Finally the Company recommends against the complete elimination of non-list and non-published number charges,[63] as proposed by GCI, although these services should be considered for price reductions in the event of rate reinitialization. The traditional regulatory rationale for charging for non-list and non-pub numbers is to encourage customers to list their numbers. Being able to find a person's telephone number in the phone book or from directory assistance improves the overall utility of the network to all consumers. Therefore, at least some residual charge should be retained for non-list and non-pub telephone numbers. (Am. Ill. Ex. 9.1, p. 13; Am. Ill. Ex. 9.2, p. 4).

If rate reductions are ordered, the Company recommends that services be considered for reduction in the following order: residence service ordering and installation charges (but only if offsetting monthly price increases are implemented), residence Band B usage, residence pay per use calling services, carrier access charges, residential ISDN lines, residential vertical features, and residential complimentary central office features. (Am. Ill. Ex. 9.1, p. 14).

VII. THE COMPANY'S COST OF SERVICE STUDIES COMPLY WITH THE ILLINOIS COST OF SERVICE RULE AND WERE DEVELOPED BASED ON APPROPRIATE ASSUMPTIONS

A. THE COMPANY'S EVIDENCE

William C. Palmer, a principal of the economics and finance consulting firm of LECG, presented extensive evidence supporting the cost of service studies relied on by the Company as support for its rate rebalancing proposal. (Am. Ill. Ex. 10.0; Am. Ill. Ex. 10.1; Am. Ill. Ex. 10.2;

[63] Non-list numbers are not included in printed directories but are available from directory assistance. Non-published numbers are not included in printed directories or directory assistance records.

Am. Ill. Ex. 10.3).[64] In developing its cost of service studies, Ameritech Illinois used the LRSIC methodology prescribed by the Act and the Rule. The LRSIC of a service is the forward looking additional cost incurred by a telecommunications carrier to provide the entire output of a service. (Am. Ill. Ex. 10.0, p. 6). LRSIC excludes any costs, including common costs, that would not be incurred if the service was not produced. LRSIC is developed over a planning horizon long enough to eliminate any sunk inputs or costs. (Id.).

To determine the LRSIC of a particular retail service, Ameritech Illinois first determined the underlying costs of the network components used to provide the service. It then developed a LRSIC based on the service's individual consumption of total network capacity. It identified the resources, such as material, software, and labor, required to provision the service, in each case assuming state-of-the-art technology. (Am. Ill. Ex. 10.0, pp. 15-16). Each of these resources was treated either as an asset to be capitalized for recovery over the asset's economic life, as a current one-time expense, or as a recurring expense, as appropriate. Investments in resources that are to be used over a long period of time, such as outside plant cable and local switching equipment, were capitalized and projected to the year 2001. (Id., p. 16). These capital investments were converted to annual charges, consisting of depreciation, cost of capital, and income taxes, associated with the investment, using the Economic Costs of Network Services/Capital Costs (ECONS/CAPCOST) model. Other costs, such as maintenance costs and ad valorem taxes, were identified as recurring expenses. Those resources that involved a one-time cost, such as the labor cost of processing a service order, were identified as non-recurring expenses. The formulae for

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[64] Mr. Palmer, who has over 20 years of experience in performing cost of service studies, is uniquely qualified to testify on the cost of service issues in this case. (Am. Ill. Ex. 10.0, Sch. 1). Prior to joining LECG in 1998, Mr. Palmer was Ameritech's Director of Economic Analysis, a position in which he was responsible for developing the methodological framework for the cost studies of Ameritech and all of its operating telecommunications subsidiaries, including Ameritech Illinois. (Id., pp. 1-2). Mr. Palmer has presented testimony on cost of service matters in numerous regulatory proceedings in Illinois and other states. (Id.).

these computations have been incorporated into computer programs to facilitate the process. (Id.).

The Company's cost studies fully comply with the Rule's requirement that LRSICs be based upon existing network central office locations and reflect the best technology currently available. (83 Ill. Admin. Code Section 791.20(c), 40(c)). Ameritech Illinois' models assume that each central office is equipped with the switching equipment and capacity that would be efficient, going forward, for the current demand conditions in that office. The models also assume efficient placement of outside plant facilities, including feeder, distribution, and Serving Area Interfaces ("SAIs"), using the most efficient cables available, given Ameritech Illinois' central office locations and customer locations. The models used by the Company include, inter alia, (i) the Loop Facility Analysis Model ("LFAM"), used to develop investments for the feeder, distribution and drop portions of the local loop for purposes of calculating network access line LRSICs; (ii) the Network Usage Cost Analysis Tool ("NUCAT"), used to determine the LRSICs of usage services; and (iii) the Ameritech Regional PIP Switching Model ("ARPSM"), used to calculate forward-looking switching investments. These models were fully described by Mr. Palmer. (Am. Ill. Ex. 10.0, pp. 15-29, Schs. 3-6).

