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Staff Ex. 3

93-516-TP CSS

93-487-TP ACT

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	:	
	:	
Petition to Regulate Rates and Charges of Noncompetitive Services Under An Alternative Form of Regulation.	:	92-0448
	:	
Citizens Utility Board -vs- Illinois Bell Telephone Company	:	
	:	
Complaint for an investigation and reduction of Illinois Bell Telephone Company's rates under Article IX of the Public Utilities Act.	:	93-0239 Consol.

HEARING EXAMINERS' PROPOSED ORDER

May 3, 1994

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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HEARING EXAMINERS' PROPOSED ORDER

By the Commission:

On December 1, 1992, Illinois Bell Telephone Company ("Illinois Bell" or "the Company" or "IBT") filed its Petition to regulate rates and charges of its noncompetitive services under an alternative form of regulation ("Petition"). The Company filed its Petition pursuant to Section 13-506.1 of the Illinois Public Utilities Act ("the Act").

The following parties intervened or entered appearances in this proceeding: the Illinois Independent Telephone Association ("IITA"); the Illinois Office of Public Counsel ("OPC"); the Independent Coin Payphone Association ("ICPA"); Central Telephone Company of Illinois ("Centel"); MCI Telecommunications Corporation ("MCI"); Citizens Utility Board ("CUB"); GTE North, Inc., and Contel of Illinois, Inc. d/b/a GTE Illinois ("GTE"); Illinois Consolidated Telephone Company ("ICTC"); the Illinois Cable Television Association ("CATV"); the Cook County State's Attorney, People of Cook County ("Cook" or "Cook County"); AT&T Communications of Illinois, Inc. ("AT&T"); the City of Chicago ("Chicago"); the Illinois Electronic Security Association ("IESA"); the Attorney General, People of the State of Illinois ("Attorney General" or "AG"); Teleport Communications Chicago, Inc. ("Teleport"); the Labor Coalition on Public Utilities ("LCPU"); LDDS Communications ("LDDS"); Northwest Central 9-1-1 System; Sprint Communications Company, L.P. ("US Sprint"); the American Association of Retired Persons ("AARP"); the Department of Defense and all other Federal Executive Agencies ("DOD/FEA"); the Illinois Telephone Association ("ITA"); and Lew Meyers. OPC subsequently withdrew as a party in this case. During the proceeding, Illinois Bell adopted the name of its parent corporation, Ameritech. To avoid confusion, this Order retains the use of the name Illinois Bell to refer to the Petitioner, and Ameritech, to refer to the parent corporation.

Hearings were held in this proceeding before duly authorized Hearing Examiners on January 14 and 27; March 1; April 8 and 30; May 17-21 and 24-28; June 1-4, 7, 8, and 14; August 2-6 and 9-13; October 14; November 8-10, 12, 15-19, and 24, 1993. On November 24, 1993, the record was marked "Heard and Taken."

On July 13, 1993, CUB filed an earnings complaint ("Complaint") based on precisely the same testimony which the Company and CUB already had filed in this proceeding. CUB also moved to consolidate the Complaint with this proceeding. The Hearing Examiners duly consolidated the cases, without objection, on August 11, 1993.

The record of this proceeding consists of the testimony of 25 witnesses for Illinois Bell; 22 for Staff; 3 for the AG; 3 for CUB; 1 jointly on behalf of CUB, Cook County, and AARP; 2 for MCI; 1 for Chicago; 1 for Sprint; 1 for LDDS; and 1 for DOD/FEA. The transcript of this proceeding is more than 7,000 pages long.

Public forums were conducted by the Commission for the purpose of receiving public comment on the Company's Petition on March 18, 1993, in Mount Vernon; March 23, 1993, in Decatur; April 7, 1993, in Chicago; April 15, 1993, in Granite City; and April 19, 1993, in Peoria.

Initial and reply briefs in this proceeding were filed by IBT, US Sprint, CUB/Cook, AT&T, Staff, LDDS/ICPA; the Chicago; the AG; MCI; CATV and DOD/FEA.

On May 3, 1994, a Hearing Examiners' Proposed Order was served on the parties.

