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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.	:	

GCI/City's ERRATA TO GCI/City's EXCEPTIONS

The Citizens Utility Board ("CUB"), by its attorney, the People of the State of Illinois, *ex rel.* James E. Ryan, Attorney General; the City of Chicago, by Mara S. Georges, Corporation Counsel; and the Cook County State's Attorney's Office, by Richard A. Devine, State's Attorney (collectively referred to as "Governmental and Consumer Intervenors/City" or "GCI/City"); hereby file an Errata to the Exceptions filed by GCI on June 13, 2001. The following changes should be made to the Exceptions document forwarded to all parties on the Service List on that date:

1. A Revenue Requirements section, including separate listings for each Revenue and Expense, Rate Base and Cost of Capital adjustment proposed by GCI and Staff, and discussed in the Exceptions at pages 138 through 182, was inadvertently omitted from the

Table of Contents. Similarly, a listing for the Rate Design section, which can be found at pages 182 through 185 of the Exceptions, was inadvertently omitted from the Table of Contents. A corrected Table of Contents is attached.

2. In the Rate Reinitialization section of the Exceptions, which begins on page 101 of the Exceptions, the full and correct description of the GCI position was inadvertently omitted. The attached supplemental pages include that description.

3. Beginning at page 103 through page 113 of the Exceptions, a section entitled “SERVICED (sic) QUALITY”, which is a duplicate version of the Service Quality section from GCI’s *Brief on Exceptions*, was inadvertently inserted as GCI’s proposed language. These pages should be deleted. The actual GCI-proposed language for “Service Quality – Going Forward” begins on page 114 of the Exceptions.

4. At page 60, line 9 of the Exceptions, the figure “\$2*** million” appears. That reference should read “\$276 million.”

5. At page 87, line 3 of the Exceptions, a parenthetical “cite” reference for the federal Telecommunications Act of 1996 “TA96” is included. The parenthetical cite reference should be omitted.

Respectfully submitted,

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TO BE INSERTED AFTER THE HEADING “Rate Reinitialization” on page 101, in place of the first paragraph:

Before the Commission approves any new regulatory plan, alternative or otherwise, for Ameritech Illinois, GCI/City argue that 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. A plan that is not in the public interest and produces or perpetuates unjust and unreasonable rates is unlawful under Section 13-506.1(b)(1) and (2) of the Act, GCI/City assert.

GCI/City note that under the Company’s view of its current regulatory world, its rates are just and reasonable as long as they have been set in accordance with the pricing provisions of the existing plan -- even within the context of a review proceeding. According to the Company, no adjustment to current rates is needed on a going-forward basis no matter what level of Company earnings the plan produces. AI argues that no adjustment to rates based upon a rate of return revenue requirements analysis is appropriate or relevant – even if the Commission chose to return to rate of return regulation. AI witness Gebhardt opines that reinitializing rates based upon a revenue requirements analysis “fundamentally abrogates the regulatory bargain which Ameritech Illinois and the Commission entered into in 1994.”

In fact, GCI/City point out that no such regulatory bargain to permanently render earnings information irrelevant was struck between the Commission and the Company. GCI/City argue that the Price Cap Order is replete with references to the validity and relevance of earnings information – especially within the context of this review proceeding. For example, in the 1994 Order, the Commission cautioned that its decision to exclude earnings sharing from the alternative regulation plan at that time should not be construed as a rejection of earnings sharing mechanisms in the future and that it would consider inclusion of earnings sharing provisions in future review proceedings of the alternative regulation plan. Price Cap Order at 50-51. Moreover, 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. In addition, the Price Cap Order requires the Company to file earnings information for each preceding calendar year, including total company and jurisdictional rate base, total company and Illinois jurisdictional operating revenue and expenses, other income and deductions, preceding calendar end-of-year capital structure, total company and Illinois jurisdictional return on net utility rate base, and total Company return on common equity – in other words, all of the necessary accounting data needed to calculate the Company’s earnings and revenue requirements. Price Cap Order at 93-94.

Indeed, GCI/City argue that reinitialization is not an option but a *requirement* for the Commission’s establishment of any regulatory plan for the Company. GCI/City note that when it first established price cap regulation, the Commission specifically recognized that reinitializing rates before the start of an alternative regulatory plan was essential to the finding that rates under the plan would be “fair, just and reasonable.” Specifically, a review of the Commission’s analysis in the Price Cap Order of the statutory requirements

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for the approval of alternative regulation, and specifically the just and reasonable standard set out in 13-506.1(b)(2), underscores the necessity of re-initializing rates on a going-forward basis before any new price cap plan is adopted. The Commission noted:

With its proposal for an alternative form of regulation, the Company provided all of the information typically submitted in a general proceeding. In addition, in response to CUB's rate reduction complaint, the Commission has evaluated whether IBT's current rates are just and reasonable. As a result of the evaluation, the Commission is directing rate changes in order to establish just and reasonable rates *and to establish an appropriate starting point for the alternative regulation plan.*

After rates are initialized, the price index mechanism will continue to produce reasonable rates.