Mr. Palmer explained that the LRSIC studies do not identify all of the costs which should be considered in setting prices for telecommunications services. For example, as discussed in Section VI.A., above, the LRSIC studies do not include the cost of spare capacity built into the feeder and distribution plant to (i) accommodate future growth in the number of customers and (ii) also makes it possible to provide additional lines to existing customers quickly and inexpensively. (Am. Ill. Ex. 10.0, p. 11). The Company separately identified the cost of spare

capacity which is not reflected in the LRSICs for network access lines by modifying the studies to reflect actual utilization rather than utilization based on usable capacity. (Id.).

The Company also provided information regarding shared and common costs. As previously discussed, the Rule distinguishes between common costs that are shared by a subset of the services provided by a carrier ("shared costs") and those costs common to the provision of every service or element provided by a carrier ("common costs"). The Rule requires that shared costs, such as vehicles or maintenance facilities, be included in the LRSIC of the group of services that actually cause the shared cost. The Rule also recognizes that common costs, such as executives' salaries, are not directly attributable to any service or group of services and only requires that they be apportioned between non-competitive and competitive services on an aggregate basis for purposes of the Aggregate Revenue Test. (Am. Ill. Ex. 10.0, pp. 53-54). Loading factors were used to assign forward-looking shared and common costs to the services at issue in this proceeding.[65] Although common cost allocations are not required by the Rule, Ameritech Illinois provided the information as further evidence that its rate proposals are reasonable. (Id., p. 54).

A summary of the LRSICs for all of the services for which price changes were proposed by the Company and/or other parties to this proceeding is set forth in Schedule 4 of Ameritech Illinois Exhibit 10.3. The summary schedule also identifies the shared and common costs calculated for each of those services and the spare capacity costs calculated for network access lines.

[65] The method used to calculate loading factors is discussed in detail in Mr. Palmer's Direct Testimony. (Am. Ill. Ex. 10.0, pp. 53-56, Sch. 7).

B. STAFF'S POSITION

The only aspect of the Company's studies on which Staff commented was the LFAM used to develop loop costs for purposes of calculating network access line ("NAL") service LRSICs.[66] Staff's concern stems from the fact that changes made to the LFAM model since the Company's last Aggregate Revenue Test ("ART") filing resulted in increases in the LRSICs calculated for NAL service. (Staff Ex. 24.0, p. 3; Staff Ex. 27.0, p. 13). This concern is unfounded. The LFAM model was improved significantly and was applied using more realistic input assumptions. The model improvements are described in detail in Mr. Palmer's testimony. (Am. Ill. Ex. 10.0, pp. 28-29; Am. Ill. Ex. 10.1, pp. 41-46). For example, the previous model relied on 1600 samples that were over ten years old to develop distribution and drop investments. The new model uses 5.2 million addresses in almost 12,000 distribution areas. The new model also captures necessary component costs that were not included in the old samples, such as Service Area Interfaces and interior terminals and drops. The new model also reflects a mix of 22-, 24-, and 26- gauge cable, which is the forward-looking mix actually being deployed by Ameritech Illinois. The old model assumed that all cable was 26-gauge, which is the smallest and least expensive gauge. In addition, the previous study did not include investments for the huts and cabinets that house terminal equipment. (Am. Ill. Ex. 10.1, pp. 28-29; Am. Ill. Ex. 10.2, pp. 42-45). As a result of these and other LFAM model improvements, the cost studies under review in this proceeding resulted in a more accurate estimate of the Company's NAL costs. (Id.).

Staff witness Marshall incorrectly asserted that the LFAM does not comply with Section 791.40(a)(i) of the Rule, which requires that the LRSIC be based on the "locations of, and

66 Staff did not present testimony criticizing the calculations of LRSICs for other services. (Tr. 2014).

planned locational changes to, the existing network configuration." (Staff Ex. 18.0, p. 5). In fact, the investment calculations performed by the LFAM are tightly linked to the actual Ameritech Illinois network configuration data, characteristics and engineering practices. (Am. Ill. Ex. 10.2, pp. 4-7). In this regard, the main building block in the architecture used for distribution facilities is the Distribution Area ("DA"), a well-defined geographically specific portion of the wire center. (Am. Ill. Ex. 10.2, p. 4). The most significant cost drivers within the DA are loop length and cable sheath size. (Id.). Mr. Palmer described in detail the manner by which the LFAM engineers a realistic network configuration and captures these important cost drivers for almost 12,000 DAs containing over 5.2 million circuits. (Id.). By comparison, the distribution characteristics used to derive the costs reflected in the last ART filing were based on 1600 samples drawn over ten years ago. In fact, Ameritech Illinois developed its new methodology largely in response to criticisms received in Docket No. 96-0486/0569 regarding the age and accuracy of the distribution characteristics reflected in the old sample. As a result, the new LFAM develops an accurate estimate of the Company's forward-looking DA investment, as required by Section 791.40 of the Rule. (Am. Ill. Ex. 10.2, p. 7).

