

OFFICIAL FILE  
ILLINOIS COMMERCE COMMISSION

STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION

ORIGINAL  
ILLINOIS COMMERCE COMMISSION  
MAR 23 12 22 PM '01  
CHIEF CLERK'S OFFICE

Illinois Bell Telephone Company	:	
Application for review of alternative regulation plan.	:	98-0252
Illinois Bell Telephone Company	:	98-0335
Petition to rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates.	:	
Citizens Utility Board and The People of the State of Illinois vs- Illinois Bell Telephone Company	:	00-0764 (Consolidated)
Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief.	:	

INITIAL BRIEF  
OF THE  
CITIZENS UTILITY BOARD

Dated: March 22, 2001

Karen L. Lusson  
Attorney for  
Citizens Utility Board  
349 S. Kensington Av.  
LaGrange, IL 60525  
(708) 579-9656

I.	SUMMARY OF THE CASE/CUB POSITION .....	5
II.	REVIEW OF THE ALTERNATIVE REGULATORY PLAN.....	8
A.	Scope of the Review Proceeding .....	8
B.	Commission Goals for the Plan .....	12
C.	Issues Specified in the 1994 Order .....	19
1.	Whether the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation. ....	19
2.	An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.....	19
3.	Whether the adopted monitoring and reporting requirement should be retained or adjusted.....	20
4.	The extent to which Illinois Bell has modernized its network, and additional modernization plans for the near term. ....	21
5.	A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect. ....	22
6.	A listing of any services that have been withdrawn during the period.....	23
7.	A listing of all services that have been reclassified as competitive or noncompetitive during the period. ....	23
8.	A summary of new services that have been introduced during the period.....	24
9.	Information regarding any changes in universal service levels in Illinois Bell's service territory during the price cap period. ....	25
10.	Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals.....	26
D.	Meeting the Statutory Criteria .....	26
1.	Has the plan reduced regulatory delay and costs over time? (Section 13-506.1(a)).....	26
2.	Has the plan encouraged innovation in telecommunications services? (13-506.1(a)(1)) .....	27
3.	Has the plan "promote(d) efficiency" within Ameritech Illinois? (Section 13-506.1(a)(3)) .....	29
4.	Has the plan "facilitate[d] the broad dissemination of technical improvements to all classes of ratepayers? (Section 13-506.1(a)(4)).....	30
5.	Has the plan enhanced the economic development of the State? (Section 13-506.1(a)(5)).....	31
6.	Has the plan produced "fair, just and reasonable rates"? (Section 13-506.1(a)(6) and 13-506.1(b)(2)).....	32
7.	Has the plan responded to changes in technology and the structure of the telecommunications industry that are, in fact, occurring? (Section 13-506.1(b)(3))	41
8.	Has the plan "specifically identifie(d) how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and	

improvements in productivity due to technological change? (Section 13-506.1(b)(5))

43

9. Has the plan maintained the quality and availability of telecommunications services? (Section 13-506.1(b)(6))..... 43

10. Has the plan unduly or unreasonably prejudiced or disadvantaged any particular customer class, including telecommunications carriers? (Section 13-506.1(b)(7))..... 53

11. Is the plan "in the public interest" and "a more appropriate form of regulation"? (Section 13-506.1(b)(1), 13-506.1(b)(4))..... 53

III. GOING-FORWARD PROPOSAL.....	54
A. Relative to Existing Components.....	54
1. Inflation Measure.....	55
2. Productivity Offset.....	55
3. Exogenous Factor.....	63
4. Pricing Flexibility and Basket Consolidation.....	67
5. Residential Service Rate Cap.....	71
6. Exclusion of Certain Noncompetitive Services From Alternative Regulation.....	73
7. New Service Provision.....	75
8. Calculation of the PCI and the API.....	77
B. Relative to New Components.....	80
1. Fixing the Incentive To Prematurely Reclassify Services and Raise Rates.....	80
C. Accounting for Merger Savings.....	83
D. Reinitialization of Rates/CUB/AG Complaint for Rate Reduction.....	84
E. Earnings Sharing.....	91
F. Rate of Return Regulation.....	97
IV. SERVICE QUALITY – GOING FORWARD.....	98
A. The Legal Standards.....	98
B. Existing and Proposed Measures and Benchmarks.....	99
C. It Is Necessary to Provide Benchmarks for POTS Installation and POTS Repair Because POTS Is an Essential Service Which Should Be Readily and Reliable Available to Illinois Citizens.....	101
1. POTS Installation Measures.....	102
2. POTS Repair Measures.....	104
D. The Other Major Category of Measures Is Intended to Insure That Customers Can Contact the Company Without Undue Delay.....	108
E. The Final Measure, Trouble Report Rate per 100 Access Lines, Is a General Measure of Performance That Should Be Continued and Clarified If Alternative Regulation Is Retained.....	109
F. The Uneven Service Quality Provided to Residence and Business Customers and to Customers in Various Areas of the State Makes Monthly Reporting by Customer Class and Geographic Area Necessary.....	109
G. Existing and Proposed Penalty Structures.....	110

1.	The Existing Service Quality Penalty Structure Has Been Ineffective in Overcoming the Perverse Incentives Inherent in Price Cap Regulation to Cut Costs While Allowing Service Quality for Inelastic Services to Deteriorate.....	110
2.	The Service Quality Adjustment Should Be Substantial Enough to Provide Adequate Incentives to Maintain And/or Improve Service Quality and Should Be Administered Outside a Price Cap Index.....	111
3.	If the service quality adjustment is made within the price cap, the Commission must insure that the adjustment is equivalent to that proposed for a non-PCI adjustment.....	113
H.	In Addition to a Service Quality Adjustment, Whether Within or Outside the PCI, Consumers Affected by Certain Service Quality Problems Should Receive Direct Compensation. ....	114
I.	Summary.....	116
V.	REVENUE REQUIREMENTS ANALYSIS.....	116
A.	Revenue and Expense Adjustments.....	118
1.	Directory Revenues.....	118
2.	Depreciation Expense.....	130
3.	Pension Settlement Gains.....	131
4.	Among the new adjustments to the Company's 1999 Intrastate Operating Income made by AI witness Dominak in his rebuttal testimony was his proposed revision for the nonregulated factor applied to the Company's proposed \$117.902 million of so-called "prior period" expense. This adjustment should be rejected for two reasons: (1) the 13% factor was adequately documented as being appropriate in IBT's responses to data requests, and thus does not require revision, and (2) the Company's latest calculation is inconsistent with its own original filing in Exhibit 7.0, Schedule 1, is inconsistent with GCI's filing (Exhibit GCI 6.1), and is internally inconsistent with the derivation of other adjustments on IBT Exhibit 7.1, Schedule 1, such as the \$9.253 million reduction to expense for Merger Costs shown in Column J.	145
B.	Rate Base Adjustments.....	151
1.	Materials and Supplies.....	151
2.	Telephone Plant Under Construction.....	152
3.	Accumulated Deferred Income Taxes.....	156
C.	Cost of Capital.....	157
VI.	COST OF SERVICE/RATE DESIGN.....	159
VII.	CONCLUSION.....	160

STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	:	
	:	98-0252
Application for review of alternative regulation plan.	:	
	:	
Illinois Bell Telephone Company	:	
	:	98-0335
Petition to rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates.	:	
	:	
Citizens Utility Board and The People of the State of Illinois vs- Illinois Bell Telephone Company	:	00-0764 (Consolidated)
	:	
Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief.	:	

**INITIAL BRIEF OF THE  
CITIZENS UTILITY BOARD**

The Citizens Utility Board ("CUB"), through its attorney, hereby submits its Initial Brief in the above-captioned proceeding in accordance with the schedule established by the Hearing Examiners.

**I. SUMMARY OF THE CASE/CUB POSITION**

When the Commission initiated alternative regulation for Ameritech Illinois ("AI", "IBT" or the Company") in 1994, it repeatedly recognized the experimental nature of the price cap plan it approved. While the 1994 Order expressed confidence that the Commission was correct in its decision to adopt a price cap plan for AI in order to transition the Company and ratepayers to a more competitive marketplace, it also acknowledged the fact that "uncertainty always accompanies change", and that, as such,

the new regulatory plan “must be carefully monitored to ensure that its intended results are realized.”<sup>1</sup>

The Commission’s “intended results” included unleashing the Company from the regulatory constraints of rate of return regulation in order to encourage efficiency and innovation in preparation for the arrival of competition to the local service market. At the same time, the Commission concluded, ratepayers would reap the benefits of the Company’s increased productivity through annual rate decreases, without having to pay for new investments or bear the risk that accompany increased innovation.

