contends there was no evidence in that record that AI has acted in bad faith. In fact, AI notes that more of its competitive classifications have been approved than rejected by the Commission over the last several years.

Furthermore, AI argues that nothing in the Act permits the Commission to impose penalties in this situation. AI asserts that the Commission's powers and authority are defined by the terms of the Public Utilities Act. Business and Professional People for the Public Interest v. Commerce Commission, 136 Ill. 2d 192, 201, 240 (1989). AI further asserts that the Commission's authority to impose penalties is limited by Sections 5-202 and 13-516. The sanctions found Sections 5-202 and 13-516 apply to conduct which violates specific provisions of the Act or specific orders or rules of the Commission. In AI's view, neither of the sections would permit the imposition of additional penalties, just because the Commission disagrees with a service reclassification. In addition, AI contends the law disfavors penalties in the absence of demonstrable bad faith, intentional wrongdoing or other comparable conduct, as being violative of due process. Southwestern Telegraph and Telephone Co. v. Danaher, 238 U.S. 482, 489-490, 35 S.Ct. 886, 888 (1915). Furthermore, AI opines that Section 13-502(e) already provides mechanisms to ensure that the Company does not profit from, and customers are not harmed by, classifications that are later overturned, because the Commission has the authority to require that rates be returned to their pre-reclassification level and that any rate increases be refunded to customers.

Finally, AI contends that City/GCI's reclassification penalty proposal is outside the scope of this proceeding. AI asserts this proceeding was initiated to review the functioning of the Plan under Section 13-506.1 which has nothing to do with competitive service reclassifications, which are governed by Section 13-502.

Commission Analysis and Conclusion

The Commission rejects the improper reclassification penalty proposal advanced by City/GCI. We agree that our authority is limited to that which is expressed within the Public Utilities Act, specifically the refund provisions of Section 2-202, 13-502 (d) and the enforcement provisions of 13-515. Section 13-515(j) already provides a sanction mechanism, albeit significantly less than that proposed by City/CUB. While this matter was pending, HB 2900 was enacted. The legislature had an opportunity to amend the above referenced statutes or impose additional sanction provisions as propounded by City/GCI and Staff, however it did not.

~~At first blush~~ City/CUB's reclassification penalty provision would most certainly serve as a deterrent to the reclassification of non-competitive services. A review of the law and the consequences such a proposal would have~~,~~ however, leads us to conclude that such a proposal must be rejected.. ~~A through examination of the~~ From a policy prospective, the City/CUB proposal ~~proposal leads us to conclude however, that such a deterrent~~ will impede the development of a competitive market place for telecommunication services by causing AI to be overcautious when reclassifying services. ~~Should the~~ City/CUB or Staff ~~seek~~ could have sought an amendment to the PUA while HB 2900 was pending. We note, as we do hereinabove, the legislature did not amend the PUA to allow for penalties as proposed by City/Cub or Staff. ~~they should be mindful of the effect a penalty provision will have on the development of a competitive telecommunications marketplace. Finally, it is our expectation that the Orders in Dockets 98-0860 and 98-0861 will provide substantial clarification to the parties as to our interpretation of Section 13-502(b) and the evidence required to support a competitive classification and thus eliminate the perceived ambiguity which currently exists.~~

VI. RATE REINITIALIZATION

A. The Evidence – Revenue Requirement Analysis

Staff and the GCI/City each prepared a revenue requirement analysis in the event that the Commission considers it appropriate to either re-initialize the rates of Ameritech or to return Ameritech to rate of return regulation. (Staff Ex. 5.0). At various times the GCI/City have argued for one or both of these ends. (Neither Staff nor AI share their views). The record contains testimony addressing AI's cost of capital, depreciation, rate base and expenses for the test year beginning January 1, 1999 and ending December 1, 1999.

In addition, the GCI/City and Staff presented the Commission with rate design recommendations to accommodate the rate reductions that would follow under their analyses. We note that the parties positions in this instance were developed on the record evidence and the law that existed prior to June 30, 2001.

The following sections summarize the record, highlighting both the disputes (contested issues), and the agreements (uncontested issues), among the litigants.

1. Revenue and Expense Adjustments

AI's final proposed operating statement appears in witness Dominak's Additional Surrebuttal Testimony. (AI Ex. 7.3, Sched. 2.) Staff and GCI proposed several adjustments to AI's operating statement, as follows:

(Contested Issues)

a Interest Synchronization

Staff witness Voss proposed an interest synchronization adjustment to reflect the tax savings generated by the interest component of Ameritech's revenue requirement. (Staff Ex. 5.0 at 12) The GCI/City also recommended an interest synchronization adjustment, calculated by applying the weighted cost of debt to the recommended rate base to obtain a synchronized interest deduction for use in the calculation of test year income tax expense. According to the GCI/City, there is long-standing precedent for an interest synchronization adjustment and, in the Alt Reg Order, the Commission rejected the same claim that AI raises in this proceeding.

Ameritech opposed the recommended adjustments pointing to its witness Dominak's explanation that an interest synchronization adjustmemt is inappropriate for purposes of determining the Company's actual earnings under the Plan because the methodology does not allow for fluctuation in interest rates, particularly the short-term interest rates on balances outstanding. (AI Ex. 7.1 at 10). As a result, AI argued, the effect of Staff's and GCI's proposed adjustments is to reflect interest payments the Company never made in 1999, thereby understating income tax expense and overstating earnings. (Id.).

b. Pension Settlement Gains

AI made an adjustment to its 1999 Operating Income Statement to remove the impact of a $98.6 million net pension settlement gain recorded on the books during 1999. The effect thereof is to eliminate a credit to pension expense in the amount of $66.189 million, thereby increasing 1999 operating expense by the same amount. The Company made a similar adjustment to remove AI's allocable share of the 1999 net pension settlement gains charged from Ameritech Services, Inc. ("ASI'). (AI Ex. 7.1 at 32; Ex. 7.3, Sch. 1).

Staff witness Hathhorn proposed an adjustment which would add back a "normal" level of pension settlement gains and amortize, over five years, the amount by which the actual 1999 gain exceeded a "normal" level. She also proposed a similar adjustment of $6.795 million for the Company's allocable share of ASI's net pension settlement gains for a total adjustment in the amount of $23.65 million. (Staff Ex. 20.0, Schedule 20.01, at 1.) Pension settlement gains are a recognition of the difference between actual pension payments to participants and a value determined by the Financial Accounting Standards Board. In short, Hathhorn's adjustment was calculated from two components: (1) a normalized pension settlement gain, and (2) a five-year amortization of abnormal gains.

GCI/City witness Ralph Smith proposed to amortize the $98.6 million that AI would remove over a period of five years which would reduce Ameritech Illinois' proposed intrastate operating expense by $13.238 million as reflected on GCI/City Ex. 6.5, Schedule E-3 Revised.

Similarly, the GCI/City proposed that the Ameritech Services 1999 pension settlement gains be amortized over a five-year period (Id., Schedule E-15). Finally, Mr. Smith also made an adjustment to amortize over a five-year period the impact of $98 million in known pension settlement gains recorded by IBT in 2000 for retirements that occurred during the 1999 test year. (Id., Schedule E-19).

Staff opposed the GCI/City pension settlement gain adjustment for year 2000 activity, as being outside the test year and also noted that their methodology does not recognize a normal level of pension gains based on prior years or support the inclusion of curtailment losses. (Staff Initial Br. At 89).