Ms. Marshall also misinterpreted Section 791.40 as requiring that "the demand utilized to capture the capacity included in the LRSIC study must also be used to allocate the costs to that capacity." (Staff Ex. 18.0, pp. 5-6). In fact, that Section requires only that all demand for a service subject to a LRSIC study be included in the study. (Am. Ill. Ex. 10.2, p. 8). Nonetheless, the Company's cable sizing and costing methodology does, in fact, comply with Section 791.40 as interpreted by Ms. Marshall. For example, the interpretation would require Ameritech Illinois to divide the cost of the capacity required to serve 150 lines by 150 lines. If the required capacity is a 200 pair cable because 150 pair cables are not manufactured, then, according to Ms.

Marshall's interpretation, Ameritech Illinois should divide the cost of the 200 pair cable by 150 lines. That is exactly what LFAM does. (Am. Ill. Ex. 10.2, p. 9).

Staff witness Green incorrectly asserted that the LFAM may be too "forward-looking" and reflect a design that "goes well beyond the needs to provide basic telephone service." (Staff Ex. 24.0, pp. 3-4). The LFAM is based on current network configuration and locations and reflects only the demand for loops expected during the study period, in this case 2001. (Am. Ill. Ex. 10.2, p. 27). Moreover, it is based on the least cost currently available technology for which prices can be determined from existing data. Contrary to Mr. Green's suggestion, therefore, the LFAM does not model a hypothetical, futuristic network. (Id.).

Furthermore, Mr. Green's concerns about the LFAM were predicated solely on the fact that the LFAM model, as applied by the Company in this case, utilized a breakpoint of 6,000 feet between copper and fiber cables in the loop. (Id.). Mr. Green observed that "today there exists copper loops of more than twice that distance." (Id.). The evidence, however, demonstrates that the 6,000 feet breakpoint is fully consistent with appropriate engineering practices and principles and complies with the "forward-looking" cost requirement of the Rule. As Mr. Palmer explained, the breakpoint represents the distance from the central office at which fiber, rather than copper, feeder cables are used. The LFAM requires an input for the breakpoint to model the overall average forward-looking least cost network. (Am. Ill. Ex. 10.2, p. 24). Historically, the breakpoint has been moving closer to the central office as the costs of remote terminals and central office terminals have decreased. Furthermore, bandwidth management (i.e., assigning and modifying working pairs) is easier using fiber plant rather than copper plant. In addition, fiber facilities tend to be more reliable than their copper counterparts, resulting in lower operating costs. (Am. Ill. Ex. 10.2, pp. 24-25).

As a result, if network access lines were being provided for the first time, the most economical fiber/cable breakpoint would be 6,000 feet. (Am. Ill. Ex. 10.2, p. 28). Accordingly, use of that breakpoint as an input in the LFAM complies with Section 791.20(c) of the Rule, which requires that LRSICs be calculated "as if the service were being provided for the first time." (Id.). Moreover, changing the breakpoint to 12,000 feet (which is less economical than a 6,000 feet breakpoint), as Mr. Green suggested, would result in an increase in the LRSICs for network access lines. (Am. Ill. Ex. 10.2, p. 26). Accordingly, there is no merit to Mr. Green's suggestion (Staff Ex. 24.0, p. 3) that the breakpoint assumption made by the Company imposes a "burden" on residential customers.

Staff witness Hanson alleged that a consultant retained by Staff to review the LFAM had encountered a "problem" operating the model while attempting to test alternative fiber/copper breakpoint assumptions. Mr. Hanson incorrectly asserted that the 6,000-foot copper/fiber breakpoint was "hard-coded" in a database. (Staff Ex. 28.0, p. 2). As Mr. Palmer explained, however, the 6,000 breakpoint is not "hard-coded." To the contrary, all breakpoints that a user may define are placed within database tables within LFAM. The "problem" Staff's consultant actually encountered was a malfunction in the Graphical User Interface ("GUI"), not the LFAM model itself. After the malfunction was discovered, the GUI was bypassed by an Ameritech programmer, who manually updated the database. All breakpoint tables that had been created prior to the GUI malfunction were available to the Staff for use in future runs. Any problems with the GUI had absolutely no impact on the accuracy of the LRSIC studies developed using the LFAM model. (Am. Ill. Ex. 10.2, pp. 10-11).

Mr. Hanson also asserted that when the LFAM model was run under alternative scenarios, an "anomalous" result was produced, thereby calling into the question the model's

accuracy. (Staff Ex. 28.0, p. 4). As Mr. Palmer explained, however, the alleged "anomaly" was, in fact, created by Mr. Hanson's incorrect assumption regarding the results of the "base case" scenario. In the first alternative scenario, Staff asked Ameritech Illinois to run the LFAM using a copper/fiber breakpoint of 12,000, rather than 6,000 feet. One would reasonably expect the cost estimates produced by LFAM to increase in this scenario because fiber is the economical technology choice for loops greater than 6,000 feet. Instead, Mr. Hanson quantified the impact of scenario one as lowering LRSIC, an apparent anomaly. However, Mr. Hanson was mistaken because the "base case" LRSIC to which he compared the results of the first alternative scenario did not reflect reductions that were made in response to errors discussed by Mr. Dunkel in his direct testimony and corrected in Mr. Palmer's Rebuttal Testimony. Using the corrected "base case" result as a starting point, the LRSIC increased under the first alternative scenario, consistent with expectations. (Am. Ill. Ex. 10.2, p. 14).