Nearly seven years later, the record evidence demonstrates that the Commission’s admirable goals for AI’s price cap plan have failed in most respects. While the Company has enjoyed staggeringly high earnings levels, approximating 43.08% in 1999, monopoly customers have endured sharp declines in critical service quality areas, nominal rate decreases in some noncompetitive services and some rate increases in basic residential service. Time and Company actions have revealed that the existing price cap plan includes perverse incentives for AI to 1) reclassify noncompetitive services as competitive when in fact no price-constraining competition exists for those services, 2) increase the rates for many of these reclassified services, and 3) permit Company investment in the network and monopoly service operations to stagnate to the point where AI’s service quality in critical categories has significantly declined.

Despite the Company sky-high profit levels and declining service quality, AI stands before the Commission in this docket seeking a substantial rate increase in the cost of residential network access lines, *the* monopoly service least subject to price elasticities and competitive pressures. The Company’s “rate rebalancing” proposal requests that the

---

<sup>1</sup> Price Cap Order at 20.

price of all residential access lines be increased by \$2.00 per month to offset Commission-ordered decreases in carrier access charges. In addition, the Company seeks to increase the pricing flexibility provisions of the plan, thereby permitting substantial increases in the price of residential service, recover any lost revenues associated with any Commission-ordered rate change through the exogenous treatment factor in the price cap formula, and reduce the already ineffective productivity factor in the formula that has helped fuel the Company's attainment of earnings that would be labeled excessive by any standards. As discussed below, Company witnesses have even testified that raising the rates of its residential customers will aid in the development of competition. Given the General Assembly's goal of ensuring for the People of the State of Illinois that "the economic benefits of competition" are realized<sup>2</sup>, and the requirement that rates under an alternative regulatory plan shall be "fair, just and reasonable"<sup>3</sup>, this AI regulatory precept can only be described as skewed.

Before the Commission approves any alternative regulatory plan for Ameritech Illinois, the Commission must demonstrate that the plan is in the public interest, and produces "fair, just and reasonable" under Section 13-506.1(b)(1) and (2) of the Act. In recognition of these statutory requirements, and within the context of the Commission's review of the AI price cap plan, CUB and the Attorney General filed a complaint for rate reduction against Ameritech Illinois. The CUB/AG Complaint cites the evidence presented by Governmental and Consumer Intervenor ("GCI")/City of Chicago witnesses Ralph Smith and William Dunkel that shows that AI's rates should be reduced by \$956 million to be at just and reasonable levels. As discussed further in Part V of this Brief, Mr. Smith concluded that AI's noncompetitive and competitive local exchange service

---

<sup>2</sup> 220 ILCS 5/13-102(e).

<sup>3</sup> 220 ILCS 5/13-506.1(b)(2).

revenues and rates are unjust and unreasonable, and need to be reduced to just and reasonable levels based upon a review of AI's most recent intrastate operating results for the 1999 test year, the various testimony and exhibits sponsored by AI witnesses in this docket and scores of specific data request responses. CUB/AG Complaint at 5. Moreover, GCI witness Dunkel demonstrated that a \$1.30 reduction in the network access lines for both residential and business customers would still cover the entire network access line costs, including all loop costs. IBT's request to "rebalance" rates should be rejected, and the rate reductions recommended by GCI witness Dunkel should be adopted.

Finally, GCI/City witnesses Charlotte TerKeurst and Lee Selwyn provide specific recommendations to the Commission designed to rectify the deficient aspects of the price cap formula – namely the woefully inadequate service quality penalty provision and the insufficient productivity factor. Specifically, Ms. TerKeurst calls for the establishment of additional service quality benchmarks, a stricter penalty provision designed to incent the Company to fix existing service quality problems and customer-specific remedies that compensate customers who are personally affected by AI's inadequate service quality performance. Dr. Selwyn proposes that the Commission increase the existing 4.3% productivity factor to 6.5%, coinciding with the FCC's approval of such a level.

Unless these and other recommendations made by the GCI/City witnesses are implemented, CUB urges the Commission to terminate the price cap plan and return Ameritech Illinois to rate of return regulation.

## **II. REVIEW OF THE ALTERNATIVE REGULATORY PLAN**

### **A. Scope of the Review Proceeding**

This docket represents the Commission's first review of an alternative regulatory plan for a telecommunications carrier in Illinois, and more specifically the first assessment of the price cap plan approved for Ameritech Illinois in October of 1994. Since that time, AI's noncompetitive service rates have been established according to an annually adjusted price cap formula or index that reflects the offsetting impact of inflation and productivity gains on AI operations. The formula also reflects an offset for failed service quality performance and exogenous revenue changes that comply with specific, Commission-developed criteria. The AI price cap formula is set forth as: PCI = Gross Domestic Product Price Index (GDPPI) minus 4.3% for a productivity offset, minus 0.25% for each missed service quality benchmark, +/- a possible Commission-approved exogenous change factor.<sup>4</sup>

The decision to incorporate a review of the AI price cap plan five years after its inception was an integral component of the 1994 order.<sup>5</sup> In doing so, the Commission in effect acknowledged what it clearly pronounced in the Order: that "uncertainty always accompanies change." *Id.* at 20. As such, the Commission concluded:

...any alternative form of regulation must be carefully monitored to ensure that its intended effects are being realized.

*Id.*

Both Section 13-506.1 of the Act, which grants the Commission the authority to approve alternative forms of regulation for telecommunications carriers, and the Commission's 1994 Price Cap Order, which primarily references Section 13-506.1 as the framework for the regulatory goals of the plan, outline the appropriate parameters for the

---

<sup>4</sup> An approved exogenous change is calculated as the ratio of the amount of the exogenous change to the total company revenues for the period in which the change occurred. Price Cap Order at Appendix A, p. 5.

<sup>5</sup> See Price Cap Order at 94-95.

Commission's review of the existing AI price cap plan and the directives to be followed in determining whether or not to continue the plan. At issue in this docket is whether the plan as designed in 1994 has performed in accordance with both the statutory goals outlined in the Act and the regulatory goals delineated in the 1994 Price Cap Order. Along with determining whether the existing plan has met these goals and directives, the Commission must also consider whether a new, modified alternative regulatory plan should be adopted, or whether AI should return to rate of return regulation.

On a going-forward basis, the Commission's determination of whether the AI price cap plan should be continued, replaced with a different plan or scrapped in favor of rate of return regulation is, as the initial assessment of alternative regulation was, proscribed by the directives of Section 13-506.1 of the Act. Thus, in addition to the public policy goals declared in Section 13-103, the Commission must consider, in determining the appropriateness of any proposed alternative form of regulation, whether it will:

- (1) reduce regulatory delay and costs over time;
- (2) encourage innovation in services;
- (3) promote efficiency;
- (4) facilitate the broad dissemination of technical improvements to all classes of ratepayers;
- (5) enhance economic development of the State; and
- (6) provide for fair, just, and reasonable rates.

220 ILCS 5/13-506.1(a). Moreover, under part (b) of this section, the Commission may authorize the implementation of an alternative regulatory plan "only if it finds, after notice and hearing, that the plan or modified plan at a minimum:

- (1) is in the public interest;
- (2) will produce fair, just, and reasonable rates for telecommunications services;
- (3) responds to changes in technology and the structure of the telecommunications industry that are, in fact, occurring;

- (4) constitutes a more appropriate form of regulation based on the Commission's overall consideration of the policy goals set forth in Section 13-103 and this Section;
- (5) specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change;
- (6) will maintain the quality and availability of telecommunications services; and
- (7) will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers.

Id.