AI opposed both Staff's and the GCI/City's adjustments. AI maintains that the pension settlement gain recorded in 1999 is related to favorable market returns on pension plan assets in years prior to 1999 meaning that such "relate back" to prior periods. Given that the pension settlement gains recorded in 1999 were abnormally high due to the retirement of an unusually large number of employees who elected to receive their pensions in a lump sum payment, AI maintains that to present a normalized view of 1999 financial results, the gain should be removed in its entirety from the 1999 operating income statement developed for regulatory financial reporting purposes. (Am. Ill. Ex. 7.1, at 32-33; Am. Ill. Ex. 7.2, at 11-12). Further, AI argued, the revenue requirement used to establish "going-in" rates approved in the Alt Reg Order did not contain an allowance for pension expense such that there is no basis for the contention that customers have been paying for pension expense or that they deserve credit for the abnormal pension settlement gain.

According to AI, GCI witness Smith's total adjustment of $16.938 million ($13.238 million for Ameritech Illinois + $3.7 million for ASI) exceeds the "normal" level pension settlement gains by $9.847 million and his proposal to use a five year amortization period is arbitrary. Assuming arguendo, that an amortized level of pension settlement gains were to be reflected in the 1999 data , AI contends that the appropriate amortization period would be 11.4 years for management and 16 years for non-management employees as these are the time periods used, pursuant to FAS 87, to amortize unrecognized deferred pension plan gains and losses. (Am. Ill. Ex. 7.2, p. 11). With respect to GCI/City's proposed adjustment for 2000 Pension Settlement Gains, AI contended that its witness Dominak, made clear that the recognition of pension settlement gains in the year 2000 was triggered by lump sum pay-outs made in the year 2000, not 1999. (AI Ex. 7.2, at 12; Tr. 1165-66).

c. Directory Revenue

Staff witness Everson recommended that Ameritech's Directory Revenue be increased by $126,000,000 ($75 million directory contract + $51 million imputed directory revenue) using the methodology applied in the Alt Reg Order. (Staff Ex. 7.0)

The GCI/City define Directory Revenue as the profit Ameritech Illinois has received from publishing and selling advertising Illinois directories. (GCI Ex. 6.0 at 24, lines 16-19.) GCI proposed an adjustment similar to Staff largely on grounds that the

Commission found an imputation to be necessary for the purpose of establishing an appropriate revenue requirement in the Alt. Reg. Order, Docket No. 92-0448/93-0239 (consol.), at 101-03.

Ameritech opposed the imputation and proposed to adjust Directory Revenue downward to represent the year 1999 expiration of a contract with Ameritech Publishing, Inc. d/b/a Ameritech Advertising Services. AI maintained that the positions taken on this matter are unsupported by law or fact. According to AI, the GCI/City fail to comprehend the basis for the 1994 imputation or account for the changes in both current circumstances and the federal law, and further ignore the Commission's prior 1984 regulatory pronouncement.

d. Incentive Compensation Plan

Staff witness Everson recommended that Ameritech's expenses be reduced by $16.117 million to account for the expensed portion of the management incentive compensation plan that does not benefit the ratepayer. (Staff Ex. 21.0, Sched. 21.02, at 1.) Staff maintains that its adjustment is consistent with the Commission's actions in adopting previous exclusion adjustments for incentive compensation. (See, Illinois Power Company, Docket No. 93-0183, and in MidAmerican Energy Company, Docket 99-0534.)

Ameritech claimed that the Company's incentive compensation plan is a prudent business expense which, if eliminated, would require increases in base salaries. To ignore a portion of the expense incurred to compensate employees is improper, AI claimed, and would overstate the Company's 1999 earnings. Further, AI explained that for a company operating under price cap regulation, the financial goals to be achieved through incentive compensation do not include a request for increases in base rates.

e. Social and Service Club Dues

Staff witness Everson recommended that the revenue requirement be reduced by $266,994 for fees and dues attributed to Social and Service Clubs. (Staff Ex. 21.0, Sched. 21.03 at 1.) Ameritech claimed that these types of dues and membership fees (e.g. Chambers of Commerce dues) are normal, prudent operating expenses, were previously allowed, and therefore should be included in the determination of the Company's revenue requirement. (Ameritech Ex. 7.2 at 26.) According to Staff, the Commission has previously disallowed dues paid to similar community organizations. (Staff initial Brief at 93-94).

f. External Relations

Staff witness Everson recommended that $20,387,000 associated with external relations be removed from the revenue requirement. (Staff Ex. 30.0, Sched. 30.02, p. 2; also Staff Ex. 21.0, Sched. 21.04.) Ameritech identified its external relations as non-product-related corporate image advertising, costs associated with maintaining relations with government, regulators, other companies and the general public. (Ameritech Ex. 7.1 at 23.) Such costs, Staff maintains, have been disallowed from rate recovery under PUA Section 9-225(1)(c) and 83 Ill. Adm. Code 295.10(a).

AI indicated that of the $20.413 million in intrastate external relations expense incurred during 1999, only $6.807 million represents "brand" advertising expense. The remainder is for costs associated with other activities including (a) preparing and presenting information for regulatory purposes, e.g. tariff and service cost filings; (b) administering relations, e.g. contract, with telecommunications carriers, utilities and other businesses; (c) administering investor relations; and (d) reviewing existing and pending legislation. (AI Ex. 7.2 at 2, Sch.5)

The GCI/City propose an adjustment of $6.807 million to remove the expense associated with non-product, corporate-image advertising. (GCI /City Ex. 6.0, at 35.) They asserted that corporate-image advertising is of little or no benefit to Illinois jurisdictional ratepayers because its purpose is to promote the image of Ameritech, and now SBC. Consistent with the Commission's findings in Docket 92-0448, the GCI/City maintain that advertising which promotes the Company's image and goodwill should be disallowed. The GCI/City further contend that the link between non-product advertising and increased sales of regulated services in Illinois is remote and not quantifiable.

AI maintained that brand advertising is vital to the Company's efforts to promote the sale of its products and services and, in particular, to successfully bid on communications solutions for large business and institutional customers. (AI. Init. Br. at 120-21). According to AI, Mr. Dominak's testimony showing that "brand" advertising is a necessary cost of doing business in an increasingly competitive environment was unrebutted and the prudence of such costs was unchallenged. Assuming, arguendo, the adjustment proposed by GCI/City is appropriate in the context of a rate increase proceeding for a traditionally regulated public utility, AI maintains that it is completely inappropriate in the context of a review of the earnings of a price-cap regulated carrier.

g. Depreciation and Amortization

FAS 71 Adjustment

In late 1994, AI implemented an eight year amortization of the $1.152 billion asset value write-down resulting from the discontinuation of Financial Accounting Standards Board Statement No. 71 ("FAS 71").

Staff witness Marshall recommended that the Commission remove $107,906,000 from Ameritech's Depreciation and Amortization due to FAS 71 corrections. Staff states that "FAS 71" is an accounting rule, which allows a regulated company to account for transactions on its financial records in the same way it does on its regulated books under certain condition and that in the Alt. Reg. Order, Docket No. 92-0448/93-0239 (consol.), the Commission found that no amortization of a depreciation reserve deficiency was appropriate for inclusion in the plan. Staff proposed that the FAS 71 adjustment be treated as a one-time event occurring outside of the test year.

The GCI/City also recommended the disallowance of FAS 71 amortization expense since there is no annual amortization related to FAS 71 occurring on either Ameritech's financial reporting books or its books used for FCC purposes. They asserted that, accordingly, no such amount should be recognized for the sole purpose of intrastate ratemaking.