Price Cap Order at 186 (emphasis added). Here, the Commission recognized that no price cap formula could produce just and reasonable rates if the going-in rates were not themselves established to be just and reasonable. The Commission's language makes clear that setting rates at just and reasonable levels at the start of a plan is essential to satisfying the statutory requirement of 13-506.1(b)(2) as a part of the approval of an alternative regulatory plan, GCI/City state.

The same analysis and conclusions apply today, according to GCI/City. As noted by Dr. Selwyn in this docket, it makes no sense for the going-in rates to be excessive at the very outset of a plan. No matter how correct the various price cap formula factors might be in any new plan approved in this docket, the rates established on a going-forward basis would likely never achieve just and reasonable status given the current excessive earnings level that the present rates produced. This is precisely the scenario that would exist if the Commission adopts alternative regulation without first re-initializing rates, GCI/City argue.

A central tenet of the price cap plan was to allow AI to realize benefits from reasonable management efforts to cut costs, and to pass those benefits on to customers, in order to allow both "the Company and ratepayers to transition themselves to a more competitive environment," according to GCI/City. Price Cap Order at 20. This language points to the goal inherent in the Commission's decision to implement alternative regulation: 1) to make a regulated, monopoly carrier more efficient than it might have acted under rate of return regulation in preparation for the day when it will face competition, and 2) permit *both* the Company and ratepayers to directly benefit from the increased efficiencies achieved, GCI/City argue. It is important to remember that in a competitive market, the existence of multiple providers and competitive alternatives would restrict a carrier's ability to earn the kind of excess profits AI earned under the existing plan, GCI/City state. In a competitive market, an examination of the prices offered by competitors can be used as a comparison of whether another company's rates are just and reasonable. However, no such competition developed in any meaningful, price-constraining way during the life of the price cap plan, according to GCI/City.

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As such, the market forces that prevent abuse of monopoly power have not been in play. As a result, the Company has enjoyed the kind of windfall profits of which companies in a competitive marketplace can only dream, according to GCI/City.

The high earnings AI reports in this proceeding represent a warning flag that the price cap plan has failed in its goal to "protect the interests of all interested parties" in the transition to a more competitive marketplace, GCI/City argue. In the instant docket, an evaluation of earnings is the only principal means of determining whether rates are just and reasonable. Either

a significant re-tooling of the plan or a return to rate of return regulation is needed. But under either scenario, the going-in rates for a particular regulatory plan must be just and reasonable, according to GCI/City. The Company's position that the Commission, in approving the first price cap plan, intended to unleash AI from any further earnings review, is insupportable in theory and the law.

GCI/City point out that Staff witness Jeffrey Hoagg concurred that rate re-initialization of rates would not violate any perceived, implicit regulatory contract between the Commission and the Company under the price cap plan. He further stated concurred that an earnings review is a valid component of this Commission's review of the price cap plan. Tr. at 1196, 1198. Moreover, nothing in Section 13-506.1 of the Act supports AI's position in this regard, according to GCI/City.

GCI/City note that AI has the burden of proving by a preponderance of the evidence that the rates in place today for its noncompetitive services are "fair, just and reasonable". In an effort to ensure that this proceeding remains focused on the establishment of just and reasonable rates, CUB and the AG filed in November a Complaint for Rate Reduction against Ameritech, which was consolidated with this docket. ICC Docket No. 00-0764. CUB likewise filed a Complaint for Rate Reduction in the original AI price cap proceeding, which was consolidated with the Company's petition for the adoption of alternative regulation. ICC Docket Nos., 92-0448/93-0239. In that docket, before adopting the price cap plan now under review, the Commission re-initialized rates by ordering a \$93 million rate reduction. Price Cap Order, Appendix B, Schedule 1, page 1 of 2.

The CUB/AG Complaint cites the evidence presented by GCI witnesses Ralph Smith and William Dunkel that shows the Company earning a revenue excess of \$956 million, assuming the adoption of a conservative 11.8 percent return on equity.¹ See GCI/City Ex. 6.2 at 52. As discussed further in Part V of this Brief, Mr. Smith concluded that AI's noncompetitive and competitive local exchange service 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 12-month period ending December 31, 1999, the various testimony and exhibits sponsored by AI witnesses in this docket and scores of specific data request responses. CUB/AG Complaint at 5. The specific adjustments to the Company's intrastate operating income and rate base recommended by both Mr. Smith and Mr. Dunkel should form the basis of the rate reinitialization established by the Commission, according to the Complaint.