In another alternative scenario discussed by Mr. Hanson, Staff requested that the Company run LFAM using a 12,000-foot breakpoint, a 10.52% cost of money and FCC (rather than ICC) depreciation lives. This scenario, like the first one, increased LRSIC because (i) the 12,000 foot breakpoint introduces more copper cable circuits, which are more expensive than fiber circuits at distances greater than 6,000 feet, and (ii) the FCC lives for the copper cable accounts are shorter than those used in the original studies, thereby inflating the annual charge factors. In sum, once the appropriate base case result is established, there are no anomalies in the results of the sensitivities requested by Staff, and the LFAM performs according to expectations. (Am. Ill. Ex. 10.2, pp. 13-14).

Mr. Hanson also alleged that the LFAM "fail[s] to take into account any reduction in material costs resulting" from the Ameritech/SBC merger. (Staff Ex. 28.0, p. 3). Mr. Hanson,

however, provided no support for the assumption that there will be such a cost reduction. As Mr. Palmer explained, the material prices used in LFAM reflect the vendor contracts in effect at the time the cost studies were undertaken. The studies, therefore, comply with Section 791.20(c) of the Rule, which requires that costs be "based on the least cost technology currently available whose costs can be reasonable estimated based on available data." (Emphasis added) (Am. Ex. Ill. 10.2, pp. 11-12). As Mr. Palmer also explained, there is no basis to conclude that all costs of materials used in provisioning loops will decrease under new, post-merger supplier contracts. Contracts are developed for many hardware and plug-in items and there are often tradeoffs. New contracts often decrease prices for certain items while increasing prices for others. This situation is especially likely to occur here because, prior to its merger with SBC, Ameritech's vendor contracts did not match SBC's contracts. SBC may have been given bigger discounts on certain items, while Ameritech may have received bigger discounts on other items. The new combined contracts will likely contain some price decreases and some increases when compared to either SBC's or Ameritech's old contracts. Each new contract must be evaluated on its own merits as it pertains to particular LRSIC studies. (Id.).

Finally, Mr. Green argued that the Company understated the usable capacity of buried drop wire, suggesting that the usable capacity of a five pair buried drop wire is 100%. Mr. Green's analysis, however, failed to take into account the fact that, when a facility such as a buried drop is dedicated to one customer, obtaining a 100% or even 85% average utilization across all buried drops is an unrealistic expectation and will never be achieved as an average in the long run. (Am. Ill. Ex. 10.2, p. 17). Moreover, as Mr. Palmer explained, in a forward-looking design, five pair drops are placed in newer areas and are usually buried to allow for the possibility that the customer at that location may someday demand additional lines. Realistically,

and from an engineering and planning perspective, however, five pairs will rarely be used. Ameritech Illinois used the value of 1.5 pairs in use per drop cable as a high estimate of the actual number of working lines per household. This results in a conservative estimate of drop costs, because the total drop investment is divided by the average number of working lines per drop. In any event, for reasons explained by Mr. Palmer, if the cost studies were run using Staff's assumption regarding the usable capacity of buried drop cable, the impact on the resulting LRSICs for NAL service would be minimal. (Am. Ill. Ex. 10.2, p. 19).[67]

C. GCI'S ARGUMENTS

1. Residential NAL Service LRSICs

Unlike Staff, GCI witness Dunkel did not challenge use of the LFAM model. Mr. Dunkel did, however, alleged that certain "errors" were made in the calculation of inputs to the models used to calculate those LRSICs. Mr. Dunkel correctly noted that the Company inadvertently added residential and business line field installation costs when those costs should have been weighted. A correction of that error is reflected in the revised NAL LRSICs set forth in Schedule 9 (Rev.) of Ameritech Illinois Exhibit 10.1 and Schedule 4 of Ameritech Illinois Exhibit 10.3. For the reasons discussed below, however, Mr. Dunkel's other criticisms are without merit and GCI's proposed corrections to the loop costs, as listed on GCI Exhibit 8.15,

[67] Mr. Green also argued that the usable capacity for fiber feeder assumed in the NAL cost study should be 67% rather than 33%. (Staff Ex. 24.0, p. 2). In response, Mr. Palmer explained that the methodology applied by the Company does, in effect, use a 67% fiber utilization factor. (Am. Ill. Ex. 10.2, pp. 19-22). Accordingly, this aspect of the Company's cost study does not appear to be an issue.

should be rejected.[68]

a. Network Interface Device ("NID") Costs

Mr. Dunkel alleged that the Company "double-counted" the costs of NID testing activities. In support of this allegation, Mr. Dunkel asserted that the study improperly assumes that a new NID is tested three times at each installation. (GCI Ex. 8.0, p. 46; GCI Ex. 9.0, p. 65). As Mr. Palmer explained, however, the tests referred to by Mr. Dunkel represent three separate tests performed for three different purposes. (Am. Ill. Ex. 10.3, pp. 23-24). Moreover, because each of these tests are not performed 100% of the time, the cost estimates reflect a frequency-of-occurrence factor that is used to produce a weighted average installation cost. (Id., p. 24). Accordingly, there is no "double-counting."