The GCI/City further assert that Ameritech did not request any FAS 71 amortization treatment in the interstate jurisdiction. Even if same had been granted, they point out that the FCC has ordered that a FAS 71 amortization to be treated as a "below the line" expense, not to be considered an expense for rate making purposes. Thus, the GCI/City argue, there is no factual or regulatory basis for the disparate above the line treatment Ameritech requests.

AI maintained that the discontinuance of FAS 71, and the resulting asset write-down, was a direct result of the capital recovery freedom granted to the Company (which includes the freedom to manage recovery of the asset write-down, within the constraints of the price index, through an eight year amortization) as an "integral part" of the Plan. (Alt Reg Order at 55).

If the Plan had not been adopted, and AI had continued to be regulated under traditional rate of return regulation, the Company contends that the FAS 71 asset write-down would not have occurred, and Ameritech Illinois would not have booked depreciation rates higher than those approved and calculated in accordance with Commission approved remaining life parameters. As such, AI argues, the December 31, 1999 intrastate depreciation reserve balance would be approximately $1.7 billion less (and the resulting rate base $1.7 billion more) than the reserve balance (and rate base) shown on Schedule 2 of Ameritech Illinois Exhibit 7.1. (AI Ex. 7.1, p. 39).

AI further contended that it is amortizing FAS 71 in the Illinois intrastate jurisdiction pursuant to the freedom granted by this Commission, not in the interstate jurisdiction (Am. Ill. Ex. 1.5, p. 14), and that the FCC does permit a price cap regulated carrier to amortize a FAS 71 related depreciation reserve deficiency subject to the same conditions as those imposed on the Company in the Alt Reg Order, i.e., that any change in depreciation and amortization expense will not offset the price cap formula used to set rates or otherwise be recovered through increases in customer rates. No change in the price cap formula or increase in customer rates has resulted from the FAS 71 amortization or the other capital recovery practices at issue in this case, AI asserts.

h. Depreciation and Amortization

Staff final recommendation (as reflected in its Initial Brief) is a Total Depreciation and Amortization expense of $558,680,782. (Staff Initial Brief at Appendix B, page 1 line 6.) Ameritech's Adjusted Intrastate Depreciation Expense is $607,758,155, resulting in a negative adjustment of Ameritech's Adjusted Intrastate Depreciation Expense of $49,077,373. (Ameritech Ex. 7.3, Sched. 4, and Staff Brief Appendix B, page 1.)

Staff's Total Depreciation and Amortization adjustment is comprised of three parts: (1) adjustment for overdepreciated accounts (Staff Ex. 24.0 Sched. 24.1 line R); (2) adjustment for amortization of circuit equipment, (GCI Ex. 9.0 at 50); and (3) adjustment for amortization of other freedoms (GCI Ex. 9.0 at 52) ($101,656,920 + $11,242,000 + $32,126,000, respectively). This includes Staff's adoption of GCI witness Dunkel's adjustment of $11,242,000 for amortization of Circuit Equipment (GCI Ex. 9.0 at 50), and $32,126,000 for amortization of "other freedoms" (Id. at 52).

GCI/ City proposed that Ameritech's depreciation expense be adjusted to $382.4 million for 1999 test year purposes (GCI Br. on Exceptions at 156). GCI asserted that its expert witness' testimony on depreciation was more credible than that of Ameritech's in that he detected the $160.4 million error for which Ameritech revised its number. GCI/City also challenged Ameritech's inclusion of a reserve deficiency in its calculation of amortization expense. The GCI/City's adjustment also accounted for using 1999 versus 1995 rates for certain plant life parameters.

The premise behind the GCI/City's proposals is that test year booked data is not reasonable or representative for setting rates for the future. (City Initial Brief at 48) They further assert that in the Alt Reg Order, the Commission advised Ameritech that it would continue to monitor the Company's depreciation policies and practices and re-evaluate the propriety of the Plan if any abuses were found.

Ameritech admitted that there was an error in its depreciation expense calculation and made the correction. AI maintained, however, that its adoption of the capital recovery policies which result in depreciation expense levels different from those which would result from studies of the type traditionally required for regulatory purposes is the very essence of depreciation freedom and cannot logically be deemed to be an "abuse" of that freedom. (AI Ex. 1.3, at 99-100; AI Ex. 1.5, at 23-24). This would occur only if it had violated generally accepted accounting principles ("GAAP") principles or otherwise deliberately manipulated its depreciation practices of which there is no evidence. To the contrary, AI contends, the evidence shows that the Company's composite depreciation rate is, for comparable major plant categories, below the composite depreciation rates of CLECs and IXCs whose depreciation practices are also unregulated and subject to GAAP. (AI Ex. 1.1, at 108-09, Sch. 8; AI Ex. 1.5, at 28-29)

AI maintains that for year 1999, the annual level of depreciation and amortization ("depreciation") expense resulting from the Company's exercise of its capital recovery freedom was $607.758 million (AI Ex. 7.3, Sch. 1), and represents the actual level of depreciation expense incurred by the Company in 1999 on a regulated, intrastate basis, as adjusted during the course of this proceeding for the following known changes: (i) elimination of depreciation expense incorrectly recorded on accounts fully depreciated prior to 1999 as discovered by the GCI/City; and (ii) a correction to the calculations made to separate depreciation and amortization expense between the interstate and intrastate jurisdictions. (AI Ex. 7.1, at 4; AI. Ex. 7.3; at 1-4, Schs. 1, 3-5). Its depreciation rates and other capital recovery practices which result in depreciation expense levels different from those which would result from depreciation studies of the type espoused by the GCI/City's witness Dunkel reflect depreciation freedom.(AI Ex. 1.3, at 99-100; AI Ex. 1.5, at 23-24), are not unreasonable (AI Ex. 1.3 at 105; AI Ex. 1.5 at 28-29) and were required, AI maintained, to more accurately reflect the economic value of Ameritech Illinois' assets and the diminished assurance of full capital recovery in an increasingly competitive marketplace. And, in accordance with the commitment made by the Company to the Commission in 1994, AI asserts, no increases in customer rates have resulted from these practices.

i. Revenues Related to Ameritech's Failure to Meet Service Quality Standards.

The GCI/City recommended the adoption of their witness Smith's proposal to restore or impute to Ameritech Illinois $29.579 million in forgone revenues which resulted from its failure to meet one of eight service quality standards under the Plan in years prior to 1999. (CUB Initial Brief, Schedule E-8). They argued that Mr. Smith's proposed adjustment is necessary to prevent ratepayers from being "forced to pay extra when the Company fails to meet the minimum acceptable service quality standards." While admittedly Mr. Smith's recommended adjustment would impute revenues to the 1999 test year that AI did not receive, such imputation is necessary, the GCI/City maintain, in order that the 1999 test year revenues reflect, for ratemaking purposes, an appropriate level of revenues as if the Company had provided an adequate level of service to customers.