Finally, AI argues in the alternative that if the Commission examines earnings,

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only earnings from noncompetitive services should be considered. GCI/City state that AI is dead wrong on this point for several reasons. First and foremost, the statutory requirement that rates be just and reasonable applies to rates for all services, not just noncompetitive services. See, e.g., 220 ILCS 5/13-506.1(b)(2), 13-504 and 13-505; CUB/AG Complaint at p. 4, par. 10, and at p. 6, par.19. The mere reclassification of a service does not relieve the Company from providing telecommunications services at just and reasonable levels, according to GCI/City. 220 ILCS 5/13-504, 13-505.

Second, AI's local and intraLATA services are furnished using a common set of network infrastructure and other corporate resources, GCI/City argue. At the federal level, the FCC has

¹ The 11.8% is the low end of the common equity recommendation made by Staff in this proceeding. This is a conservatively high estimate of AI's cost of common equity, as discussed in Part V.C. in the Brief of the Attorney General.

expressly determined 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, they point out. The same reasoning applies with respect to an examination of noncompetitive and competitive service revenues for purposes of determining Company earnings, according to GCI/City. Staff witnesses Hoagg and Staranczak concurred that any examination of Company earnings must be on a total company basis, including the examination of both noncompetitive and competitive service revenues. Tr. at 1221, 1282, 1283, 1284.

In addition, GCI/City write that Staff witness Judith Marshall testified that competitive services remain by definition-regulated services, unless specifically deregulated by the Commission or the FCC. Staff Ex. 4.0 at 4, citing 83 Ill. Admin. Code Part 711. Ms. Marshall testified that the Commission has the responsibility to assure that rates for competitive services are just and reasonable, and as such, should look at AI's earnings from regulated services as a whole. *Id.* at 4-5. Moreover, given the fact that many of the Company's reclassification of services to competitive during the life of the plan are suspect and indeed being investigated by the Commission, examination of noncompetitive revenues only, as classified by the Company, as a basis for determining Company earnings, is entirely inappropriate.

In their analysis of whether rates should be reinitialized, the Examiners again refer to Staff's proposed "zone of reasonableness" as the benchmark for the issue of whether rates should be reinitialized. In this section of the Order, however, the Examiners also assert that because the Proposed Order amounts to a fine-tuning of the existing Price Cap plan, and not "a switch to an entirely different type of plan", the notion of reinitializing rates, as occurred back in 1994, is "unavailing". HEPO at Section VI, par. 5. The Examiners write:

What was a rational and necessary move by the Commission at the initiation or the "establishment" of the Plan, when AI was still under ROR regulation, is not viable at this juncture where ROR has long been abandoned in favor of alternative regulation.

Id. at Section VI, par. 4.

While GCI/City agree that the approved price cap plan permits the Company to earn profits in excess of its allowed rate of return, 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

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the approval of alternative regulation includes an open-ended right to unlimited, excessive earnings, such as the 43% level achieved by AI. Instead, GCI/City argue that the Price Cap Order includes numerous provisions that reflect the Commission's desire to cautiously 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. While this pronouncement in no way guaranteed that the Commission would adopt earnings sharing at its five-year review of the plan, GCI/City state that it did make clear that the Commission would be (1) monitoring the Company's earnings in order to determine whether rates set under the plan were just and reasonable, and (2) entertaining evidence from parties during the review proceeding that earnings sharing was needed and appropriate. Thus, GCI/City note that it is not enough to simply determine whether the plan produced annual rate reductions for the Commission to determine that "the formula has worked to our expectations."

Mindful that it was launching a novel regulatory approach to setting rates for AI, the Commission also wrote back in 1994:

Finally, although we are confident in our endeavor to fashion an innovative plan of action to meet the demands of the future, uncertainty always accompanies change. As such, any alternative form of regulation must be carefully monitored to ensure that its intended effects are being realized.

Price Cap Order at 19.

GCI/City also point out in their Exceptions that upon recognizing the relevance of earnings in the determination as to whether rates are just and reasonable, the next question that arises under the "zone of reasonableness" issue is whether the level earned by AI reaches the level of excessiveness that justifies rate reinitialization. Whether the Commission accepts the Company's unadjusted operating income statement, which puts its profit level at 24.5%, the Staff's adjusted operating income analysis, which reports AI's profit level to be 40.1%, GCI/City's adjusted operating income analysis, which reports AI's profit level to be 43%, or some level in-between, all of the evidentiary numbers reveal a level of earnings that demands the reinitialization of rates in order to satisfy the

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just and reasonable prong of Section 13-506.2(b).