Mr. Dunkel also argued that the amortization period used for NID installation costs is too short. (GCI Ex. 8.0, p. 47). As Mr. Palmer explained, the 48 month amortization period referred to by Mr. Dunkel was actually applied to the cost of locating and testing the NID and is correct for that purpose based on the average access line user location life. (Am. Ill. Ex. 10.1, p. 19).

b. Common Switching Equipment Costs

Mr. Dunkel argued that the Company inappropriately assigned all of the common costs of switching equipment to basic exchange NAL rates. (GCI Ex. 8.0, pp. 48-50). Mr. Dunkel's argument was based on a misunderstanding of the method which the Company's ARPSM model uses to identify Centum Call Seconds ("CCS") related costs. As Mr. Palmer explained, none of

[68] Mr. Dunkel argued that the costs of loop and port facilities are actually shared by several services and, therefore, should not be included in the LRSIC for network access line service. (GCI Ex. 8.0, pp. 61-83). For reasons fully discussed by Mr. Palmer, Mr. Gebhardt, and Dr. Harris, Mr. Dunkel's argument conflicts with the Rule, Commission policy, and sound economic principles. (Am. Ill. Ex. 1.3, pp. 132-34; Am. Ill. Ex. 4.2, pp. 37-41; Am. Ill. Ex. 10.1, pp. 6-8). Mr. Dunkel, however, did not propose to reduce the LRSICs for NAL service to reflect his erroneous "shared loop and port facility" theory. (GCI Ex. 8.0, p. 83). Accordingly, the arguments made by Mr. Dunkel in support of that theory should be disregarded.

the vendor contracts contain an explicit price for CCS. Instead, the contracts specify only a single per-line price, which includes all line-related, usage-related, and "common" related hardware and software costs. The Company, therefore, requested additional information from the switch vendors that would allow the Company to identify an implicit or assumed CCS component of the total per-line price. Under this methodology, any costs associated with common equipment that are inherent in the single per-line prices of the vendors are, by default, assigned to lines and usage in proportion to their respective implicit costs. Mr. Dunkel's suggestion that 100% of the common costs were assigned to NAL service is, therefore, incorrect.

c. Line Card Costs

The Company's cost studies identify the costs of line cards in remote terminals separately from the line cards in the switch. (Am. Ill. Ex. 10.1, p. 20). Mr. Dunkel claimed that line cards at remote terminals provide the same functionality as do line cards at the central office and, therefore, that the Company's cost studies "double-recover" line card costs. (GCI Ex. 9.0, pp. 69-70). Mr. Dunkel is wrong. Digital signaling from the central office switch controls the remote terminal line cards from the central office switch. Remote line cards are provided under the supervision of the central office switch and do not work without the assistance of the central office switch. Therefore, line cards at both the central office and remote terminal are required to serve a line through a remote terminal, and the costs of both components must be reflected in the LRSIC study. (Am. Ill. Ex. 10.3, p. 9).

d. Replacement and Growth Line Mix

Ameritech Illinois' switch vendors charge two separate prices for installing switching capacity on a per-line basis. One per-line price applies to a limited number of lines on analog

switches specifically identified in the contracts as being replaced with digital switches, while a higher price applies to growth lines installed on existing digital switches and growth lines subsequently installed on "replacement" switches. (Am. Ill. Ex. 10.1, p. 22). ARPSM combines these two prices with the quantities of lines expected to be installed at each price in each year of the contracts. In doing so, it generates the single price that the vendor would charge, were it to replace its two-tiered pricing structure in its most recent contract with a single per-line price. (Id.). This price per line represents the best estimate of the average forward-looking market price the switch vendors would charge Ameritech or any similarly situated carrier for any quantity of lines purchased and is, therefore, the appropriate price estimate to use in LRSIC analysis. (Id.).

Mr. Dunkel proposed an adjustment to the LRSIC for NAL service to reflect a mix of replacement and growth lines different than the mix assumed by the switch vendor contracts. (GCI Ex. 8.0, p. 51). Mr. Dunkel's approach would distort the actual forward-looking price contemplated by the vendors and the carrier at the time the contracts were negotiated, and, therefore, is inconsistent with the requirements of the Rule, which states the following regarding input prices:

> "Input prices. Each cost study shall reflect input prices (e.g., the prices for materials, labor, and capital) that the carrier is actually expected to face. The carrier shall provide the underlying bases for projected changes in input price levels, using, wherever possible, projections based on market expectations and rates set in labor contracts. Where appropriate, costs shall be based on prevailing vendor prices or vendor prices under consideration that reflect volume discounts or term discounts off listed input prices. These discounts shall be reflected in the cost study." (emphasis added) 83 Ill. Admin. Code Section 791.60(c).