AI opposed the GCI/City proposed adjustment because it would impute revenues which the Company did not receive. AI contends that if rates were reinitialized on the basis of the GCI/City proposal, the effect would be to (i) pass through to customers a second time the cumulative benefits of revenue reductions which they have already received and (ii) indefinitely lock into rates an annual penalty of $29.579 million in addition to the service quality related penalties explicitly adopted elsewhere in the Order for this case. To have the Company bear the burden of this $29.579 million penalty every year in the future whether or not it meets service quality standards would be, in AI's view, arbitrary and unfair.

j. Asset Disposition Accruals

The GCI/City recommended an adjustment to Ameritech's proposed removal of a $5.518 million credit to expense associated with "asset disposition accruals". They argue that the more appropriate ratemaking treatment would be to amortize the credit over a similar period, i.e., five years, that the over-accruals were built up over, and therefore propose that a five year amortization period be utilized. The adjustment the GCI/City recommend would reduce AI's proposed intrastate operating expense by $741,000.

AI indicated that the accruals in question were associated with property sales which occurred in 1994 and, in 1999, the Company made a reconciling adjustment on its books for financial reporting purposes in the amount of $5.518 million as a credit to Corporate Operations Expense to remove the balance of the accrual. The transaction which gave rise to the accrual had nothing to do with 1999 operations, AI maintains, and hence, the Company eliminated the credit entirely from its presentation of a normalized level of expenses. (AI Ex. 7.2, at 33). According to AI, Mr. Smith's proposed adjustment would reduce expenses by one-fifth of the amount of the credit, thereby improperly reflecting prior period activities in the test year. (Id.).

k. Revised Non-Regulated Allocation Factor

In rebuttal testimony, AI witness Dominak revised the non-regulated allocation factor applied to "prior period" expense adjustments from 0.1301 to 0.0464. (AI Ex. 7.1 at 2-3). AI maintained that the revision was made in accordance with the FCC's Joint Cost Rules which specify that costs are to be allocated based upon a direct analysis of the origin of cost. (C.F.R., Sec 64.901, Allocation of Costs).

The GCI/City's witness Smith took issue with the Company's revision. Thus, the GCI/City proposed an expense reduction based on the application of "prior period" expense adjustments of a non-regulated allocation factor of 0.1301, rather than the non-regulated allocation factor of 0.0464 used by the Company. (CUB Initial Brief at 133). They also noted that the adjustment made by AI witness Dominak in his rebuttal testimony to reflect the exclusion of certain merger costs was calculated on the basis of the 0.1301 non-regulated allocation factor and, therefore, is "internally inconsistent" with the use of a 0.0464 factor. (GCI/City Exc., at 170).

According to AI, the costs related to the prior period activities at issue were all booked to account 6728, Other General and Administrative Expense, for which the specifically applicable factor is 0.0464. (AI Ex. 7.2, p. 30). Further, the GCI/City have overlooked Mr. Dominak's surrebuttal testimony, wherein he made a correcting adjustment to increase the merger cost exclusion consistent with the use of a 0.0464 factor, thereby eliminating the alleged "inconsistency." (AI Ex. 7.2, at 30-31; AI Ex. 7.2, Sch. 1; AI Ex. 7.3, Sch. 1).

(Uncontested Issues)

l. Uncollectibles

Staff witness Voss proposed an uncollectible percentage of 1.67%. While Ameritech agreed with Staff's uncollectible percentage of 1.67%, and with the $18,685,000 correcting adjustment, Staff believes that the Company did not include all of the necessary correcting adjustments for uncollectibles in its operating statement (Staff Initial Brief at 102-103). In its Reply Brief, however, AI reports that Mr. Dominak made an adjustment to correct the error on surrebuttal. (AI Ex. 7.3, Sch 1).

m. Gross Receipts Taxes

Staff witness Voss proposed to remove both the expenses and revenues attributable to gross receipts taxes to prevent double billing of the ratepayer. (Staff Ex. 19.0) Additionally, Staff proposed that the 3% collection fee on municipal utility taxes not be included in the operating revenues required for the determination of rates. (Staff Ex. 19.0) Ameritech originally proposed to include both the revenues and expenses for certain gross receipts taxes in its operating statement. (Staff Ex. 5.0 at 16) Staff notes, however, that AI subsequently agreed with Staff's proposed adjustment to gross receipts taxes. (AI Ex. 7.2 at 2-3.)

n. Merger Planning and Implementation Costs

Staff witness Hathhorn disallowed Ameritech's pro forma adjustment for merger planning and implementation costs since analysis of such costs is more appropriate for the Commission's subsequent proceedings related to the 50% Net Merger-Related

Savings condition from Docket No. 98-0555. (Order at 262 (Finding No. 8), September 23, 1999). GCI recommended an adjustment identical to that of Staff's (which would reduce AI's proposed intrastate operating expense by $9.253 million). Ameritech accepted the adjustment noting that it is already reflected in the Company's proposed Operating Income Statement ,i.e., AI Ex. 7.3, Sch.1.

o. Advertising—Sport Team Sponsorship

The GCI/City's witness Smith proposed an adjustment to 1999 test year expense to remove the cost of sports team sponsorship. (GCI/City Ex. 6.0 at 36). According to the witness, sports team sponsorship is not a cost of providing telephone service and represents costs incurred to promote goodwill toward the Ameritech name.

Staff and Ameritech agreed with the GCI proposal to remove $96,000 from advertising expense relating to sports team sponsorship. (Staff Ex. 21) Ameritech Ex. 7.1 at 6; and GCI Ex. 6.1, Sched. E-7.) AI further notes that this uncontested adjustment is reflected in AI Ex. 7.3, Sch.1.

p. Income Tax Expense Correction

The GCI/City's witness alleged and discussed the need for making an adjustment to reduce income tax expense in the Company's test year operating income statement on a total company basis (GCI Ex. 6.0). Ameritech accepted the correction in its rebuttal testimony (AI Ex. 7.1, Schedules 1 and 3.)

q. Ameritech's Income Tax Expenses

Due to an "insert problem," Staff maintained that the amounts for Federal Income Taxes and State and Local Income Taxes are inaccurately reflected in column A on Ameritech Ex. 7.3, Sched. 1. (Tr. 1055-63; Staff Initial Br. at 102-3.) Staff's corrections are set out in its Initial Brief, Appendix A, at 8. In its Reply Brief, at page 91, AI accepts Staff's adjustment.

r. Software Cost Capitalization

In his direct testimony, the GCI/City witness Smith recommended an adjustment to correct the Company's failure to reflect in its 1999 test year filing the impact of an American Institute of Certified Public Accountants Statement of Position ("SOP No. 98-1"), which addresses the capitalization of software costs. Prior to the adoption of SOP 98-1 many companies, including AI, had been expensing internally developed software costs, which now must be capitalized in compliance with GAAP. Mr. Smith explained that, for ratemaking purposes, it was necessary to reflect the amortization into expense of software costs. The effect of the adjustment, (shown in GCI/City Ex. 6.5, Schedule E-10), decreases intrastate operating expense by $1.319 million.

In his rebuttal testimony, Mr. Dominak accepted this adjustment, but insisted that Mr. Smith used the wrong intrastate factor for purposes of calculating the adjustment. (AI Ex. 7.1 at 9). Mr. Smith agreed that the "Plant Specific Operations" factor should be used, but noted that Mr. Dominak had not followed his own advice. (GCI/City Ex. 6.2 at 12). Mr. Smith corrected the mistake. (GCI/City Ex. 6.5, Schedule E-10, line 4). In his surrebuttal testimony, Mr. Dominak concurred with Mr. Smith and made the correction. (AI Ex. 7.2 at 3).

2. Rate Base Adjustments

AI's final proposed rate base is presented in Mr. Dominak's Additional Surrebuttal Testimony. (AI Ex. 7.3, Sched. 2.)