Any changes made by the Commission to the existing price cap plan in effect constitute the establishment of a new alternative regulatory plan. This distinction is critical in terms of complying with Section 13-506.1(c) of the Act. That provision requires that, for the first 3 years the plan is in effect, basic residence service rates must be set no higher than those rates in effect 180 days before the filing of the plan.<sup>6</sup> Because Section 13-506.1(b)(2) requires the rates set under any alternative regulatory plan -- existing or new -- to be fair, just and reasonable, a critical component of the Commission's review of the AI price cap plan, and the possible modification of that plan, is the determination of whether the Company's noncompetitive service rates should be adjusted in order to establish rates that are fair, just and reasonable on a going-forward basis.

At pages 179 through 183 of the 1994 Order, the Commission listed the statutory requirements for the adoption of alternative regulation, as set forth in Section 13-506.1 of the Act, and provided an analysis of each point as support for the adoption of the AI price cap plan. In this proceeding, each component and provision of the price cap plan must be evaluated to determine whether it has met these applicable goals and requirements. If the

---

<sup>6</sup> For purposes of this Section, "basic residence service rates" shall mean monthly recurring charges for the telecommunications carrier's lowest priced primary residence network access lines, along with any associated untimed or flat rate local usage charges.

evidence shows that certain aspects of the plan have contributed to a failure to meet the statutory goals outlined in the Price Cap Order and Section 13-506.1 of the Act, then the Commission must determine whether changes can be made to those provisions to remedy the failure. If adjustments to a flawed plan are not made, then a return to rate of return regulation should be ordered.

In this proceeding, CUB and the other GCI parties propose specific changes to the existing price cap plan, as discussed in Part III below, that must be made if the statutory goals outlined in Section 13-506.1 are to be satisfied. A critical component of these modifications is the requirement that rates be reinitialized so that rates on a going forward basis are just and reasonable. Unless these changes are made to the existing price cap plan, the Commission should order a return to rate of return regulation for the Company.

#### **B. Commission Goals for the Plan**

When it first approved alternative regulation for AI in 1994, the Commission noted that it believed competition was likely to increase in the future, that “the regulatory policies of this State should be directed toward a successful transition to a more competitive environment”, and that a change in the form of regulation applicable to AI was appropriate in order to achieve that goal. Price Cap Order at 19. The Commission further concluded:

A properly designed alternative regulation plan affords the opportunity not only for the Company to transition itself to a more competitive environment, but allows this Commission to implement safeguards and allocate risk in a fashion that protects the interests of all interested parties.

Id. Although the Commission presumably embarked on AI's alternative regulation plan confident that AI's noncompetitive ratepayers' "interests" would be protected, the facts as laid out in detail in this docket tell another story.

Company data, including AI's 1999 income statement, along with AI's responses to scores of data requests, reveal that the Company earned a staggering 43.08% return on equity for intrastate operations under the price cap plan. GCI/City Ex. 6.2 (Smith Direct) at 3. While the Company has reaped the financial rewards of a regulatory structure that permits unlimited profits, ratepayers have seen AI's service quality in critical categories deteriorate dramatically since the inception of alternative regulation.

The Commission specifically recognized that one of the theoretical risks of price regulation is that the Company may, while seeking to maximize its income, reduce expenditures in certain areas such that service quality is adversely affected. Price Cap Order at 58. In implementing only a .25% service quality penalty per missed service quality benchmark in 1994, however, the Commission wrongly assumed that this amount would provide sufficient incentive to maintain service quality and avoid the payment of what was then a \$4 million penalty.<sup>7</sup>

For example, since the inception of the AI price cap plan, the Company has failed to meet the benchmark that measures AI's ability to restore service to customers within 24 hours of a reported outage in all years except one. Perhaps the most important means of measuring service quality to customers who have no other choice for local telephone service, AI's performance for OOS>24 hours has declined significantly, with the rate of

---

<sup>7</sup> Because of AI's reclassification of many of its noncompetitive services to competitive, thereby reducing the noncompetitive service revenue stream to which a penalty is applied, the .25% penalty per missed service quality benchmark now generates only a \$2.6 million penalty. GCI/City Ex. 1.0 (TerKeurst Direct) at 70.

failure in correcting OOS situations within 24 hours averaging about 14.1 percent between 1995 and 1998 – over twice the average rate of failure in 1990 through 1994. GCI/City Ex. 1.0 (TerKeurst Direct) at 10. In addition, the number of out of service lines almost doubled between late 1999 and mid-2000. Id. at 11.

AI's performance in other service quality categories tells a similar story. Since early 1999, the average number of days needed to install a new access line has more than doubled for residential customers. Id. Between 1999 and 2000, repair complaints increased by 71 percent, installation complaints increased by 190 percent, and construction and engineering complaints increased by 119 percent. Id. A more specific discussion of AI's service quality failings is provided in Part II.D.8 of this Brief below.

Other regulatory goals for the price cap plan enunciated in the 1994 Price Cap Order have also been obscured or thwarted. For example, the Commission noted that if GDPPI projections proved accurate, the adopted price regulation formula would yield an annual decrease in AI's noncompetitive rates. Price Cap Order at 41. In addition, the Commission expanded the statutorily mandated basic residential service rate cap to include Bands B and C usage, in addition to the basic service cap for residential access and Band A usage, and extended the cap for "the full five-year period of the alternative regulation plan", and concluded that "the customers whose demands are the most inelastic will be protected from the exercise of monopoly power during the pendency of this plan." Price Cap Order at 64. The Commission even went so far as to state that the plan would protect universal service "for every citizen of Illinois", and that extension of the residential rate cap would "guarantee that adoption of price regulation cannot harm the residential ratepayer." Id. at 65.

However, the Commission's goal of awarding annual rate reductions for basic service to AI's noncompetitive service customers during the life of the price cap plan has proved elusive. While the price cap formula resulted in annual revenue reductions for assorted noncompetitive services, residential, basic service customers have not been spared rate increases. For example, AI's residential Band C usage service, which at the beginning of the plan was classified as noncompetitive and subject to the residential rate cap, has steadily increased from 4 to 5 to 7 to 10 cents per minute. GCI Ex. 1.0 (TerKeurst) at 29. In addition, AI has crafted calling plans it promotes as "discount" plans that *increase* the average price for non-competitive services paid by plan users. For example, AI bundles existing services to create the "SimpliFive"<sup>8</sup> and "CallPack"<sup>9</sup> plans, and takes the position that these represent "new" services, which thereby grant the Company the flexibility to include the bundled offering in a basket other than the residential basket in which these existing services reside on an unbundled basis.

In addition, the existing price cap mechanism coupled with the PUA provisions that allow incumbent local exchange carriers ("LECs") to classify services as competitive on one day's notice have permitted AI to increase rates for services that do not yet have competitive alternatives. Since early 1997, AI has conducted a massive competitive reclassification of business services and some residential services in designated exchanges, some of which are being challenged before the Commission in Docket No. 98-0860. Many of these service offerings have experienced corresponding rate

---

<sup>8</sup> The SimpliFive plan, which provides 5 cents-per-minute calling for Bands A, B, and C calling, raises noncompetitive residential Band A and Band B usage rates.

<sup>9</sup> The CallPack plan, which provides 10 cents-per-call rates for Bands A, B, and C calling, raises noncompetitive residential Band A usage rates.

increases.<sup>10</sup> For example, the Company's competitive reclassification tariff for business access and usage services currently under investigation in ICC Docket 98-0860 alone has raised Ameritech Illinois' revenues by almost \$74 million per year. GCI Ex. 1.0. Also under investigation by the Commission is AI's reclassification of residence access and Bands A and B usage service for the exchanges of Alton, Belleville, Champaign Urbana, Collinsville, Danville, Decatur, East Moline, East St. Louis, Edgemon, Edwardsville, Granite City, Moline, O'Fallon, Peoria, Quincy, Rock Island, Rockford, Springfield and Wood River. See City of Chicago Ex. 1.2. The threat to AI's customers of improperly classifying services as competitive is a real one: under the Act, increases in the price of a service classified as competitive are permitted upon the mere filing of the proposed rate change. 220 ILCS 5/13-505(a).