Ameritech Illinois' ARPSM methodology meets this standard. (Am. Ill. Ex. 10.1, pp. 23-24).

e. "Revenue Ready" Fees

"Revenue ready" fees are associated with line ports installed on switches and are assessed on a per-line, per-year basis by switch vendors to compensate them for traffic engineering and provisioning functions, as well as for any processor upgrades and new switch generic releases. (Am. Ill. Ex. 10.0, p. 34; Am. Ill. Ex. 10.3, p. 3). Mr. Dunkel argued that "revenue ready" fees were improperly included in the line termination costs. (GCI Ex. 8.0, pp. 51-52). Mr. Dunkel's argument is without merit. The only way for the Company to avoid paying "revenue ready" fees would be to provide no line ports, and, therefore, no NAL service. The vendor contracts are clear and provide no basis for assigning "revenue ready" fees to other services. Consistent with the Rule's cost causation principles, therefore, the Company correctly assigned revenue ready costs to NAL service. (Am. Ill. Ex. 10.3, p. 3).

f. Billing Costs

Mr. Dunkel argued that the Company's assignment of billing costs to NAL service is improper because a variety of other services, including toll services and vertical services such as Call ID and Call Waiting, are also supported by such costs. (GCI Ex. 8.0, pp. 52-54). Mr. Dunkel's argument is inconsistent with the Rule's cost causation principle, which requires that the service which initially causes a cost to be incurred must be assigned that cost. 83 Ill. Admin. Code Section 791.30. (Am. Ill. Ex. 10.3, p. 6). Billing costs are brought into existence as a direct result of customer demand for network access lines. If a customer orders only a line and no other services, that customer must still be billed, an account must be established, a statement must be prepared, paper and envelopes must be used, postage must be paid, and the customer's payment processed. Conversely, none of those costs can be avoided if none of the vertical

features or other services referenced by Mr. Dunkel are utilized by the customer. In accordance with the cost causation principle, therefore, billing costs are properly assigned to the NAL. (Am. Ill. Ex. 10.1, pp. 24-25; Am. Ill. Ex. 10.3, pp. 6-7).

g. Capital Costs

Ameritech Illinois' cost models use a weighted cost of capital for LRSIC studies calculated in a manner consistent with Section 791.80(b)(1) of the Rule. (Am. Ill. Ex. 10.0, p. 10, Sch. 2; Am. Ill. 10.1, pp. 25-28). Specifically, the cost of money was calculated in the basis of a forward-looking capital structure and reflects the cost of equity (11.97%) which the Commission approved for use in the LRSIC studies adopted in the 1994 Order. (Am. Ill. Ex. 10.0, pp. 26-27; 1994 Order, at pp. 89-90). Mr. Dunkel criticized the Company's forward-looking capital structure and proposed the use of an overall cost of capital (9.74%) lower than the cost rate used in the Company's cost studies.

Mr. Dunkel's proposal should be rejected. In criticizing the Company's forward-looking capital structure, Mr. Dunkel relied on a discussion in the Order issued in Docket No. 96-0486/0569 (Consol.), a proceeding to review the Company's TELRIC cost studies. As Mr. Palmer testified, and the Commission has recognized, however, LRSIC studies serve a different purpose than TELRIC studies. (Am. Ill. Ex. 10.1, p. 26; Order, Docket 96-0486/0569 (Consol.), p. 35). TELRIC studies are used to set actual prices for wholesale network elements, whereas LRSICs are developed for the purpose of setting price floors for retail service. (Am. Ill. Ex. 10.3, p. 12). Accordingly, the decisions made in the TELRIC proceeding do not control retail LRSIC studies. (Id.).

Furthermore, Mr. Dunkel understated the cost of capital by assigning a cost rate to common equity of only 11.80%, which is less than the equity cost rate (11.97%) approved for

LRSIC study purposes in the 1994 Order, and less than the current cost rate of 13.10% recommended by Staff on the basis of the expert analysis presented by Mr. Pregozen. (Staff Ex. 25.0, p. 2). As discussed in Section V.D. of this brief, GCI presented no evidence to support a finding that the cost of common equity for Ameritech Illinois is as low as 11.80%. In this regard, Mr. Pregozen recommended an overall cost of capital for LRSIC purposes of 10.75% , which is higher than the value assumed in the Company's studies, and more than 100 basis points higher than Mr. Dunkel's recommendation. (Staff Ex. 25.0, Sch. 25.01). Accordingly, there is no basis for Mr. Dunkel's proposal to reduce the cost of capital reflected in the Company's studies.

Mr. Dunkel also alleged that the average net investment upon which the cost of money factors are calculated is overstated in the Company's studies. (GCI Ex. 8.0, pp. 56-60). Mr. Dunkel's allegation was based on an assumption that over the life of facilities, net average investment averages 50% of gross investment. As. Mr. Palmer explained, Mr. Dunkel's 50% net investment scenario only works in theory of all units of property within an account have actual service lives equal to the average service life assumed for that entire account. In the real world, however, some units remain in service longer than average and some units are retired after service lives shorter than the average. (Am. Ill. Ex. 10.1, p. 30). Unlike the model used by Mr. Dunkel, Ameritech Illinois' CAPCOST program captures these survivor effects. (Id.).