(Contested Issues)

a. Adjustment to Plant Under Construction

Staff witness Hathhorn excluded from rate base that portion of telephone plant under construction ("TPUC") generating Interest During Construction ("IDC") since such treatment is required under Section 9-214(d) of the PUA. (Staff Ex. 20.0, Sched. 20.02.) While noting that Section 9-214 (e) allows for rate base inclusion under certain circumstances, Staff claims that AI presented no evidence that its TPUC balances meet the statutory criteria. Further, according to Staff, both AI and the GCI/City proposed adjustments violate the statute.

A major point of contention between the GCI/City and AI concerned the Company's addition of $26.8 million to Total Plant In Service ("TPIS") associated with plug-in circuit board equipment. The GCI/City argued that the Company's attempt to add $26.8 million to rate base should be rejected because the evidence shows the Company has not yet paid for the plant. AI maintains that the Company paid for the equipment (acquired and placed in service during December of 1999) within 15 to 20 days after its receipt and, therefore, the $26.8 million represents an investment by Ameritech Illinois in telephone plant. (Tr. 1161).

While Ameritech, GCI, and Staff agreed that an adjustment needed to be made to prevent the double recovery of IDC, the method of adjustment remained at issue. The GCI/ City appeared to accept the Staff methodology. AI's position is less clear.

b. Incentive Compensation

Staff witness Everson recommended reducing the capitalized portion of Ameritech's incentive compensation for the same reasons stated above in the Revenue and Expense Adjustments section of this Order.

c. Accumulated Deferred Income Taxes ("ADIT")

The GCI/City recommended that the ADIT balance be adjusted to reflect the adjustment to uncollectibles expense that both they and Staff proposed and which the Company accepted. (AI. Ex. 7.1, at 7 AI Ex. 7.2 at 3). As such, they asserted that the ADIT debit balance of approximately $19 to $20 million for uncollectibles should be removed from rate base. (CUB Iinitial Brief, Schedule E-17).

Ameritech opposed the GCI/City adjustment alleging that only the tax effect of the $19 million adjustment to uncollectible expense would impact rate base. Hence, AI maintained, the correct adjustment to ADIT is $7.412 million.(AI Ex. 7.2, Sch.2).

d. Accumulated Reserve For Depreciation

In the course of this proceeding, the Company discovered that it had added incorrect amounts to the intrastate reserve for accumulated depreciation in certain years prior to 1999. As a result, the Company made an adjustment in the amount of $362 million (as detailed in Ameritech Illinois Exhibit 7.3, Schedule 6) to correct the December 31, 1999 balance of the intrastate depreciation reserve. (AI. Ex. 7.3 at 4-5; Tr. 962-64).

The GCI/City assert that Ameritech should not be allowed to decrease its depreciation reserve by $362 million for 1999 test year purposes based on alleged non-test year accounting errors. The effect thereof, they claim, would be to allow Ameritech to double-recover depreciation expenses. (City Initial Br. at 55-57). The GCI/ City contend that these expenses were actually booked by AI and that Ameritech already recovered these expenses from customers through rates that more than met its revenue requirement, with the $362 million included. They argue that if Ameritech were allowed to reduce its depreciation reserve, the Company's test year net rate base and revenue requirement would increase accordingly. Ameritech would then use this higher revenue requirement to argue against any rate reduction that the Commission may enter in this case.

According to AI, GCI/City witness Dunkel acknowledged that customers pay for service, not for "depreciation expense." (Tr. 1685-86). AI further contends that the revenue requirement adopted in the 1994 Order for purposes of setting "going-in" rates reflected an allowed level of depreciation expense substantially less than the amount which the Company actually booked during the time period referenced by the City. (Tr. 1685-87). Since the issuance of the 1994 Order, AI maintains that noncompetitive rates have decreased every year in accordance with the price cap formula. That formula contains no factor related to depreciation, AI asserts, such that rates are not affected by changes in the level of depreciation expense (or any other expense) booked by the Company. (AI Ex. 1.5, pp. 12-13). Thus, AI maintains, customers' rates during the period from 1995-98 would not have been any different had the Company booked less (or more) depreciation expense than it actually did. Hence, there is no logical basis for the suggestion that customers have "paid" for the depreciation expense incorrectly booked during the period from 1995-98.

AI contends that if the GCI/City's proposal to reduce 1999 depreciation expense for ratemaking purposes were adopted, although it should not, consistency requires that the December 31, 1999 depreciation reserve be reduced the amount by which the depreciation expense accrued since 1994 exceeded the depreciation expense that would have been accrued if the Company had not been granted depreciation freedom. (AI Ex. 1.5 at 31). Specifically, AI maintained the December 31, 1999 intrastate reserve balance (reflected in Schedule 2 of Ameritech Illinois Exhibit 7.1) would need to be reduced by $1,708,302,000. The associated adjustment to increase the deferred income tax balance would be $677.632 million. (AI Ex. 7.1 at 39).

(Uncontested Issues)

e. Materials and Supplies

GCI proposed an adjustment, the net result of which is an increase to intrastate rate base by $924,000, to reflect the current ongoing level of Materials and Supplies. Ameritech agreed with the adjustment as was indicated in Mr. Dominak's rebuttal testimony (AI Ex. 7.1 at 8).

3. Cost of Capital

a. Capital Structure and Cost of Debt

AI's position

AI maintains that its target market-weighted capital structure should be used to calculate the overall cost of capital for revenue requirement purposes. Its witness asserts that the Company's target market-weighted capital structure is that of its publicly traded peer group, which consists of 75.09% equity and 24.91% debt. (AI Ex. 1.1 at 111; AI Ex. 6.0 at 10, 38.)

In today's more uncertain environment where the Company's earnings and capital recovery are not assured, AI contends that the overall cost of capital should be determined using market weights. (AI Initial Br. at 134.) AI witness Dr. William Avera testified that book values of the components of the capital structure are appropriate for traditional, original cost ratemaking. Since AI operates in the competitive sector, however, he maintains that book values are no longer appropriate for capital structure measurement. (AI Ex. 8.1 at 9).

AI estimated its cost of short-term debt at 5.81% and its cost of long-term debt at 7.91%. (AI Ex. 6.0 at 37-38, Schedules 11 and 13.) These costs were multiplied by the respective balances of short-term and long-term debt to arrive at AI's 6.71% cost of total debt estimate. (AI Ex. 6.0, Schedule 13.)

Staff's Position

Staff witness Alan Pregozen recommended using AI's book value capital structure for the year ended December 31, 1999 to determine the weighted average cost of capital in the event that the Commission re-initializes AI's rates. Staff's recommended capital structure is comprised of 22.03% short-term debt, 18.00% long-term debt, and 59.94% common equity. (Staff Ex. 11.0, Schedule 11.01.) Staff believes its recommended capital structure for AI is reasonable since the total debt ratio of 40.06% proposed is consistent with the Standard & Poor's benchmark of 42% debt and under for AA rated telecommunications companies. (Staff Ex. 11.0 at 8.)

Book values of the components of the capital structure are appropriate for traditional, original cost ratemaking. (Staff Ex. 11.0 at 6.) The Commission only uses original cost rate base when setting rate of return-based rates. Therefore, AI's book value capital structure should be used if the Commission uses rate base/rate of return ratemaking procedures to re-initialize AI's rates. (Staff Reply Br. at 77.)