Many services reclassified by AI as competitive during the life of the plan and challenged in a regulatory proceeding have failed to withstand the test. As noted in the Staff report attached as Exhibit 1.2 to City of Chicago witness Dr. Lee Selwyn's testimony, AI's business service reclassification of Bands B and C usage, credit card calls, operator assistance services and subsequent rate increases were examined in Docket No. 95-0135/0179. In its Order in that Docket, the Commission concluded that all of the services at issue were more appropriately labeled noncompetitive, and stated:

Competitive classification under Section 13-502 requires a convincing demonstration that competition will in fact serve effectively as a market-regulator of the quality, variety and price of telecommunications services. Ameritech Illinois' ability to increase its prices notwithstanding the presence of other providers is a strong

---

<sup>10</sup> While AI has not yet increased rates for many of the reclassified residential services to date, the reprieve appears to have occurred only because AI's billing systems are not currently capable of charging different rates for residential services on an exchange-by-exchange basis. GCI Ex. 1.0 (TerKeurst Direct) at 28. AI is currently modifying its billing systems to allow exchange-specific pricing, a move that suggests rate increases for these residential services should be expected. Id. at 28-29.

indication that those rates are not just and reasonable, and that the competitive classification here fails to satisfy this statutory policy. The evidence indicates rather that the declaration of competition in this case is being used as a device to raise rates to customers which demonstrably have not found the alternative offerings by other carriers to be the functional equivalents or reasonably available substitutes for Ameritech Illinois' service.

Docket No. 95-0135/0179, Order at 29. The Illinois Appellate Court upheld the Commission's decision. Illinois Bell Telephone Co. v. Ill. Commerce Comm'n, 282 Il.App. 3d 672, 669 N.E.2d 628 (3d Dist. 1996). Other Commission orders rejecting AI's reclassification of noncompetitive services include Docket No. 96-0069 and Docket Nos. 98-0770/0771.

AI's reclassification of so many noncompetitive services as competitive, along with the Company's corresponding increases in rates for many of these services, belie the regulatory assumption that competition will bring tangible benefits to consumers. In addition, the Company's subsequent increases to the prices of services the Company claims face competitive threats, make the appropriateness of the reclassifications suspect. Indeed, AI's actions under the price cap plan point to a pattern of premature reclassification, coupled with the flexing of market power vis-à-vis corresponding rate increases.

Not only have noncompetitive service rates increased since the inception of the price cap plan, state residential subscribership levels have declined significantly over the same time period. In 1995, when the AI price cap plan had just begun, the Illinois penetration rate was just three-tenths of one percent away from the nationwide average. That gap widened considerably over the life of the plan. In 1999, Illinois lagged a staggering 2.4% behind the nationwide average percent penetration level. Specifically,

the Illinois penetration rate declined from 93.6% in 1995 to 91.8% in 1999.<sup>11</sup> GCI/City Ex. 8.0 (Dunkel Direct) at 7. A December, 2000 Federal Communications Commission (“FCC”) Telephone Subscribership Report identifies Illinois as the only state in the entire nation that has experienced a “significant decrease” in penetration rates. GCI/City Ex. 9.0 (Dunkel Rebuttal) at 1.

While the AI price cap plan was geared to transition both ratepayers and the Company to a competitive marketplace, nearly six years after the plan’s start, competition for local service residential customers is negligible. As of September, 2000, a mere 3.56% of lines were resold and a mere 2.77% of lines were provided on a UNE loop basis. GCI Ex. 1.0 (TerKeurst) at 21. See also City of Chicago Ex. 1.0 at 22-30.

Not surprisingly, in a regulatory arena that permits unchecked profit levels and negligible competition, AI’s annual returns have soared. A revenue requirements analysis for the selected 1999 test year reveals that AI earned an astounding 43.08% return on equity for intrastate operations. GCI/City Ex. 6.2 (Smith Direct) at 3. While the 1994 plan included no set cap on profit levels, the Commission noted that “unusually high reported rates of return...may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective.” Price Cap Order at 92.

Indeed, the results are in, and the conclusion is clear: virtually none of the goals of the AI price cap experiment have been achieved. The benefits of the AI price cap plan have flowed one way and one way only – into the pocketbooks of Ameritech shareholders.

---

<sup>11</sup> Because Ameritech serves 85% of the access lines in service in Illinois, the penetration rate obtained from the random sample in Illinois would be predominantly reflective of the penetration rate experienced in AI’s service territory. GCI/City Ex. 8.0 at 7, footnote 2.

### C. Issues Specified in the 1994 Order

- 1. Whether the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation.**

Currently, a fixed-weight Gross Domestic Product Price Index ("GDPPI") is incorporated in the price cap formula. A consensus exists among the witnesses in this docket that a chain-weighted GDPPI, published by the U.S. Department of Commerce's Bureau of Economic Analysis, is the appropriate measure of economy-wide output price inflation for purposes of a price cap plan. Use of the chain-weighted GDPPI, which provides for changes in the product mix and bases weights for the current year's index on the prior year, would replace the existing fixed weight GDPPI, which inappropriately assumes that the basket of goods and services upon which the index is based remains frozen over time. GCI Ex. 3.0 at 12-13.<sup>12</sup> Should the Commission approve a new price cap plan for the Company, it should incorporate the chain-weighted GDPPI in the price cap index.

- 2. An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.**

An assessment of the productivity input or X factor and how it should be adjusted on a going-forward basis can be found in Part III.A.1 below.

---

<sup>12</sup> The Bureau of Economic Affairs, the government agency responsible for publishing both these price indices, now recommends use of chain-weighted price indices as a more meaningful measure of economy-wide output price inflation. GCI Ex. 3.0 at 13.

**3. Whether the adopted monitoring and reporting requirement should be retained or adjusted.**

At pages 91 through 95 of the Price Cap Order, the Commission required AI to submit annual rate filings and adopted detailed annual reporting requirements for each of these annual filings, in order to monitor the plan to ensure that it is applied properly and that the intended benefits are realized. In doing so, the Commission specifically rejected AI's recommendation that reporting of financial information, including the provision of all of the accounting data used to calculate earnings information, would be no longer needed under alternative regulation. The Commission noted, in relevant part, that "unusually high reported rates of return, particularly in the fact of accelerated depreciation charges, may constitute an early warnings that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective." Price Cap Order at 92.

The same concerns exist today, and nearly seven years of experience has demonstrated how critical it is that the Commission receive such information in order to determine if each component of the price cap formula and the plan as a whole is working.

CUB urges the Commission to retain all of the reporting requirements included in the first Price Cap Order, with the modifications Ms. TerKeurst proposes at pages 88-93 in GCI/City Ex. 2.0 for reports on AI's service quality (discussed below in Part IV of this Brief), and with the infrastructure reports modified to contain the full amount of information required by the SBC/Ameritech Merger Order.

In addition, the requirement that the plan be reviewed within five years should also be retained, with the Company filing an application for review as was the case in the instant docket.

**4. The extent to which Illinois Bell has modernized its network, and additional modernization plans for the near term.**

As discussed in Part D below, the network infrastructure investment requirements that were adopted as part of the price cap plan in 1994 have not been effective in achieving the goals of high quality telecommunications service available to all customers. Ms. TerKeurst points out that despite AI's claimed \$3.7 billion investment level over the life of the plan, the Company apparently has not invested sufficient amounts in the basis local network to ensure timely availability of network access lines, particularly in areas with high growth rates, such as new housing developments. GCI Ex. 1.0 at 73. Inadequate investment in network access facilities has been one of the reasons for AI's extensive delays in installation of POTS. Id. GCI Exhibits 11.4, 11.5, 11.6 and 11.7 detail AI's low ranking as compared to other Bell Operating Companies ("BOCs") with respect to total plant in service per access line and total plant in service additions per access line.

Moreover, as noted by Dr. Selwyn, the \$3.7 billion in investment reported by AI was not "new" investment, but was largely funded by ongoing depreciation charges and thus represents *replacements* of existing, "worn out" equipment rather than an infusion of new capital. City of Chicago Ex. 1.0 at 38. Over the first five years of the plan, AI took a total of \$3.4 billion in depreciation accruals at the state level. Offsetting these charges against the \$3.7 billion "investment" that Mr. Gebhardt claims leaves an actual net investment of only \$300 million. Id.

With respect to the provision of new services, AI has chosen to suspend its “Project Pronto” deployment of DSL service. Tr. 1989.