In addition, the CAPCOST program properly reflects straight-line equal-life group book depreciation ("ELG"), a refinement of straight-line depreciation accounting which allows the total allowable lifetime depreciation of any item to be accrued at a depreciation expense over its actual life, whether it is longer or shorter than the average. When compared with the straight-line vintage group method, ELG will shift more of the capital repayment costs for a group or

account towards the early years, which is reflected in the average reserve calculated by CAPCOST. (Am. Ill. Ex. 10.1, pp. 32-33). Mr. Dunkel's capital cost model does not properly apply the ELG method. (Am. Ill. Ex. 10.3, pp. 13-14).

As Mr. Palmer testified, the CAPCOST model used in this proceeding is essentially the same as the model which the Company has been using since the mid-1980s. Although CAPCOST inputs, such as average lives, costs of money and capital structure have been debated during the time period, the basic CAPCOST methodology and model have never been questioned. (Am. Ill. Ex. 10.1, p. 35). On the other hand, the capital cost model used by Mr. Dunkel to calculate the annual cost factors which he recommended has never been used in an Illinois cost of service proceeding. (Am. Ill. Ex. 10.1). For these reasons and the other reasons discussed above and in Mr. Palmer's testimony, Mr. Dunkel's proposed adjustments to the LRSICs to reflect his calculation of capital costs should be rejected. (Am. Ill. Ex. 10.3, p. 15).

2. LRSICs for Local Usage Service

Mr. Dunkel calculated LRSICs for local usage services by revising the results of the Company's LRSIC cost studies to reflect his proposals regarding (i) capital costs and (ii) the assumed mix of replacement and growth lines. (Tr. 1693). For the reasons discussed above, Mr. Dunkel's proposals in this regard are unsupported. Accordingly, his proposed revisions to the Company's LRSIC calculations should be rejected.

3. Shared and Common Costs

Mr. Dunkel repeatedly suggested that Ameritech Illinois has either improperly included shared and common costs in its LRSIC studies or is recommending that such costs be included. Neither proposition is correct. The Company clearly identified shared and common costs

separately from the LRSIC costs. (Am. Ill. Ex. 10.1, Sch. 9 (Rev.); Am. Ill. Ex. 10.3, Sch. 4). For the reasons discussed in Section V. above, however, shared and common costs should be considered in establishing service rates.

In this regard, the Company, unlike Mr. Dunkel, clearly distinguished shared costs from common costs. Mr. Dunkel cited Section 791.20(a) of the Rule, which requires that costs that would be incurred even if a service is not produced be excluded from LRSIC. (GCI Ex. 8.0, p. 38). He failed, however to cite Section 791.20(g), which requires that costs caused by a group of services (shared costs) be included in the LRSIC of the group of services. The shared costs shown separately from the LRSICs on Schedule 4 of Ameritech Illinois Exhibit 10.3 are product support costs incurred on behalf of, or shared by all of, Ameritech Illinois' retail services including the basic exchange services at issue in the proceeding. (Am. Ill. Ex. 10.1, p. 3). The amounts identified represent a reasonable apportionment based on the relative LRSICs of the services in question.[69] Further, the Aggregate Revenue Test, as specified in Section 791.200 of the Rule, requires that shared and common costs be apportioned between competitive and noncompetitive services pursuant to the relative LRSIC method. Although the sum of such apportionments and LRSICs of noncompetitive services do not represent a price or revenue floor for noncompetitive services, they do provide useful information for consideration in pricing decisions. That is why Ameritech Illinois provided the additional cost information in this case. Contrary to Mr. Dunkel's suggestions, however, the Company did not include those additional costs in LRSIC.

Mr. Dunkel asserted that the Company's allocations of shared and common costs were

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[69] Mr. Dunkel incorrectly argued that the Company allocated the shared costs of a group of services to only one service. (GCI Ex. 9.0, p. 79). In fact, the Company apportioned the shared costs of all retail services to the specific services at issue in this proceeding based on their LRSICs.

"arbitrary." (GCI Ex. 8.0, pp. 38-39). This assertion is unfounded. In fact, the allocations are based on the Aggregate Revenue Tests' relative LRSIC methodology, as required by the Rule and accepted by the Commission. (Am. Ill. Ex. 10.1, p. 5). Mr. Dunkel argued that the "relative LRSIC method" is intended to apply only to competitive services. Mr. Dunkel's interpretation of the Rule is erroneous. Section 791.200(a)(3) requires that competitive services receive an allocation of the total common costs equal to the ratio of: (the LRSICs of competitive services – LRSICs of noncompetitive service elements imputed into the costs of competitive services subject to imputation) / (Sum of LRSICs of all competitive services + Sum of LRSICs of all noncompetitive services). By definition, the "relative LRSIC" methodology requires two things to be related to each other – in this case, the sum of the competitive LRSICs must be related to the non-competitive LRSICs. (Am. Ill. Ex. 10.3, p. 17). Furthermore, in order to allocate common costs to competitive services as required by Section 791.200(a)(3), shared costs caused by groups of services must first be attributed to the LRSIC of groups of services as required by Section 791.20(g) of the Rule. In the immediate case, Section 791.20(g) requires that shared costs caused by non-competitive and competitive services as groups be reflected in the LRSIC of the groups before common costs are allocated to either group. This apportionment is precisely what is represented by the separately identified shared costs shown on Schedule 4 of Ameritech Illinois Exhibit 10.3. (Am. Ill. Ex. 10.3, p. 18).