Mr. Pregozen estimated that the appropriate balance of short-term debt to include in AI's capital structure was $671,284,205. (Staff Ex. 11.0 at 7.) This balance of short-term debt is the average balance for the period from June 1999 through June 2000, which is centered in time at December 31, 1999 (the measurement date for the other components of the capital structure). Mr.Pregozen testified that the appropriate cost of short-term debt was 6.61%, based on the current annual yield on thirty-day "AA nonfinancial" commercial paper. (Staff Ex. 11.0 at 9.)

Staff's witness Pregozen further testified that the balance of long-term debt outstanding as of December 31, 1999 was $547,746,000 and its cost was 6.73%. (Staff Ex. 11.0 at 9-10, and Schedule 11.03.) The balance of common equity that Staff recommended was $1,824,500,000, which the Company reported in its annual report to the Federal Communications Commission. (Staff Ex. 11.0 at 8.)

GCI's position

GCI/City witness Smith used Staff's recommended capital structure and cost of short-term debt and long-term debt to calculate AI's revenue requirement. (GCI Ex. 6.0 at 14.)

b. Return on Common Equity

AI's Position

AI witness Dr. Roger Ibbotson performed a two-stage Discounted Cash Flow ("DCF") analysis and a risk premium (Capital Asset Pricing Model or "CAPM") analysis on a group of peer companies to estimate the cost of equity for AI. He estimated that the cost of equity for AI is within a range of 11.86% to 12.71%, based on the average cost of equity of its peer group. (AI Ex. 6.0 at 4.) Dr. Ibbotson did not make an explicit adjustment for flotation costs in his cost of equity analysis. (AI Ex. 6.0 at 37.)

Dr. Ibbotson formed his peer group by examining publicly traded telecommunications companies in the Standard & Poor's Compustat database. He excluded long-distance companies, companies not included in Value Line's Telecommunications Services sector, companies with less than 50% of their sales in SIC code 4813, and companies with less than two years of available data. (AI Ex. 6.0 at 12-13.) He concluded that AI was at least as risky as the proxy firms in the peer group due to AI's high capital intensity and operating leverage, and an alleged loss of regulatory protection and accelerating competition. (AI Ex. 6.0 at 14.)

Dr. Ibbotson used the quarterly version of a two-stage DCF model to estimate the cost of equity for each peer group company. The first stage covers the next five years, and the second stage covers the long-term, defined as years six and thereafter. (AI Ex. 6.0 at 19.) He used analysts' recent estimates of five-year growth in earnings per share published by IBES and Value Line for his first stage growth rate. For the second stage growth rate, Dr. Ibbotson used the historical long-term real growth in the economy and then added an estimate of long-term inflation to arrive at a nominal growth forecast of 7.4%. Dr. Ibbotson measured the historical long-term growth in the economy by computing the compound annual growth in real (adjusted for inflation) Gross Domestic Product ("GDP") for the period 1948 to 1999. He then added his 3.3% real GDP historical growth estimate to his 4.1% inflation forecast, which was based on his assessment of the long-term inflation rate implied in bond yields. (AI Ex. 6.0 at 21-22.)

Dr. Ibbotson averaged the dividend yield for each peer group company as of February 29, March 31, and April 28, 2000 to estimate the dividend yield for his DCF analysis. The three companies in his peer group that did not pay dividends were excluded from his DCF analysis. (AI Ex. 6.0 at 22-23.)

For his CAPM analysis, Dr. Ibbotson averaged the yield on twenty-year U.S. Treasury bonds for the three dates of February 29, March 31, and April 28, 2000 to estimate the risk-free rate. (AI Ex. 6.0 at 34.) For the equity risk premium, he calculated the difference between the historical arithmetic mean return on the overall stock market, as measured by the total return on the Standard & Poor's 500 Index, and the historical average yield return on long-term U. S. Treasury bonds, measured over the period of 1926 to 1999. (Id.) To estimate beta, Dr. Ibbotson averaged the three-year IBES and two-year Bloomberg beta estimates for each company in the peer group. Dr. Ibbotson opined that the last five years might not accurately represent AI's current risk given the rapid pace of change in the telecommunications industry and the dramatic events in recent years. Therefore, he thought that beta should be estimated over a shorter period. (AI Ex. 6.0 at 34-35.) Using the methodologies described above, Dr. Ibbotson estimated the risk-free rate, market risk premium and beta equaled 6.31%, 8.07% and 0.79, respectively.

Dr. Ibbotson's estimate of the weighted average cost of capital for AI ranges from 10.58% to 11.21%. He arrived at this estimate by applying AI's target market capital structure to his estimates of AI's cost of debt and his peer group cost of equity. (AI Ex. 6.0 at 40.)

Staff's Position

Staff witness Alan Pregozen also measured the investor-required rate of return on common equity for AI with the DCF and risk premium models. He performed the DCF analysis under constant-growth and two-stage non-constant growth scenarios. His risk premium analysis utilized the capital asset pricing model ("CAPM"). Since AI's stock is not market-traded, he applied those models to a sample of five telecommunications companies comparable to AI. (Staff Ex. 11.0 at 10-31.)

To form his telecommunications sample, Mr. Pregozen eliminated several of the companies in Dr. Ibbotson's peer group because of recent developments and lack of necessary data. This screening reduced the number of companies in the sample to four, i.e., Bell South Corporation, CenturyTel Inc., SBC Communications Inc., and Verizon Communications. To find additional companies comparable to AI, Mr. Pregozen examined the revenue mix of telecommunications industry companies and eliminated those with less than fifty percent of revenue derived from local telephone operations, including access revenues. He also eliminated those companies that lacked the data necessary to conduct the DCF and CAPM analyses. One additional telecommunications company, Hickory Tech Corporation, met those criteria. (Staff Ex. 11.0 at 11; Tr. 2241-2243.)

Under the constant growth DCF scenario, the firm's dividends (or earnings) are expected to grow at a constant rate. For his constant growth DCF scenario, Mr. Pregozen averaged the projected earnings growth rates provided by IBES and Zacks for each of the telecommunications companies in his sample. (Staff Ex. 11.0 at 13-14.)

He measured the current stock price of each company in his sample using closing market prices from September 6, 2000. Current stock prices are more appropriate than historical stock prices because the former reflect all information that is available and relevant to the market. (Staff Ex. 11.0 at 14-15.) The expected growth rate was applied to the last four dividends paid to estimate the next four expected quarterly dividends. (Staff Ex. 11.0 at 15.) Mr. Pregozen's DCF analysis under the constant growth scenario produced a 15.76% estimate of the required rate of return on common equity for the telecommunications sample. (Staff Ex. 11.0 at 16.)

Under the non-constant growth DCF scenario, dividends are expected to grow at different rates during different future periods. For the non-constant growth scenario, Mr. Pregozen used the same growth rate estimates employed in the constant growth scenario for the short-term growth stage over the first five years. The second, or long-term growth stage, was assumed to continue into perpetuity. Since company-specific growth rates are unavailable, Mr. Pregozen used long-term economic growth for the second stage growth rate, which he measured by computing the compound forecasted annual growth in nominal Gross Domestic Product for the period from 2000 through 2019. (Staff Ex. 11.0 at 15-17.) He used the same stock prices and dividends that were used in his constant growth scenario. (Staff Ex. 11.0 at 17.) The DCF cost of equity equaled 8.30% under the two-stage non-constant growth scenario. (Staff Ex. 11.0 at 18.)