5. **A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.**

AI witness David Gebhardt discusses this issue at pages 13-14 of his Exhibit 1.0. In addition, he includes a Schedule that reports the cumulative percentage changes for all services in the plan over the first five years of the plan. This exhibit demonstrates that the prices for the most inelastic residential services – namely network access and Band A local calling – were reduced either not at all or modestly. Not surprisingly, given the Company’s “rate rebalancing” proposal, AI never decreased residential network access lines during the life of the plan. Yet, GCI/City witness Dunkel provided evidence that the residential network access line could be reduced by \$1.30 per line and, along with the End User Common Line Charge (“EUCL”), still contribute more than 100% of the loop and port facility cost. GCI/City Ex. 8.0 at 4. Moreover, the cumulative reduction to Band A usage rates was modest – only 3.85%. High usage customers benefited from more significant reductions, especially in the volume discount categories. AI Ex. 1.0 Schedule 1.

Conspicuously absent from this exhibit is information about price increases sustained by customers of the SimpliFive and CallPack calling plans. As discussed further below, AI has crafted calling plans it promotes as “discount” packages that *increase* the average price for non-competitive services paid by plan users. For example,

AI bundles existing services to create the "SimpliFive"<sup>13</sup> and "CallPack"<sup>14</sup> plans, and takes the position that these represent "new" services, which thereby grant the Company the flexibility to include the bundled offering in a basket other than the residential basket in which these existing services reside on an unbundled basis.

*Implementation of the rate design proposals put forth by GCI/City witness Dunkel, in concert with the recommended \$956 million rate reduction recommended by GCI/City witness Ralph Smith, would go along way toward correcting these inequities.*

**6. A listing of any services that have been withdrawn during the period.**

AI witness Gebhardt provided a list of services withdrawn by the Company during the life of the plan. AI Ex. 1.0, Schedule 2. To CUB's knowledge, no issues have been raised in this proceeding regarding the elimination of any of these services.

**7. A listing of all services that have been reclassified as competitive or noncompetitive during the period.**

Mr. Gebhardt's Ex. 1.0, Schedule 3 lists all services reclassified by the Company during the first five years of the plan. As discussed in above in Part B, since early 1997, AI has conducted a massive competitive reclassification of business services and residential service in 19 designated exchanges, some of which are being challenged before the Commission in Docket No. 98-0860. Many of these service offerings have experienced corresponding rate increases.

Particularly relevant to residential customers has been AI's pricing behavior with respect to Band C usage. Following the competitive reclassification of residential Band C usage in 1996, AI's Band C usage rate has steadily increased from 4 to 5 to 7 to 10 cents per

---

<sup>13</sup> The SimpliFive plan, which provides 5 cents-per-minute calling for Bands A, B, and C calling, raises noncompetitive residential Band A and Band B usage rates.

<sup>14</sup> The CallPack plan, which provides 10 cents-per-call rates for Bands A, B, and C calling, raises noncompetitive residential Band A usage rates.

minute when purchased on a stand-alone basis. GCI Ex. 1.0 at 29. As noted by GCI witness TerKeurst, the reclassification and unchecked rate increases have been a major contributor to AI's high earnings levels, as indicated by AI's own representation of the earnings levels for its services classified as competitive. GCI Ex. 1.3 shows that the Company reports an average annual return on investment of 34.76 percent between 1995 and 1999. GCI Ex. 1.3.

Ms. TerKeurst also testified that following the competitive reclassification of Business Bands B and C usage and operator services, AI raised the rates for those services by amounts ranging from 23 percent to 164 percent. GCI Ex. 1.0 at 27-28. The Commission ultimately rejected that classification and ordered refunds. Id. AI also raised the rates for its operator services, including busy line verify and busy line interrupt, by as much as 500 percent following their reclassification. Id. at 28. AI subsequently agreed to withdraw its competitive reclassification of the two busy line services and refund their rate increases, and the Commission rejected the reclassification of some of the remaining services and ordered customer refunds. Id.

In light of the Company's pricing behavior following reclassification of some noncompetitive services, the Commission should reduce AI's incentives and ability to increase its earnings through premature reclassifications followed by rate increases. *GCI's specific proposals to address this problem are discussed in Part III.B and D below.*

**8. A summary of new services that have been introduced during the period.**

AI witness Gebhardt provided a list of new services introduced during the first five years of the plan. IBT provided a listing of new services offered in each year from

1995 to 1999. Am. Ill. Ex. 1.0, Sch. 4. No specific information describing the function of the services or the customer category to which they belong is provided.

Some of the “new services”, such as “usage discount plans” merely constitute a repackaging of services that exist on a stand-alone basis, as discussed by Ms. TerKeurst. GCI Ex. 1.0 at 30. She recommends that a bundle of services that are already available to customers on a stand-alone basis be labeled as a restructured service, and retained within the price cap plan. GCI Ex. 11.0 at 61. Mr. Gebhardt argues that innovation in the telecommunications industry “occurs in the areas of pricing, packaging, and call plans, not new services per se.” AI Ex. 1.1 at 51. He adds that none of the service providers today actually design or manufacture switching equipment. Id. Accordingly, it is clear that the existence of alternative regulation does little if anything to promote “innovation” and “new services” in the traditional sense of these terms.

**9. Information regarding any changes in universal service levels in Illinois Bell’s service territory during the price cap period.**

Universal service levels achieved during the life of the plan have declined as compared to the levels that existed prior to the plan. AI Ex. 1.1 at 62. Mr. Gebhardt acknowledged “Illinois’ standing in comparison to the rest of the nation appears to be low, whether one looks at current or historic data.” Id. at 64.

As discussed later in this Brief, GCI/City witness William Dunkel reported that state residential subscribership levels have declined significantly over the 1995-1999 time period. He noted that the Illinois penetration rate declined from 93.6% in 1995 to 91.8% in 1999.<sup>15</sup> GCI/City Ex. 8.0 (Dunkel Direct) at 7. A December, 2000 FCC Telephone Subscribership Report identifies Illinois as the only state in the entire nation that has

---

<sup>15</sup> Because Ameritech serves 85% of the access lines in service in Illinois, the penetration rate obtained from the random sample in Illinois would be predominantly reflective of the penetration rate experienced in AI’s service territory. GCI/City Ex. 8.0 at 7, footnote 2.

experienced a “significant decrease” in penetration rates. GCI/City Ex. 9.0 (Dunkel Rebuttal) at 1.

Clearly, it cannot be argued that the AI price cap plan has served universal service goals. As discussed further below, significant reductions in AI’s rates are needed to establish rates that are fair, just and reasonable.

**10. Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals.**

A discussion of whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals is discussed immediately below in Part II.D.

**D. Meeting the Statutory Criteria**

As noted above, the Commission’s review of the AI price cap plan necessitates the same statutory analysis as the initial price cap proceeding. As noted at page 95 of the Price Cap Order, the Commission must determine “whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals.” Only then can the Commission determine whether the plan should be continued. Such an analysis for each of the statutory requirements of Section 13-506.1(a) and (b) follows.

**1. Has the plan reduced regulatory delay and costs over time? (Section 13-506.1(a))**

In addition to the public policy goals declared in Section 13-103, the Commission must consider, in determining whether the AI price cap achieved its goals, whether it has: “reduced regulatory delay and costs over time.” 220 ILCS 5/13-506.1(a)(1). As noted by City of Chicago witness Dr. Lee Selwyn, the adoption of price cap regulation for AI has

*not* resulted in such a reduction. First, the initial alt. reg. proceeding itself took some 22 months to complete. In addition, each year, a three-month proceeding occurs through which noncompetitive service rates are set. When considered cumulatively, these proceedings significantly surpass the amount of time spent on three, 11- month rate cases.

In addition, at least two major proceedings that occurred because AI was under price cap regulation may well have been avoided had the Company remained under rate of return regulation. The first is the SBC Communications Inc./Ameritech Corporation merger proceeding. AI's plentiful earnings under price cap regulation surely play a role in SBC's invitation to merge. *City of Chicago Ex. 1.0 (Selwyn Direct)* at 32-33. The second such proceeding is the challenge to the premature reclassification on noncompetitive services to the competitive category. *Id.* at 33. As Dr. Selwyn notes, while the reclassification of service from noncompetitive to competitive is not restricted to those carriers operating under an alternative form of regulation, it appears that the improper reclassification of such services has only been an issue while AI has been under a price cap plan. In sum, the AI price cap plan has *not* reduced regulatory delay and costs over time.