Mr. Dunkel also argued that the overhead costs calculated for NAL service were "discriminatory" because overhead factors were applied to a base which included 100% of the costs of the loop and NTS Central Office Equipment. (GCI Ex. 8.0, pp. 39-42). Consistent with the cost causation principle established in Section 791.30(a) of the Rule, however, all of the costs of the loop and NTS Central Office Equipment <u>are</u> appropriately assigned to NAL service

because such costs are "brought into existence as a direct result of providing [NAL] service." 83 Ill. Admin. Code Section 791.30(a). (Am. Ill. Ex. 10.1, pp. 6-7). Accordingly, the inclusion of such costs in the base to which the overhead factor is applied for purposes of allocating common overhead costs to NAL service is perfectly appropriate. Furthermore, as discussed by Mr. Palmer, the application of Ameritech Illinois' shared and common cost loading factors simply mirrors how those factors were developed. The model calculates an estimated loading for shared and common costs on a per-dollar of LRSIC basis. The Ameritech Shared and Common Cost Factors model is "blind" to product and/or service distinctions (with the exception of retail vs. wholesale definitions where applicable). As such there can be no discriminatory allocation specific to residential NALs or any other service. (Am. Ill. Ex. 10.1, p. 10).

Mr. Dunkel also argued that the Company's shared and common cost calculations are "meaningless" because they are based on an embedded data. This argument is without merit. As Mr. Palmer explained in detail, the Ameritech Illinois Shared and Common Model appropriately estimates forward-looking costs by (i) developing relationships between expenses and investments as of 1998, (ii) adjusting these relationships explicitly for reasonable cost savings, inflation and merger-related savings as noted above, and (iii) applying these relationships to expenses based on forward-looking investments. (Am. Ill. Ex. 10.1, pp. 13-16). By applying meaningful expense relationships to expenses based on forward-looking investment, Ameritech Illinois is producing forward-looking shared and common expenses. Because Ameritech Illinois' forward-looking investment is substantially lower than investment today, this approach results in a significant reduction in shared and common expense. (Id., p. 16).

Moreover, as Mr. Palmer also explained, the application of factors derived from historical data to theoretical LRSIC calculations to calculate forward-looking costs is common industry

practice which is recognized and permitted under the Rule. (See, e.g., Sections 791.80(b), 791, 60(f); Am. Ill. Ex. 10.1, p. 17). Ameritech Illinois has for several years used historical data to develop forward-looking cost factors for use in its cost of service studies. During that time the Commission has never cited Ameritech Illinois' approach as inconsistent with the Rule. (Am. Ill. Ex. 10.1, p. 17).

VIII. CUB/AG COMPLAINT

On December 4, 2000, CUB and the AG filed a complaint requesting a reduction in Ameritech Illinois' rates and for other relief, pursuant to Sections 9-250, 13-505, and 13-506.1 of the Public Utilities Act. Based on the same earnings analysis provided in its testimony in this review proceeding, CUB/AG contended that Ameritech Illinois' rates are unjust and unreasonable and that rate reductions are required. For all of the reasons stated previously in this Initial Brief, CUB/AG are wrong on the facts, the law and the applicable policy. Nothing in Sections 9-250, 13-504 or 13-505 of the Act override the express provisions of Section 13-506.1 which make rate of return regulation inapplicable to companies which operate under a price regulation plan. As Ameritech Illinois pointed out in its Motion to Dismiss and related pleadings, CUB/AG have never explained why they filed this complaint or what impact they believe it will have on the Commission's resolution of the contested policy issues. Ameritech Illinois' Motion to Dismiss, p. 7; Reply to CUB/AG Response to Motion to Dismiss, pp. 3-4. Accordingly, the Company will provide a more complete response in its Reply Brief after it has had an opportunity to review CUB's and the AG's Initial Briefs.

IX. CONCLUSION

For the foregoing reasons, the Commission should conclude that Ameritech Illinois' Alternative Regulation Plan has performed well and should extend it. The minor modifications proposed by the Company are reasonable and should be approved. Ameritech Illinois' noncompetitive service rates are just and reasonable within the meaning of Section 13-506.1 of the Act and there is no legal, policy or factual support for GCI's rate reinitialization proposal. All of Ameritech Illinois' customers -- both retail and wholesale -- as well as the State of Illinois generally will continue to benefit from the forward-looking, innovative alternative to rate of return regulation which the Commission adopted in 1994.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Louise A. Sunderland, an attorney, hereby certify that copies of the foregoing Initial Brief of Ameritech Illinois were served upon the parties on the attached service list via electronic mail and/or by Federal Express on March 22, 2001.

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