Mr. Pregozen used forecasted growth in nominal GDP as his second stage growth rate because it incorporated inflation expectations into the projected values that he used to estimate growth over the long-term. In contrast, Dr. Ibbotson used historical growth in real GDP plus his inflation forecast as his second stage growth rate. Mr. Pregozen testified that Dr. Ibbotson's inflation estimate is much higher than the forecasts of WEFA and the *Survey of Professional Forecasters*. When combined with his GDP estimate it produces a nominal GDP forecast that is in excess of the yields on U.S. Treasury bonds of all maturities. This does not make sense, according to Mr. Pergozen, since Treasury bond yields should incorporate elements, GDP growth and inflation, plus a risk premium. (Staff Ex. 11.0 at 18.)

Mr. Pregozen's CAPM analysis utilized an adjusted beta of 0.85, estimated over a sixty-month period. (Staff Ex. 11.0 at 20-23.) He testified that a beta estimate using five years of monthly data is more appropriate than a shorter period. Mr. Pregozen stated that the rapid pace of technological change and the advent of competition in the telecommunications industry are not recent developments. The Commission altered the regulatory structure of Ameritech I Docket 92-0448 to allow the Company and the ratepayers to transition themselves to a more competitive telecommunications marketplace. Hence, use of five years of data to calculate beta is within the era of rapid structural and technological change in the telecommunications industry. In addition, a longer period incorporates more data points and is less susceptible to the wide variations as manifest in as comparison of the two-year and three-year beta estimates that Dr. Ibbotson employed. Moreover, use of monthly data mitigates the effect of non-simultaneous closing prices. (Staff Ex. 11.0 at 22-23.)

To estimate the risk-free rate, Mr. Pregozen used the yield on thirty-year U.S. Treasury bonds because the WEFA and *Survey of Professional Forecasters* estimates of inflation and real GDP expectations indicated that the thirty-year U.S. Treasury bond currently more closely approximates the long-term risk free rate. (Staff Ex. 11.0 at 27-28.) He estimated the expected rate of return on the market by conducting a DCF analysis on the firms composing the Standard & Poor's 500 Index. (Staff Ex. 11.0 at 28.) He then subtracted his estimate of the risk-free rate from this market return to determine the risk premium, multiplied the risk premium by his beta estimate, and added the result to his estimate of the risk-free rate. This resulted in a 14.62% estimate of the required rate of return on common equity for Mr. Pregozen's sample of telecommunications companies. (Staff Ex. 11.0 at 28.)

Based on his DCF and CAPM analyses, Mr. Pregozen concluded that the investor required rate of return for AI's common equity ranged from 11.80% to 14.40%, with a midpoint estimate of 13.10%. He formed this range by: 1) averaging the DCF-derived estimates of the required rate of return on common equity, or 12.03% and rounding to the nearest tenth of a percent, or 12.0%; 2) rounding the risk premium estimate of the required rate of return on common equity (14.62%) to the nearest tenth of a percent, or 14.6%; and 3) adjusting downward both ends of the range by 20 basis points to reflect the less risky position of AI relative to the telecommunications sample as a whole. (Staff Ex. 11.0 at 29-30; Staff RB at 79.) Mr. Pregozen testified that no adjustment for issuance costs should be made to the investor-required rate of return on common equity for AI. (Staff Ex. 11.0 at 30-31.)

In the end, Staff's recommended overall cost of capital for AI for revenue requirement purposes - in the event that the Commission orders rate re-initialization in this proceeding - ranges from 9.74% to 11.30%, with a midpoint estimate of 10.52%. The midpoint estimate reflects a cost of equity of 13.10%. (Staff Ex. 11.0 at 31.)

GCI's Position

GCI witness Smith utilized the low end of Staff's cost of equity range, 11.80%. He claimed that 11.80% appeared reasonable in comparison to the cost rate for common equity for intrastate telephone operations in other recent cases in which he participated as a witness. (GCI Ex. 6.2 at 54.) Mr. Smith did not conduct an independent analysis of the company's intrastate cost of equity for this proceeding. His recommendation for the overall cost of capital for AI for revenue requirement purposes is the low end of Staff's range, 9.74%. (GCI Ex. 6.0 at 16.)

4. Rate Design

The GCI/City's Position

Based on the analyses put forth by GCI/City witness Smith, the GCI/City's witness Dunkel proposed significant rate reductions for a variety of Ameritech's services. (GCI and City Ex. 8.0 at 11). In summary, the GCI/City's rate design proposal is as follows:

1. Reduce residential and business network access line (NAL) rates by $1.30 per line per month;
2. Reduce residential and business rates for local usage in Bands A and B;
3. Reduce residential installation and connection non-recurring charges;
4. Reduce residential and business vertical service rates; and,
5. Eliminate the charges for non-published and non-listed numbers.

AI's Position

It is Ameritech's position that rates should not be reinitialized in this proceeding and thus, it has not formulated a specific and comprehensive rate design proposal. AI states that it is withdrawing its rate rebalancing proposal in light of the changes brought on by the recent legislation and further maintains that rate reinitialization is not appropriate in this alternative regulation review proceeding. AI detailed its principal objections to GCI/City's rate design proposals in AI Reply Brief on Exceptions, Appendix B) some of which relate to the newly enacted changes to the Act.

Assuming arguendo that any rate reductions were to be required, Ameritech Illinois would recommend that reductions be taken in the residence Band B usage rate, residence pay per use calling services, carrier access charges, residential ISDN lines, residential vertical features and residential complimentary central office features, in that order. (Am. Ill. Ex. 9.1, p. 14). No service, however, should be priced below LRSIC AI contends and, wherever possible, services should provide reasonable contribution towards recovery of the indirect and overhead costs of the business. (AI Reply Brief on Exception, Appendix B at 19).

Staff's Position

Staff also does not recommend the reinitialization of rates. Should the Commission deem otherwise, Staff advocates that the GCI/City rate design proposal be rejected in its entirety. (Staff Reply Brief on Exceptions). According to Staff, the

GCI/City proposals cannot be reconciled with the recent amendments to the Act. (See, Staff Reply Br. On Exceptions at 22-24).

If the Commission were to reduce rates, the Staff recommends that usage rates for non-competitive services be reduced first, then the usage rates in non-competitive calling plans, and finally, non-competitive vertical and services. (Staff Ex. 28.0 at 15).

Commission Analysis and Conclusion

We are not yet prepared to render any decisions on the revenue requirement or any adjustments to the revenue requirement. So too, we do not address the various cost of equity positions set out on the record. Nor will we consider the rate design proposals.

All of the evidence reviewed thusfar presupposes that rate re-initialization or a return to rate of return is the appropriate course of action (and was presented at an early stage of this proceeding). We now turn to the larger core issues, the arguments and positions thereon, and the new legislation.

B. Positions On The Central Issue

1. The Initial Positions and Arguments

GCI/City Position:

The GCI/City point to the Company's earnings and generally assert that AI should be permitted to earn only its authorized return on equity established at the outset of the Plan. They would have the Commission perform a traditional analysis and reset rates according to an authorized level of earnings.

In their exceptions, the GCI/City point out that the Alt Reg Order directed rate changes in order to set just and reasonable rates as an appropriate starting point for the Plan. No matter how correct the various price cap formula factors being adopted here might be, they argue that the rates would likely never achieve just and reasonable status given the current excessive earnings level that the present rates produced. According to the GCI/City, the high earnings that AI reports in this proceeding are a "warning flag" that the Plan has failed to protect the interests of all interested parties. (GCI/City Exceptions at 101B). They maintain that an evaluation of earnings is the only principal means of determining whether rates are just and reasonable. Further, the GCI/City assert, the statutory just and reasonable rate requirement applies to rates for all services, not just competitive services as Sections 13-506.1, 13-504, and 13-505 of the Act would indicate.