**2. Has the plan encouraged innovation in telecommunications services? (13-506.1(a)(1))**

The Commission must consider, in determining how well the AI price cap plan functioned, whether it has: "encouraged innovation in telecommunications services." 220 ILCS 5/13-506.1(a)(2). Here the record evidence suggest that no more innovation occurred than would have otherwise under rate of return regulation. No evidence was presented by the Company that the price cap plan worked to "encourage innovation in services." As pointed out by Dr. Selwyn, basic telephone service in Illinois today is

hardly different than that which existed in 1994. Whatever “enhancements” or “innovations” in services that have taken place can be traced primarily to equipment vendors rather than to specific AI initiatives. City of Chicago Ex. 1.0 at 34. Moreover, despite the fact that the costs of individual telephone calls are virtually distance-insensitive, and the costs of network usage have declined dramatically over the past decade, AI continues to make unwarranted distinctions in name and price in local and toll calls. In addition, as noted above, AI has actually increased its rates for certain local and intralata calls. Id. Third, although DSL technology has been around for a number of years, it is today available in only a limited number of exchanges, and with it those exchanges to only a limited number of subscribers. Id. at 35.

Moreover, the network infrastructure investment requirements that were adopted as part of the price cap plan in 1994 have not been effective in achieving the goals of high quality telecommunications service available to all customers. For example, while AI reports that it spent about \$3.7 billion on its network infrastructure (AI Ex. 1.1 at 14), AI apparently has not invested sufficient amounts in the basis local network to ensure timely availability of network access lines, particularly in areas with high growth rates, such as new housing developments. GCI Ex. 1.0 at 73. Inadequate investment in network access facilities has been one of the reasons for AI’s extensive delays in installation of POTS. Id. Moreover, GCI Exhibits 11.4, 11.5, 11.6 and 11.7 detail AI’s low ranking as compared to other Bell Operating Companies (“BOCs”) with respect to total plant in service per access line and total plant in service additions per access line. In addition, AI has chosen to suspend its “Project Pronto” deployment of DSL service. Tr. 1989.

In sum, significant declines in AI's service quality and a failure by the Company to identify with any specificity how the plan has encouraged innovation in services is evidence that the AI price cap plan has *not* encouraged innovation in telecommunications services.

**3. Has the plan “promote(d) efficiency” within Ameritech Illinois? (Section 13-506.1(a)(3))**

AI witness David Gebhardt claims that since the inception of the plan, the Company has focused on customer-oriented marketing strategies and “streamlined its decision-making processes”, thereby promoting efficiency and making AI a “more responsive organization.” AI Ex. 1.1 (Gebhardt Supplemental Direct) at 17-18. From the residential customer perspective, these so-called marketing achievements have amounted to little more than the furious promotion of Caller ID and other vertical services – a much ballyhooed and lucrative goal promoted by SBC during the merger proceeding. Such promotional activities were a central tenet of the implementation of what AI and SBC characterized as the “best practices” that would result from the merger, and not a byproduct of alternative regulation. As for the claimed improvements in the Company's management structure, residential customers clearly have not been the beneficiaries. As noted above and discussed in detail below, service quality, as measured by restoration of service outages, installation of access lines and adherence by service personnel to appointments for customer premises visits, has declined precipitously. Record evidence shows that the deteriorating service quality linked to AI, and indeed the entire Ameritech region, suggests that the Company has confused a failure to invest in POTS-related technology and the necessary technical workforce with increased “efficiency”.

Moreover, AI is proposing that the productivity offset or X factor, which is supposed to reflect AI's annual rate of productivity growth, should be decreased on a going-forward basis. This proposal belies the commonly known trend of large-scale price decreases in the prices of most telecommunications equipment and facilities<sup>16</sup>, resulting both from major technological breakthroughs as well as the increasing level of competition in the telecommunications equipment market itself. City of Chicago Ex. 1.0 at 37.

In short, the Company has presented no evidence that the approved alternative regulation plan resulted in increased efficiency for AI.

**4. Has the plan “facilitate[d] the broad dissemination of technical improvements to all classes of ratepayers? (Section 13-506.1(a)(4))**

AI witness Gebhardt opines that the Company exceeded its \$3 billion infrastructure investment commitment made in the original price cap proceeding, and notes that all of AI's customers now have digital facilities available to them. AI Ex. 1.1 at 53-54. The problem is that the Company presented no evidence that any technical improvements that were realized since 1994 would not have been achieved and spread over all customer classes had the Company been operating under rate of return regulation. Moreover, as pointed out by Dr. Selwyn, the \$3.7 billion that AI claims it invested over the term of the plan was not “new” investment, but was largely funded by ongoing depreciation charges and thereby represents the replacement of existing, “worn out” equipment rather than an infusion of new capital. City of Chicago Ex. 1.0 at 37-38. Moreover, because the Company recorded a total of \$3.4 billion in intrastate depreciation

---

<sup>16</sup> AI witness Gebhardt acknowledges in his Supplemental Direct Testimony that “telecommunications carriers have been experiencing higher productivity growth in their operations than in the economy as a whole.” AI Ex. 1.1 at 26.

accruals over the 1995 – 1999 time period, AI actually made only \$300 million in net investment.

Additionally, the \$3.7 billion in investment claimed by the Company has not been sufficient to maintain basic service quality. AI did not target sufficient investment amounts into its basic local network, particularly to its outside plant, to ensure timely availability of network access – particularly in new housing areas with high growth rates. GCI Ex. 11.0 at 68. Executives at SBC, AI’s corporate parent, conceded that point recently to the investment community, blaming service quality failures on Ameritech’s “lack of maintenance and capacity in the outside plant.” GCI Ex. 2.0 at 68-69. Neither of AI witnesses Jacobs or Gebhardt made any mention of any growth in the number of network access lines available to end users. GCI Ex. 1.0 at 73. In addition, AI has chosen to suspend its “Project Pronto” deployment with respect to DSL service. Tr. 1989.<sup>17</sup>

Accordingly, the record evidence belies AI’s claim that the plan has successfully facilitated any broad dissemination of technical improvements to all classes of ratepayers.

**5. Has the plan enhanced the economic development of the State? (Section 13-506.1(a)(5)?**

---

<sup>17</sup> Additionally, the company’s use of pair gain arrangements, where several network access lines (up to 12) are derived from a single copper loop has allowed Ameritech Illinois to avoid needed network access line investments to the detriment of service quality. There are approximately 60,000 Pair Gain/Pair Gain Flex switched access lines in Illinois at this time. Use of pair gain arrangements adversely affects service quality because it significantly decreases data transmission speed, e.g., when accessing the Internet. As a result, customers served using this inferior arrangement are stymied in their access to advanced services, contrary to national policies supporting advanced services including the Internet. use of pair gain technology appears to be inconsistent with the requirements of 83 Illinois Administrative Code Part 730.310, which requires that, “No local exchange carrier shall connect more than one customer per access line. GCI Ex. 1.0 at 73.

As evidence that the AI price cap plan enhanced the economic development of the State, the Company offers the following statements: In 1994, the Commission concluded in the Price Cap Order that there was a generally positive relationship between price regulation and network modernization, and between network modernization and economic development. Accordingly, because AI fulfilled its \$3 billion investment commitment, “the Commission can assume that the Plan has enhanced economic development.” AI Ex. 1.1 at 91.

This unsupported leap in logic ignores a few crucial facts. First, any Commission conclusion about the relationship between network investment and economic development was based on evidence presented in *that* docket. The Company presented no such evidence in this proceeding. Second, the Company failed to provide a single example of economic development in this State that was a direct result of the AI price cap plan. Third, as noted above, the Company’s assessment of its meeting the \$3 billion commitment is suspect given that the majority of the investment represents replacement of worn equipment that, absent evidence to the contrary, would have occurred under rate of return regulation.

In sum, AI failed to show how the existing price cap plan enhanced economic development in Illinois.