For example, GCI/City note that assuming the Commission accepts AI's position that it earned an understated 24.5% on common equity during the 1999 test year, this still amounts to an excessive earnings level in need of rate reinitialization. This level is more than double the cost of common equity of 11.30% approved by the Commission at page 175 of the Price Cap Order. See also GCI/City Ex. 6.2 (Smith Rebuttal) at 5. While the Commission envisioned the Company would achieve earnings in excess of its allowed return when it initiated price cap regulation, it is unreasonable, and unsupportable in fact or law, to assume that the Commission assumed the Company would more than double the level of profit the Commission deemed appropriate when it started the plan, according to GCI/City. This is especially the case given the conclusions in the 1994 Order, referenced above, that point to an interest in proceeding cautiously with alternative regulation and with an eye toward monitoring achieved earnings under the novel plan, GCI/City argue.

The conclusion that even the Company's significantly understated assessment of its test year earnings level triggers a need for rate reinitialization is buttressed by record evidence of recently adopted cost of equity rates for incumbent LECs in other jurisdictions, as well as the Company's and Staff's assessments in this docket of what constitutes an appropriate return on equity for AI on a going-forward basis, according to GCI/City. For example, as reported in GCI/City witness Smith's rebuttal testimony, the adopted cost of equity figures for three incumbent LECs in recent proceedings before state commissions established ROEs of between 11.0 and 11.75%. GCI/City Ex. 6.2 (Smith Rebuttal) at 52.

Moreover, in this docket, even the Company's own assessment of what constituted a reasonable investor-required return on AI's common equity ranged from 11.86 percent to 12.71 percent. AI's reported, unadjusted test year 24.5% ROE is more than double either the low end or the mid-point of its own estimate of what constitutes a reasonable return on equity, GCI/City point out. If the Commission adopts either Staff's or GCI/City's test year operating income/earnings assessment, the Company's earnings are more than three and three-and-a-half times respectively what the Company considers to be a fair return on equity.

Staff witnesses also provided their own estimates of what constituted a reasonable investor-required return on equity for AI. For example, Staff witness Pregozen testified that a reasonable investor-required return on AI's common equity ranges from 11.80% to 14.40%. AI's unadjusted, reported 24.5% ROE is nearly double the midpoint of Staff's generous ROE estimated range, and is more than double Staff's 11.80% recommendation, GCI/City note. Moreover, should the Commission adopts Staff's operating income analysis, the Company's earnings are more than three times what Staff considers to be a reasonable, investor-required AI return on equity, according to GCI/City. Likewise, if the Commission endorses GCI/City's revenue requirements assessment, the Company's earnings are more than three-and-a-half times Staff's lower-end proposed return on equity.

Given this data, it is incomprehensible to assume that merely because rate reductions occurred under the existing price cap plan, existing rates are, therefore, just and reasonable, according to GCI/City.

STATE OF ILLINOIS

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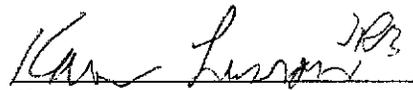
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Application for review of alternative)
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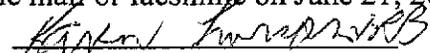
PLEASE TAKE NOTICE that on June 21, 2001 the Citizens Utility Board ("CUB") mailed one original and eight copies of The Citizens Utility Board ("CUB"), by its attorney, the People of the State of Illinois, *ex rel.* James E. Ryan, Attorney General; the City of Chicago, by Mara S. Georges, Corporation Counsel; and the Cook County State's Attorney's Office, by Richard A. Devine, State's Attorney (collectively referred to as "Governmental and Consumer Intervenors/City" or "GCI/City"), **Errata to CGI's Brief on Exceptions** and **Errata to GCI's Exceptions** to Donna Caton, Chief Clerk of the Illinois Commerce Commission, 527 E. Capitol Avenue, Springfield, Illinois 62701, for filing.

Dated: 6/21/2001


Karen L. Lusson

CERTIFICATE OF SERVICE

I, Karen L. Lusson, certify that the foregoing documents, together with the Notice of Filing, were sent to all parties of record listed on the attached service list by United Parcel Service – overnight delivery for receipt on June 21, 2001 or by hand delivery, United States mail proper postage prepaid, electronic mail or facsimile on June 21, 2001.


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