 25-26). Moreover, Band B usage service and the calling features are available to all customers, and the lower charges would make those services more attractive to customers. (Tr. 1535-36). Finally, service changes and customer relocations are common among residence customers, and lower ordering and installation charges would make it easier for customers to make desired service changes. The most important point, however, is that the price changes overall will (i) encourage competition in the residential market and (ii) improve economic efficiency and overall consumer welfare to the net, long-term benefit of all customers.

Staff's specific suggestion to improve customer equity was to lower the Band A untimed calling rate. GCI also recommended decreasing the Band A per call rate. This would be a bad idea. The average call duration for Band A calls is increasing rapidly because of the growing percentage of internet calls, which have long holding times. Since usage costs increase with duration, the LRSIC of Band A calls is steadily increasing and approaching the current Band A rate. In the foreseeable future, it may be necessary to increase the Band A rate, just to cover LRSIC. (Am. Ill. Ex. 9.1, p. 11; Am. Ill. Ex. 9.2, p. 2). Lowering the Band A per call rate would send a false economic signal to consumers and bring much closer the day when the rate would not cover LRSIC. Pricing both the residence access line and Band A usage below cost would have a disastrous financial impact on Ameritech Illinois[62] and would have a similar impact on Ameritech Illinois' competitors who were attempting to compete with these below cost services.

B. Rate Design in the Event of Rate Reinitialization

Ameritech Illinois strongly opposes rate reinitialization. Therefore, the Company has not proposed and does not support any rate changes other than those included in, and necessary to support, the Company rate rebalancing plan.

Staff also opposes rate reinitialization. However, in the event that the Commission does order reinitialization of rates, Staff discussed how rate reductions might be accomplished. First, Staff recommended against any price reductions for competitive services. (Staff Ex. 14.0, p. 20). Ameritech Illinois agrees. Competitive services are outside the scope of alternative regulation under the Act, 220 ILCS 5/13-506.1.

Second, Staff opposed lowering any individual service rate below LRSIC. (Id.). The Company agrees that every service should recover its LRSICs, but every service also should recover its share of shared costs. (Am. Ill. Ex. 1.2, p. 15). Shared costs are the LRSICs of a group of services that share facilities, and each of the services that shares the facility should recover its proportionate share of the LRSICs of those facilities.

Third, Staff recommended that the Commission should limit any price reductions in a manner that produced a "reasonable result." (Staff Ex. 4.0, p. 7). Staff noted that lowering

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62 The Company is already losing hundreds of millions of dollars on Band A calls terminated by CLECs to internet service providers (ISPs) because the Company must pay per minute terminating access charges to the CLECs under the reciprocal compensation rules that are in effect. These issues are currently being examined by the Commission in Docket 00-0555. (AT&T Ex. 1.0, p. 12).

Ameritech Illinois' noncompetitive rates by the amount shown by Staff witness Voss under a traditional rate of return analysis would require that all of Ameritech Illinois' noncompetitive service prices would be reduced to LRSIC. (Staff Ex. 14.0, p. 20). In other words, the Company would have to recover 100% of its shared and common costs (including spare capacity costs) from competitive service revenues. This approach would be inconsistent with the Commission's decisions in the TELRIC, Access Charge Reform and FLEC proceedings, as stated earlier, and presumably, Staff would not consider this result reasonable.

Ameritech Illinois believes that such a result would be neither reasonable nor lawful. Section 13-507 of the Act requires an allocation of the total costs of the business between noncompetitive and competitive services. In making that allocation, the Commission

> "may establish, by rule, appropriate methods for ensuring against cross-subsidization between competitive services and noncompetitive services as required under this Article, including appropriate methods for calculating the long-run service incremental costs of providing any telecommunications service and, when appropriate, group of services and methods for apportioning between noncompetitive services in the aggregate and competitive services in the aggregate the value of facilities utilized and expenses incurred to provide both competitive and noncompetitive services, for example, common overheads that are not accounted for in the long-run service incremental costs of individual services or groups of services." 220 ILCS 5/13-507 (emphasis supplied).

The emphasized language implies that the legislature contemplated that noncompetitive and competitive services would each recover their own LRSIC and shared costs and that only common costs would be apportioned. The legislature also contemplated that there would be at least some apportionment of common costs to noncompetitive services. In Illinois Bell Telephone Company v. Illinois Commerce Commission, 203 Ill. App. 3d 424, 561 N.E. 2d 426, (2d Dist. 1990), the Court ruled it was a violation of Section 13-507 to fail to allocate at least some portion of common costs to competitive services. It would be a similar violation to fail to apportion at least some portion of common costs to noncompetitive services. As the Court stated:

> "By apportioning 0% of common overhead to the cost of competitive services, however, Bell has itself made an arbitrary apportionment. The statute could not more clearly require that some apportionment of common costs be made. . ." (Id., p. 441, 561 N.E. 2d at 438).

Thus, to accomplish a reasonable result, noncompetitive service prices individually should recover their LRSIC and shared costs, and noncompetitive services in the aggregate should recover a reasonable allocation of common costs. (Am. Ill. Ex. 1.3, pp. 140-141).

Because of its concerns that no service should be priced below LRSIC and rates should be set to produce a reasonable result, Staff proposed an alternative approach. Staff suggested that in the event the Commission reinitialized rates, it could allocate the revenue requirement determined under the rate of return analysis between noncompetitive and competitive services. Noncompetitive rates could then be reduced so that they only recovered the portion of the revenue requirement allocated to noncompetitive services. Competitive service rates would not be affected. The allocation of the revenue requirement between competitive and noncompetitive services could be based upon either the comparative revenues or the comparative LRSICs of the two sets of services.

Ameritech Illinois does not support any revenue reduction. As Mr. Gebhardt demonstrated in his analysis of the Company's earnings from noncompetitive services, noncompetitive services, in the aggregate, are barely profitable and are far below the cost of capital. (Am. Ill. Ex. 1.6, p. 2). Noncompetitive service rates are too low already and can expected to be reduced even further under the Plan if it is continued in the future. Rate reinitialization simply is not warranted in this docket.

For its part, GCI recommended a massive $1 billion rate reduction and has suggested deep reductions in many of the Company's individual service rates. The Company will briefly state its position on these proposed rate design changes. The Company strongly opposes any reductions in monthly network access line prices or up-front service ordering and installation charges (in the absence of offsetting increases in monthly charges) for the reasons already stated. These services are already priced below cost, and, at the very least, the situation should not be made worse. (Am. Ill. Ex. 9.1, pp. 10-11). The residence Band A per call rate should not be reduced for the reasons already stated. Competitive service rates should not be reduced because competitive services are outside the scope of the alternative regulation plan under Section 13-506.1 of the Act, 220 ILCS 5/13-506.1. (Am. Ill. Ex. 9.1, p. 11). Wholesale prices should not be separately reduced because wholesale customers will automatically receive price reductions as a result of price decreases at the retail level. Unbundled network element prices should not be reduced because they are already priced at cost as required by law. Late payment charges should not be reduced because the Commission should do nothing to encourage late payment or reward customers who pay late. Residential automatic volume discounts on usage should not be deepened; instead any usage rate reductions should be accomplished by simplifying the usage rate structure. (Am. Ill. Ex. 9.1, pp. 14-15). Finally, residential optional calling plans should not be changed. These plans include competitive Band C usage which would not be affected by the reductions. Changes should not be made that affect only part of the plan. The symmetry of the plans is affected, and their attractiveness and benefits to customers are changed in unexamined ways. (Am. Ill. Ex. 9.1, p. 12).