**6. Has the plan produced “fair, just and reasonable rates”? (Section 13-506.1(a)(6) and 13-506.1(b)(2))**

The Commission’s consideration of whether the AI price cap plan produced fair, just and reasonable rates is an essential determination in its analysis of the existing AI plan, and in addressing the question of how the plan should be modified or whether rate of return regulation should be reinstated. In addition to the requirement in Section 13-

506.1(a)(6), which directs the Commission to consider whether the price cap plan provided for fair, just and reasonable rates, Section 13.506.1(b)(2) *requires* the Commission to specifically *find* that the plan indeed produced “fair, just and reasonable rates.” 220 ILCS 5/13-506.1(b)(2). Likewise, the policy goals of Section 13-103 of the Act, which the Commission must consider when reviewing the AI price cap plan, includes the provision that “telecommunications services should be available to all Illinois citizens at just, reasonable and affordable rates.” 220 ILCS 5/13-103(a).

As highlighted earlier in the Brief, a preponderance of the evidence reveals that the rates currently being charged under the AI plan are *not* just and reasonable. GCI/City witness Ralph C. Smith<sup>18</sup> performed a detailed analysis of the Company’s pro forma income statement and reviewed hundreds of Company data requests in order to assess the earnings of AI under the price cap plan and to present adjustments to the Company’s intrastate revenue requirement, rate base and net operating income. That analysis uncovered an AI intrastate return on equity of a staggering 43.08% -- nearly four times the authorized return on equity established by the Commission in the Price Cap Order. GCI/City Ex. 6.2 (Smith Rebuttal) at 2. Based on calculations made by Mr. Smith and thoroughly discussed in Part V of this Brief, the Company currently is overearning in excess of approximately \$956 million for IBT’s intrastate operations. Id.

---

<sup>18</sup> Mr. Smith, whose professional credentials included being a certified public accountant, a certified financial planner and attorney, is a utility analyst with the Michigan firm of Larkin & Associates. Mr. Smith functions as project manager on consulting projects involving utility regulation, regulatory policy and ratemaking and utility management. His projects have included in-depth analyses of numerous issues involving telephone, electric, gas and water and sewer utilities. Mr. Smith has performed work on behalf of industry, state commission staffs, state attorney generals, municipalities and consumer groups concerning regulatory matters before agencies in Alabama, Alaska, Arizona, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New York, Nevada, North Carolina, Ohio, Pennsylvania, South Carolina, South Dakota, Texas, Canada, the Federal Regulatory Energy Commission, and various state and federal courts of law. His complete curriculum vitae can be found in GCI/City Ex. 6.0, Appendix RCS-1.

The Company's own assessment of its 1999 intrastate operating results, which include AI proposed adjustments to intrastate revenues and expenses, reflects its admission of a still astounding 24.53% return on common equity – more than double the cost of common equity approved by the Commission in 1994. Id. at 5. As noted by Mr. Smith, these results indicate that the present price cap plan has permitted the Company to dramatically overearn, and that rates must be reduced significantly before any new regulatory plan – alternative or otherwise – is established by the Commission. Id. at 5-6. As discussed in detail in Part V of this Brief, rates should be re-initialized to reflect a \$956 million revenue reduction on a going-forward basis.

Even the Company does not deny that its earnings are substantial. Instead, AI attempts to divert the Commission's attention away from its obscenely high profit levels, and asserts that rates are just and reasonable because annual overall revenue reductions have been passed through each year since the inception of the price cap plan. AI Ex. 1.1 at 12. Mr. Gebhardt also alleges that the revenue reductions passed through to consumers under the plan exceed what might have occurred under rate of return regulation. Id. at 12-14.

AI's testimony on this point is unpersuasive, however. First, only a small portion of the cited revenue reductions were applied to residential usage rates. Moreover, some residential customers experienced rate *increases* under AI's price cap plan, depending on the calling plan selected, as noted above. In addition, given the Company's reported level of earnings, the uncontroverted evidence shows that AI is earning more than double the authorized level of intrastate earnings that was adopted by the Commission back in 1994, thereby confirming that the rates AI charged to its noncompetitive customers

declined far less than the Company's actual costs. Finally, AI witness Gebhardt admitted during cross-examination that his tally of a purported \$943 million in cumulative rate reductions to customers does *not* include the increases in rates that have accompanied AI's reclassification of noncompetitive services. Tr. at 398-399.

Moreover, as noted by Staff witness Jeffrey Hoagg and Judith Marshall, Mr. Gebhardt's comparison of what would have happened to rates under rate of return regulation is flawed because it assumes the Commission would not have institute any rate case over the life of the plan. Staff Ex. 1.0 at 9; Staff Ex. 4.0 at 3-4. As Mr. Hoagg notes, given the performance of the macro economy, the rapid growth in demand for telecommunications services provided by AI and the earnings performance of the Company over the life of the plan, it is likely that the Commission would have instituted one or more revenue investigations that may have resulted in aggregate revenue and rate reductions. Staff Ex. 1.0 at 9-10.

Ever defensive of its high earnings, AI argues that the Commission's examination of the justness and reasonableness of its rates should be based on an "affordability" analysis that compares telephone rates with the changes in the consumer price index ("CPI"), wage levels and the rates of other local exchange carriers. IBT Ex. 1.1 at 72-76. Earnings, AI opines, are irrelevant to the Commission's review because customers are more interested in the price they pay relative to the value they attach to the service. *Id.* at 75-76.

Mr. Gebhardt's assessment in this regard should be rejected. First, it is worth noting that Mr. Gebhardt chose a comparison of rates of other LECs, and not competitive carriers, for purposes of defending the Company's rate levels. That's the case because

there is insufficient competition in the local market to provide any apples-to-apples comparison. Moreover, examining other LECs' rates is a poor criterion for measuring the justness and reasonableness of AI's rates. As noted by GCI witness TerKeurst, AI is one of the lowest cost incumbent LECs in the U.S., as shown in GCI Ex. 11.6. AI's earnings were also some of the highest among incumbent LECs, as shown in GCI Exhibits 11.1, 11.2 and 11.3. Given its lower costs and higher earnings levels, it is reasonable to expect that AI's rate would be lower than those of other incumbent LECs. In addition, the Commission previously rejected reliance on rates assessed by other carriers to assess whether a carrier's rates are just and reasonable. See ICC Docket No. 97-0601/97-0602 (consolidated), Order of ???? at ??.

Second, Mr. Gebhardt's insistence that the "affordability" of telephone rates is the prime criterion for evaluating the reasonableness of rates ignores the fact that AI is still the monopoly provider of local telephone service. AI residential customers have no ability to shop around for lower priced local service because no real competition exists. This is a critical distinction in the Commission's assessment of the justness and reasonableness of AI's rates: Because AI is still the monopoly provider of residential local telephone service, and a comparison of prices of competitors is impossible, the ultra-subjective criterion of "affordability" necessarily requires an examination of the Company's costs and earnings.

Indeed, when the Commission approved the AI price cap plan, it specifically noted that it was not abandoning the future examination of the Company's costs and earnings as a result of its adoption of alternative regulation:

(t)he Company should not interpret our endorsement of an alternative regulation plan as an abandonment of our long-standing

commitment to marginal cost-based prices. The Commission wishes to make clear that by approving an alternative regulation plan, we will not abdicate our responsibility to scrutinize the pricing practices of the Company, and we will suspend proposed price changes where warranted, even if the proposed price changes are in technical compliance with the price regulation formula.

Price Cap Order at 71. Moreover, the Commission specifically highlighted the continued usefulness of earnings information in determining whether the plan has established just and reasonable rates at the time it approved the plan:

unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective.

Id. at 92. Clearly, the Commission viewed earnings data as an important indicator of how well the plan is working.

As Dr. Selwyn notes in his testimony, if a “competitive outcome” analysis cannot be conducted due to a lack of competitors, then the other principal means by which the justness and reasonableness of AI’s rates can be judged is on the basis of the Company’s earnings. *City of Chicago Ex. 1.0* at 41-42. If, for example, AI consistently earns a return on its investment that is well in excess of the rate of return that the Commission would customarily authorize under rate-of-return regulation *and* is higher than would be expected arise under competitive market conditions, then it is reasonable to conclude that AI’s rates are excessive and thus violate the “fair, just and reasonable” requirement. Id.