I. INTRODUCTION

The telecommunications industry is changing at a very rapid pace. The extent of this change is such that it is impossible to predict what the industry will be like in five years. Technology has now made it possible for the general public and business to have immediate access to almost limitless amounts of information. This information can be anything from a motion picture to an encyclopedia to a foreign newspaper. The possibilities are breathtaking. Potential applications of this new technology for business, include real-time video conferencing, telecommuting and

Year	Annual PCI	Aggregate PCI	Cell 1 increase	Banked PCI	PCI + 5 Pricing	Offset Required
1	0	100	0	0	0	0
2	2	102	0	2	7	0
3	2	104	0	4	7	0
4	2	106	0	6	7	0
5	2	108	7	1	7	0

Year	Annual PCI	Aggregate PCI	Cell 1 increase	Banked PCI	PCI + 5 Pricing	Offset Required
1	0	100	0	0	0	0
2	2	102	0	2	7	0
3	3	105	0	5	8	0
4	3	108	0	8	8	0
5	4	112	9	(3)	9	0

Year	Annual PCI	Aggregate PCI	Cell 1 increase	Banked PCI	PCI + 5 Pricing	Offset Required
1	0	100	0	0	0	0
2	2	102	0	2	8	0
3	3	105	0	5	8	0
4	1	106	0	6	6	0
5	3	109	8	1	8	0

Staff Ex. 1

The Staff proposed the data requests that follow to API:

API-7	The rate of return earned on the sales to Ameritech Bell Operating Companies for 1987, 1988, 1989, 1990, 1991, 1992, and the first 9 months of 1993.
API-12	The total API revenue received in 1987, 1988, 1989, 1990, 1991, 1992, and the first 9 months of 1993 from any source related to the provision of any service based in whole or in part on the relationship with Ohio Bell including revenues derived from the provision of directories containing any information provided by Ohio Bell.
API-13	The costs incurred by API in generating the revenues identified in response to Data Request API-12.
API-14	The capital investments of API attributable to the revenues identified in response to Data Request API-12.
API-15	The net earnings retained by API from the revenues identified in response to Data Request API-12.

The answer given by API was, "Data does not exist in the requested form. Significant manual effort would be required to create it, and would be of questionable value since it would need to be developed on an allocation basis.

instant transfer of documents and files to anywhere in the world. The effect on education and the medical industry would also be enormous.

One may wonder whether things such as mail service or airline travel for business purposes will become obsolete. Only time will tell what an advanced telecommunications infrastructure may bring. What is clear, however, is that just how people today wonder about what life was like before the VCR or how business managed before the facsimile machine, people ten years from now will think back to a time when it was not possible to have so much information available so quickly.

While all of this technology may be available in the near future, a central question for the Commission in this docket is whether this technology can flourish in the current regulatory environment. The Commission faces a dilemma with respect to this technological revolution; the Commission must now decide who will pay for the implementation of new technologies <u>and</u> who will bear the risks that go along with the new technology?

In deciding who will pay for the implementation of new technology, the Commission must weigh the interests of the average telecommunications user who, for the time being, is, for the most part, content with plain old telephone service or "POTS." One of the ways that the Commission is forced to hold the line on the cost of POTS is through the regulation of IBT's depreciation rates which have the effect of regulating the pace of IBT's investment. When the Commission slows the depreciation of equipment, the Commission potentially slows the deployment of new technology. The disputes between the parties in the depreciation section of this order highlight this dilemma.

Any decision that the Commission makes in this docket can have significant consequences. Either the acceptance of the plan, or some modification thereof, or a total rejection of alternative regulation, involves many unknowns. Any decision that the Commission makes in this docket will carry with it some uncertainty. The Commission's goal in this proceeding is to weigh all of the risks and to proceed in a manner that balances all of the interests at stake, within the confines of the Act.

This proceeding involves all of the issues associated with alternative regulation as well as the issues typically associated with general rate cases under traditional rate of return ("ROR") regulation. That is because the Company submitted all of the conventional cost of capital, accounting and other evidence associated with general rate cases in order to demonstrate that its current rate levels are reasonable, and that such rates are an appropriate starting point for a price cap regulation plan.

CUB's rate reduction complaint also requires the Commission to evaluate whether IBT's current rates are just and reasonable. The Commission notes, however, that this is not a rate case under Article IX of the Act. The Commission's objective is to establish a plan of regulation that will be viable over the long term and produce benefits for ratepayers, IBT and the State of Illinois.