According to the GCI/City, the specific adjustments to the Company's intrastate operating income and rate base recommended by their witnesses, Messrs. Smith and

Dunkel, should form the basis of the rate reinitialization. Even if the Commission were to accept AI's unadjusted operating income which puts its profit level at 24.5% on common equity in year 1999, the GCI/City maintain that that this reflects an earnings level in need of rate reinitialization. Such is more than double, the GCI/City observe, than the 11.30 % cost of common equity which was approved in the Alt Reg Order.

The GCI/City contend that no part of the Alt Reg Order or of Section 13-506.1 suggests that an alternative regulation plan approval includes an open-ended right to unlimited earnings at the level that, they maintain, AI has achieved. While rate reductions have occurred under the existing plan, this does not mean, the GCI/City contend, that rates are just and reasonable.

Staff's Position:

To the extent that rate re-initialization is defined as reducing rates to the level that would result from a traditional rate case, Staff recommends that there be no rate re-initialization. In other words, Staff opposes reinitialization based on, or due to, AI's earnings under the Plan because it does not consider those earnings and associated rates to be unfair, unjust or unreasonable.

According to Staff, the parties favoring reinitialization judge the reasonableness of AI's rates solely by the level of its earnings. In doing so, they fail to recognize on any deep level that alternative regulation provides non-competitive service subscribers with a "guarantee" that their overall rates will rise less than general inflation while AI is only given the "opportunity" to earn higher returns. If AI succeeds in earning higher returns, Staff notes that that is surely one of the possible outcomes that was to be expected. As such, it is not the basis for reinitialization.

In Staff's view, AI has earned well under the Plan primarily because it has been able to classify services as competitive when such effective competition did not actually exist. In doing so, it was able to raise prices for services out from under the cap. The remedy for this overreaching, Staff claims, is to move the services in question back into the non-competitive category.

Staff recommends that the Commission not reduce existing non-competitive rates in order to bring AI's earnings back to rate-of-return levels. Such action, Staff asserts, would lower the price of these services to below what would exist in competitive markets. The right thing to do, Staff maintains, is to reduce the prices of services that are returned to the non-competitive class back to what they were had they stayed under the Plan. (Staff Reply Brief at 27-28). According to Staff, the ~~HEPO~~ Proposed Order in Docket 98-0860, if adopted, sets out the appropriate end result. Staff expects that when that proceeding is ultimately completed, it will produce both a revenue reduction and a one-time refund to end users.

AI's Position:

AI argues that rates should not be re-initialized. Such an action, it claims, is contrary to the principles of price regulation and would undermine the incentive to operate efficiently and invest in more risky technologies. AI further contends that the proposal to reinitialize rates on the basis of AI's financial performance during the single best Plan year, i.e., 1999, at a high economic period, ignores the reality of the changing economic climate during which competition and technological advances will be accelerating. AI maintains that its earnings over the initial review period of the Plan were impacted by three main factors: 1) the superb economic environment; 2) the successful promotion of discretionary services; and 3) aggressive cost reductions. The Company also believes it unlikely that any of these conditions are sustainable for the future.

2. Arguments On The New Law

The GCI/City keep the position that the Commission must review AI's overall earnings using a traditional earnings analysis and reinitialize the Company's rates if its earnings exceed the level arrived at under such analysis. (The GCI/City Br.on Exceptions at 10-18). They further contend that PA 92-22 (also referred to as HB 2900) supports their view that competitive and noncompetitive operations should be combined in assessing whether AI's rates are fair, just, and reasonable. (The GCI's Initial Brief on the Impacts of HB2900 at 3-6).

In support, the GCI assert that the General Assembly did not remove the "just and reasonable" rates requirement from Section 13-506.1. Nor did it amend Section 13-505, the GCI maintain, which requires the carrier to prove its competitive rates are just and reasonable upon complaint. (Id. at 3) According to the GCI, however, the General Assembly did amend Section 13-101, to require that as regards to competitive rates and services and the regulation thereof, "all rules and regulations made by a telecommunications carrier affecting or pertaining to its charges or services to the public shall be just and reasonable..." 220 ILCS 5/13-101. In addition to the new directives in Section 13-518 and the amendments to Section 13-502, the GCI point out that Section 13-502 (b) specifies that until July 1,2005 "services provided to business end users with 4 or fewer access lines shall not exceed the rates the carrier charged for those services on May 1,2001." (Id.at 5).

The GCI generally note that the General Assembly removed business services and vertical services from the pricing limitations of the Plan but, they argue, the intent and directive that competitive service rates, rules and regulations be just and reasonable has been reiterated. Indeed, the GCI assert, given that the prices for services classified as "competitive" are outside the Plan, the only way the Commission can insure that those rates are just and reasonable, is by reviewing AI's overall investment, expense, income and rate of return as they recommend.

Citing to Cripes v. Leiter, 703 N.E.2d 100, 106-107 (1998), the GCI maintain that the General Assembly is presumed to know the construction that a statute has been given and, by re-enactment, is assumed to have intended for the new statute to have the same effect. (Id. at 3). In reliance on this principle, the GCI contend that the General Assembly is presumed to know that the court have interpreted the phrase "just and reasonable" to require that shareholders and ratepayer interests be fairly balanced so that shareholders and ratepayers receive a favorable return on their investment and ratepayers pay no more than necessary for service. Citizens Utility Board v. Illinois Commerce Commission, 658 N.E. 2d 1194 (1st Dist. 1995) (See also, GCI/City Brief on Exceptions at 13-14 wherein it sets out other decisions cited therein). In the GCI's view, all of this means that the legislature intended the Commission to review AI's overall earnings to insure they are fair to customers and do not provide a windfall to the utility.

AI Position

AI points out that all of the cases on which the GCI rely were decided in the context of rate of return regulation where the determination of 'just and reasonable' rates has a different basis than it does under Section 13-506.1. There is no case law, AI contends, construing the term "just and reasonable" rates in the context of an alternative regulation plan review proceeding under Sec 13-506.1 and certainly no case law to suggest that competitive services are part of such a proceeding. To be sure, AI maintains, Section 13-506.1 is clear on its face that alternative regulation only applies to noncompetitive services. 220 ILCS 5/13-506.1. (Reply Br. of AI on Impact of New Legislation at 11).

AI contends that the one and only existing judicial construction of Section 13-506.1, set out in Illinois Bell Telephone Company v. Illinois Commerce Commission, 669 N.E. 2d 919 (2nd Dist. 1996), stands for the proposition that earnings are not the measure of just and reasonable rates. As such, AI maintains, an earnings analysis in the context of a price regulation plan or review is inappropriate.

AI further asserts that the General Assembly directly addressed competitive service rate levels when it declared business service to be competitive as a matter of law and required a $90 million rate reduction under new Section 13-502.5 (d). Under this statute, AI maintains, the General Assembly clearly intended to allow the Company to preserve the revenue stream from its business customers subject only to a one-time $90 million credit. Any further reduction, AI assets, would be inconsistent with the determination reflected in Section 13-205.5. AI further informs that this statutorily prescribed credit will begin to appear on customer bills in September 2001. (Id. at 13).

Staff Position

Staff remains firm in its position that the Commission should not conduct an earnings review or reinitialization rates. (Staff Reply Br. on the Effects of HB 2900).