As noted by GCI witness TerKeurst, while it may not be possible to determine with precision what rates would have been under rate-of-return regulation, e.g., when rate cases would have been held and with what result, it is clear that Ameritech Illinois would

not have been allowed to reap its current earnings levels. GCI Ex. 11.0 at 19. Ms.

TerKeurst noted:

Further, while one central goal of an alternative regulation mechanism is to allow a carrier to receive benefits from reasonable management efforts to cut costs, it is extremely unlikely that the high levels of earnings experienced in recent years are due solely to Ameritech Illinois' business acumen. The lack of effective, price constraining competition and the substantial increases in demand for telecommunications services since inception of the Plan are factors from which Ameritech Illinois is benefiting irrespective of its management ability. It certainly was not the intent to allow Ameritech Illinois to reap excess profits that have nothing to do with its management capabilities on an ongoing, indefinite basis.

Id. at 19-20. No provision in the Price Cap Order or Section 13-506.1 of the Act in any way suggests that the regulatory compact inherent in the approval of alternative regulation includes an open-ended right to unlimited, excessive earnings. Instead, the Price Cap Order includes numerous provisions that reflect the Commission's desire to monitor the plan and the Company's earnings in order to assess the plan's performance. For example, the Commission specifically wrote, after rejecting an earnings sharing component in the first plan:

The Commission's decision to exclude express earnings sharing from the alternative regulation plan approved in this proceeding is not to be construed as a rejection of all earnings sharing mechanisms of the future. This is the initial alternative regulatory plan for telecommunications in Illinois. The Commission will, in its future review proceedings, entertain evidence and argument of policy considerations for the provision of some forms of earnings sharing in a revised plan.

Price Cap Order at 51. As Ms. TerKeurst points out, one would expect that AI would be quick to ask for modification of an alternative regulation plan if earnings fell unacceptably low. Id. at 12.

In an effort to hedge their bet, AI takes the alternative position that if earnings are examined, the Commission should only look at noncompetitive service revenues. AI Ex. A.1 at 66-67. There are several reasons why the Commission should reject this notion. First, the statutory requirement that rates be fair, just and reasonable is not limited to noncompetitive services. See, e.g., 220 ILCS 5/13-506.1(b)(2), 13-103(a), 13-505. As intervenor witnesses TerKeurst and Selwyn point out, a regulatory plan that produces reclassification of services to competitive with corresponding price *increases* does not further the goal of fostering competition or providing just and reasonable rates. See GCI Ex. 11.0 at 25-26; City Ex. 1.0 at 43-44.

Second, all of AI's local and intraLATA services are furnished using a common set of network infrastructure and other corporate resources. As noted by Dr. Selwyn, the FCC has concluded that it is not possible to develop jurisdiction-specific estimates of total factor productivity because it concluded that no economically meaningful separation of state and interstate inputs could be made. City of Chicago Ex. 1.0 at 44. This same reasoning applies to services labeled as competitive and noncompetitive. Because the Commission no longer requires detailed cost studies to support "competitive" services, it has no adequate means of determining whether AI is overallocating costs to noncompetitive services, thereby depressing the noncompetitive rate of return, while underallocating costs to competitive services. Id.

In addition, as pointed out earlier in this Brief, a docketed proceeding already is underway in which the Commission is examining the propriety of AI's reclassification of several residential and business noncompetitive services to competitive. Docket No. 98-0860; see also City of Chicago Ex. 1.2. As noted by GCI witness TerKeurst, AI has

repeatedly taken the position in that docket that the term “reasonably available from more than one provider”<sup>19</sup> merely requires, for example, a showing that competitors have the potential ability to serve customers at some point in the future. When the Commission first approved price cap regulation for AI in 1994, only 7% of the Company’s revenues were derived from competitive services. Today, AI reports that about 58% of the Company’s intrastate revenues come from competitive services. GCI Ex. 1.0 at 27. As noted above, this massive reclassification effort has been accompanied by rate increases for some of these services. See City of Chicago Ex. 1.2. As noted by Dr. Selwyn, “(t)he very fact that such rate increases were possible as an economic matter for services that were already priced in excess of their costs and that ostensibly faced actual competition undermines fundamentally the Company’s contention that any such competition is present in the first place.” City of Chicago Ex. 1.0 at 45-46.

In short, it is absurd to assert that the review of a plan designed to bring about an efficient transition to a competitive marketplace should ignore the effects the plan has on the classification of services as competitive and whether the rates paid by AI’s customers are in conflict with the just and reasonable standard. Such a limited review, in effect, furthers the incentive already in the plan to prematurely reclassify services as competitive and then abuse the Company’s market power through subsequent or contemporaneous rate increases. See GCI Ex. 11.0 at 26. Accordingly, AI’s invitation to the Commission to ignore the earnings produced by its competitive services when examining the Company’s returns should be flatly rejected.

---

<sup>19</sup> Section 13-502(b) of the Act states: “A service shall be classified as competitive only if, and only to the extent that, for some identifiable class or group of customers in an exchange, group of exchanges, or some other clearly defined geographical area, such service, or its functional equivalent, or a substitute service, is reasonably available from more than one provider, whether or not any such provider is a telecommunications carrier subject to regulation under this Act.”

As noted above, the AI price cap plan has not achieved, among other statutory and regulatory goals, the all-important requirement that rates be just and reasonable. The preponderance of the record evidence clearly demonstrates that rates are too high given the Company's reported earnings level and, as discussed later in this Brief, AI's poor service quality.

**7. Has the plan responded to changes in technology and the structure of the telecommunications industry that are, in fact, occurring? (Section 13-506.1(b)(3))**

Another assessment that the Commission must undertake is a determination of whether the plan responded to changes in technology and the structure of the telecommunications industry that are, in fact, occurring. 220 ILCS 5/13-506.1(b)(3).<sup>20</sup> As noted earlier in this Brief, the Commission noted when it approved the AI plan in 1994 that it believed competition was likely to increase in the future, that "the regulatory policies of this State should be directed toward a successful transition to a more competitive environment", and that a change in the form of regulation applicable to AI was appropriate in order to achieve that goal. Price Cap Order at 19. As noted in Part B above, however, the goal of creating a more competitive environment has *not* been achieved under the price cap plan. In addition, the Commission's assurances in the Price Cap Order that service quality would be maintained and "that there can be no anticompetitive consequences for the captive residential customer" (Price Cap Order at

---

<sup>20</sup> The question of whether the plan is in "the public interest", as required under Section 13-506.1(b)(1) will be addressed at the end of this section of the brief, along with the inquiry required of Section 13-506.1(b)(4) of whether the price cap plan "constitutes a more appropriate form of regulation based on the Commission's overall consideration of the policy goals set forth in Section 13-103" of the Act. The question of whether the plan has produced rates that are "fair, just and reasonable", as required under Section 13-506.1(b)(2) has just been addressed above.

65) have not been realized, as evidenced by the premature reclassification of noncompetitive access and usage services, along with corresponding price increases.

With respect to the question of whether the plan has responded to changes in technology, here, too, the alternative regulation has failed to deliver. As noted earlier, AI witness Gebhardt pointed to the Company's digital network as evidence that the plan has delivered technological advancements to AI's customer base. AI Ex. 1.1 at 54. This point is hardly evidence of price cap regulation leading to technological enhancements for AI customers, however. As revealed by the Company's own testimony in the original Price Cap Order, AI it would have only 18 analog switches (the precursor technology to digital switching) remaining at the end of 1994. See Price Cap Order at 150. With or without price regulation, the Company anticipated that it would complete the analog switch replacement work by the end of 1997. Id. Accordingly, the Company's boasting of its end-to-end digital network is not evidence of, or attributable to, any alleged alternative regulation success.

AI witness Gebhardt also opines that the Company "has spent millions of dollars opening its networks to competitors." AI Ex. 1.1 at 54. Assuming this is true, it clearly has not been enough to alter in any meaningful way the competitive nature of the local exchange marketplace, particularly for residential customers. Moreover, any additional investment made by AI to spur competitive growth has been more a function of Commission decisions and federal law (see, e.g. the Federal Telecommunications Act of 1996) than alternative regulation. As noted by Dr. Selwyn, conspicuously absent from AI's testimony is any evidence that AI addressed changes in technology any differently under the price cap plan than it would have under rate-of-return regulation.