II. THE ACT

Section 13-506.1 was enacted as part of Public Act 87-856, effective May 14, 1992. It permits the Commission to "implement alternate forms of regulation in order to establish just and reasonable rates for noncompetitive communications services...." The Act lists a number of items that the Commission "shall consider," in addition to the public policy goals stated in Section 13-103. However, more importantly, the Act requires the Commission to make a number of findings before it may approve a plan as filed or as modified. The Commission must find that the plan or modified plan at a minimum:

> (1) is in the public interest;
>
> (2) will produce fair, just, and reasonable rates for telecommunications services;
>
> (3) responds to changes in technology and the structure of the telecommunications industry that are, in fact, occurring;
>
> (4) constitutes a more appropriate form of regulation based on the Commission's overall consideration of the policy goals set forth in Section 13-103 and this Section;
>
> (5) specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change;
>
> (6) will maintain the quality and availability of telecommunications services; and
>
> (7) will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers.

Section 13-506.1(c) requires "as a condition for Commission approval of the plan, that for the first 3 years the plan is in effect, basic residence service rates shall be no higher than those rates in effect 180 days before the filing of the plan." The Commission also is permitted to approve a "plan that results in rate reductions provided all the requirements of subsection (b) are satisfied by the plan."

Lastly, any plan approved for more than one year "shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented."

One fact that must be noted is that the Act does not require the Commission to adopt an alternative regulation. While the Act provides for the minimum standards that the plan must satisfy, the decision whether to adopt alternative means of regulation is for the Commission to make.

III. ALTERNATIVE REGULATION

A. Illinois Bell's Alternative Regulation Plan

Illinois Bell proposes to substitute pure price regulation for traditional ROR regulation. Under its proposal, the ability to change rates would be limited by a price index which reflects inflation in the general economy, offset by IBT's historical productivity growth. The Company's index contains a service quality component that it contends would ensure that service does not degrade over the term of the plan. Under the plan, the price index will be applied separately to four service "baskets" which represent the Company's major classes of customers (i.e., residential, business, carrier and "other"). Rate increases for each basket overall cannot exceed the index. Individual rates for services within each basket can be increased annually by a maximum of the index plus 5% to permit some modest level of rate restructuring; however, other rates within the same basket must then be reduced by an offsetting 5%. Thus, IBT states that applying the index separately to each basket ensures that the Company cannot shift its revenue requirements between major customer groups.

Under Illinois Bell's plan, there would be no regulation or monitoring of earnings whatsoever. IBT would set its own depreciation rates and attempt to manage its current capital recovery shortfall at existing rate levels and within the constraints of the price index. IBT states that if it is able to manage its business effectively and compete successfully in the marketplace, its shareholders would benefit. Conversely, it states that if the Company makes management mistakes or is otherwise unsuccessful in competing for customers' business, its shareholders would bear the brunt of IBT's shortcomings. The plan has no provision for IBT to seek rate relief in the event that its earnings deteriorate.

IBT notes that as required by Section 13.506.1(c), its plan includes a three-year rate cap on basic residential services, and future rate changes would be constrained by the index. The Company also states that it plans to eliminate the $.73 monthly charge for touch-tone service over a three-year period beginning January 1, 1995, without instituting any offsetting rate increases. IBT proposes that rates going into the plan would be set at existing levels, resulting in substantially lower rates than the Company would be entitled to under ROR regulation. Finally, IBT is making a $3 billion commitment to grow and modernize its network over the next five years, if pure price regulation and depreciation reform are approved; this ostensibly represents a $900 million increment over what the Company likely would invest under earnings sharing or any other form of earnings regulation.

As an alternative to the Company's plan; Staff, the AG and DOD/FEA all support the adoption of price regulation plans with an earnings sharing component. At a first benchmark over the target rate of return, earnings would be shared on a 50%/50% basis between the Company and customers. At a second benchmark, 100% of the Company's further earnings would be returned to customers. Each party has proposed different benchmarks where earnings sharing begins and where earnings would be capped. Staff, the AG and DOD/FEA also propose different values in many instances for the components of the price index itself.

MCI and LDDS/ICPA oppose adoption of any alternative form of regulation. However, in the event price regulation is approved, they recommend a "reverse taper" in the earnings sharing formula (to be explained later in this Order).

CUB/Cook oppose any change from ROR regulation. They request rate reductions from existing levels on the magnitude of $209 million. These recommendations are made in the context of CUB's earnings Complaint (Docket 93-0239). The AG and MCI essentially adopt CUB's rate reduction recommendations. The AG, however, supports use of the ROR recommendation of its own witness, rather than CUB's recommendation.

B. Price Regulation Versus Rate of Return Regulation

In determining whether to accept or reject Illinois Bell's proposed plan, the Commission first must decide whether changes in the telecommunications industry warrant a change in the form of regulation currently in effect in Illinois. While the Act contemplates different forms of alternative regulation, price regulation is the only form of alternative regulation discussed in the record. The main issue in this docket, therefore, is whether to accept or reject some form of price regulation.

1. Illinois Bell's Arguments Regarding The Need For Alternative Regulation

IBT describes the need for change through the testimony of two witnesses: Mr. David H. Gebhardt, Director - Regulatory Affairs for Illinois Bell; and Dr. Robert G. Harris, Associate Professor and Chair of the Business and Public Policy Group in the School of Business at the University of California, Berkeley.

Illinois Bell contends that traditional ROR regulation was designed for an environment where there is a single monopoly provider of service. IBT states that under ROR regulation, a regulated company can submit to regulatory control over its pricing with reasonable confidence that it will earn a modest, although presumably stable, level of earnings. IBT states that in making investment decisions, a regulated utility can presume that regulators will allow it to add investment and earn a reasonable return on that investment, thereby encouraging the deployment of technology in order to provide quality service to customers. IBT states that stable depreciation rates allow a company to recover its investments in a way which matches the controlled introduction of new technology.

The Company contends that because of the competitive entry which already has taken place, as well as increasing competition which looms on the horizon, this paradigm no longer applies. Mr. Gebhardt testified that competitive alternatives already exist for the Company's intraMSA calling services: facilities-based interexchange companies ("IXCs"); resellers; payphone and operator services; private line services and Centrex. Major customers also have established privately-owned alternatives to IBT's network, including Walgreens, General Motors, Chrysler, Kmart, the State of Illinois, Commonwealth Edison, Caterpillar and the Burlington Northern Railroad. These customers have purchased microwave systems or satellite systems that connect multiple locations and completely bypass IBT's network. Such entities also can sell their excess capacity to other users.

Mr. Gebhardt indicated, moreover, that new sources of competition are proliferating. Competitive access providers such as MFS and Teleport are firmly established and are expanding the range of services they provide to customers. He explained that these companies have expanded beyond the provision of point-to-point services for carriers and large customers, and now have obtained certificates to provide Centrex-like services and connections between multiple locations of the same customer for voice or data traffic. Proceedings for expanded interconnections at the Federal Communications Commission ("FCC") and at this Commission would allow service competitors to co-locate physically inside IBT's central offices and to offer end-to-end services even where they do not have facilities in place. He stated that the final step in this burgeoning expansion of competition was taken on November 10, 1993, when MFS filed for a certificate to provide facilities-based local exchange services and requested full integration with the networks of Illinois Bell and Centel (Docket 93-0409).

Mr. Gebhardt testified that yet another new source of competition is Personal Communications Services ("PCS"), which would provide wireless local exchange service. Mr. Gebhardt states that eleven experimental wireless licenses have been approved or are pending approval for the Chicago area, and MCI is among the well-financed entities pursuing a nationwide PCS license. He also stated that traditional cellular service also represents another increasingly viable alternative to IBT's services, as evidenced by AT&T's recent acquisition of McCaw Cellular Communications.

Mr. Gebhardt opined that perhaps the most potent competitive force of all is the cable television ("CATV") industry. Nationally, CATV companies pass 90% of residential households, and 55% of the households in Illinois are subscribers. Several of the larger CATV companies recently have allied themselves with telephone companies. MCI also has announced a new initiative to build local exchange facilities and compete directly for local exchange service.

Illinois Bell contends that these competitive developments undermine traditional ROR regulation in at least five ways. First, the Company maintains that the regulator no longer can guarantee that an LEC will be able to earn a reasonable return because marketplace dynamics will cause a significant erosion in its revenues as competitors enter the market and achieve gains in market share. Second, the Company asserts that noncompetitive ratepayers will shoulder the risks associated with competition because the regulator will be required to offset revenue losses with increases in noncompetitive rates. IBT states that without such increases, the regulator will not be able to meet its end of the regulatory bargain which allows IBT to earn a reasonable rate of return in exchange for relinquishing control over its own rates and earnings.

Third, the Company contends that competition and technological change undermine traditional capital recovery mechanisms. IBT states that as long as regulators continue to establish IBT's depreciation rates and defer capital recovery into the future, there is a commitment and legal obligation to allow the Company full recovery by the end of an investment's useful life. However, IBT contends that as competition intensifies and price erosion continues, there is no reasonable likelihood that the regulator will be able to guarantee that IBT can recover its capital in the future. IBT states that without reasonable assurances of capital recovery, there will be less incentive for IBT to modernize its network and, therefore, less chance that the State will realize the economic benefits which network modernization would bring.

Fourth, the Company contends that competition increases the complexity of regulatory oversight because issues such as prudent network investment, appropriate staffing levels and reasonable prices become vastly more complicated. The Company asserts that traditional regulatory oversight will create an untenable situation for IBT because the regulator will capture for ratepayers the benefits of Illinois Bell's successful ventures, but will face pressure to disallow investments in unsuccessful ventures. The expense and delay engendered by increasingly complex regulatory requirements will be particularly inappropriate in an environment of accelerating competition, as it imposes a cost burden on the LEC that is not shouldered by its competitors.

Illinois Bell contends that a properly structured price regulation plan would eliminate many of the shortcomings of traditional ROR regulation. IBT states that the capital recovery quandary facing this Commission can be resolved through price regulation. According to the Company, regulators traditionally have set depreciation rates so as to strike a pragmatic balance between allowing regulated companies to recover their capital and maintaining low customer rates. This balancing tension has tended to result in inadequate capital recovery in the short run, with the regulatory promise of full recovery reaching fulfillment only at the end of the investment's useful life, even if price increases are required. IBT argues that this paradigm is reflected in its accumulated depreciation reserve deficiency of approximately $559 million.

The Company contends that, as the telecommunications industry becomes more competitive, the Commission simply will not be able to meet its commitment to full capital recovery because prices will be set by the marketplace rather than by the Commission. Another alternative for addressing the depreciation reserve deficiency is to require Ameritech's shareholders to incur the loss through a write-down of assets. However, IBT contends that this alternative would be patently unreasonable as it would be unlawful to require the Company to write off investments in plant and equipment which have been made in good faith to meet franchise obligations. In fact, IBT contends that this would violate longstanding legal prohibitions against confiscation of utility property as set forth in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1943); Bluefield Water Works and Improvement Co. v. Public Service Commission, 262 U.S. 679 (1922); and Illinois Bell Telephone Co. v. Illinois Commerce Commission, 414 Ill. 275 (1953).

In the Company's view, the only viable solution to this dilemma is to permit Illinois Bell to use its own business judgment about investments, to set its own depreciation rates, and to live with the consequences. IBT takes the position that price regulation allows the Commission to do so at no risk to captive ratepayers, because depreciation rates no longer would affect noncompetitive customer rates.

The Company contends, moreover, that a realistic opportunity to recover its capital would provide additional impetus for network modernization. Mr. Gebhardt and Dr. Harris also testified, on behalf of IBT, that price regulation would provide greater incentives to operate efficiently, to introduce new services, and to be more responsive to its customers. Specifically, they stated that, although the Company has no guarantee of earning a reasonable return under price regulation, the risk of lower earnings would be balanced by the potential to achieve increased earnings as a reward for becoming more efficient and for investing wisely in network modernization. They also stated that at the same time, customers under a price regulation plan would be protected from the risks of competition because price increases would be limited by a predetermined formula based on cost changes for the economy as a whole, rather than on IBT's internal costs.

The Company also contends that the streamlined tariff procedures under a price regulation plan would reduce the delays, burdens, and expenses of regulation for all parties. Finally, the Company asserts that a properly structured price regulation plan would avoid the implicit earnings regulation of competitive services inherent in ROR regulation. All of these objectives can be achieved, the Company argues, while at the same time maintaining just and reasonable rates based on the price index mechanism.

2. Staff

The Commission Staff's position was presented by Ms. Charlotte TerKeurst, Director of the Telecommunications Program in the Office of Policy and Planning. She agreed with Illinois Bell that the rate of technological change over the past few years has been breathtaking, and that the rate of change and introduction of new telecommunications products and services appear to be accelerating. In general terms, Staff also agrees with the Company's criticisms of traditional ROR regulation in the climate current and expected market conditions. Staff agrees that the difficulties inherent in determining the various components that go into the revenue requirement are exacerbated by competition. Staff believes that ROR regulation tends to make an LEC more cautious in its investment in risky ventures and, at the same time, ~~less likely to cut costs for the more traditional services~~. However, Staff cautions that these disincentives should not be exaggerated, given the Company's posture that it is a well-run and efficient organization which has made significant modernization and streamlining efforts in recent years. Staff also believes that there are strong incentives for the Company to cut costs and become more efficient under traditional regulation, because of "regulatory lag" which is the opportunity to increase earnings in the period between rate cases.

Staff agrees with IBT that the Company should be regulated under a price regulation plan. Staff believes that, by breaking the link between prices and costs, price regulation protects basic customers from competitive risks, i.e., the risk that rates might need to be increased to maintain revenue requirements if demand for IBT's competitive services were to decrease in an increasingly competitive market. Staff also agrees that price regulation ~~protects customers from the risk of failed investments, because prices are not directly impacted by the level of capital investment.~~ Staff further contends that price regulation can prevent the Company from degrading service quality for those services with limited competitive alternatives, if an appropriate service quality provision is adopted. In addition, Staff contends that compared to ROR regulation, price regulation would reduce regulatory costs somewhat because the application of a price regulation system should be fairly straightforward and should require fewer resources. Overall, Staff believes that price regulation would provide additional incentives to invest in advanced technologies and that some amount of additional economic development is likely to occur as a result. ~~Staff notes that this investment may not take place evenly throughout the State,~~ but asserts that, if necessary, this issue can be addressed separately in another proceeding.

Staff believes that all of these desirable goals can be attained while maintaining Illinois Bell's financial integrity. They can be attained, in part, by allowing higher "rewards" than under traditional regulation, thus compensating IBT for any increased risk and encouraging innovation. Removal of the likelihood of prudence reviews and "second guessing" of investment decisions, argues Staff, also should encourage the Company to be more innovative and to take more risks. Staff contends that price regulation would put Illinois Bell on a more even footing with other potential competitors, because the Company would be able to respond more quickly to competitive conditions as they develop, without incurring protracted regulatory proceedings. Staff notes that all of these benefits may not be achieved in a real world environment because IBT may have some incentive to keep earnings levels within some range perceived as "reasonable" in order to avoid regulatory backlash; and, as a result, could choose to increase expenses or investments for that reason rather than for reasons of efficiency.

3. Attorney General

Dr. Lee L. Selwyn, an economist and President of Economics and Technology, Inc., examined Illinois Bell's proposal on behalf of the Attorney General. A passage from Dr. Selwyn's direct testimony best summarizes the AG's position:

> Although the public interest has been well served by traditional rate of return regulation of local telephone companies for many years, recent developments in the technological and competitive complexion of the telecommunications industry warrant reexamination of existing regulatory practices. Rate of return regulation has fostered the development of a ubiquitous public telephone network, universally accessible and affordable, to a broad spectrum of citizens and businesses throughout the state and the nation. By shifting most investment risk to ratepayers, ROR regulation has enabled the regulated local exchange carriers (LECs) to acquire and to construct an extensive and modern public network infrastructure that is not likely to be duplicated by any other entity within the foreseeable future. At the same time, the entry and growth of competition in certain segments of the telecommunications market fundamentally alters the traditional role and goals of economic regulation, implying reduced concern with pricing and availability of truly competitive services, but increased attention to pricing, availability, and interoperability of so called "bottleneck" functions that only the dominant local exchange telephone company can feasibly provide.

AG Ex. 1.0 at 3.

Dr. Selwyn testified that traditional ROR regulation actually may create disincentives for efficient behavior. He stated that incentive regulation plans can induce a utility's management to exhibit competitive behavior; to pursue efficiency opportunities;

to maximize the use of its capital resources; and, in general, to accept certain risks normally associated with the competitive marketplace in return for the opportunity to increase earnings in excess of levels traditionally associated with ROR regulation. However, Dr. Selwyn cautioned that a price regulation system must minimize the possibility that a company will be rewarded for actions that expressly disadvantage captive ratepayers or for events that are beyond its management's control. He stated several concerns that must be taken into consideration in developing an adequate incentive plan. These are as follows:

1. The establishment of an incentive plan will not convert a fundamentally monopolistic market into a fully competitive one. IBT's $8 billion gross investment in the local distribution, switching, and transport structure gives IBT a de facto monopoly. Accordingly, Dr. Selwyn states that a regulatory mechanism must continue to constrain in terms of pricing practices.

2. In a competitive market, incentives and opportunities to adopt new technologies are available to all incumbents in the industry. In stimulating a competitive result, it is essential that the company subject to incentive regulation not be afforded the opportunity or ability to achieve a permanent earnings gain as new technology and operations are developed.

3. Even if a telecommunications carrier subject to incentive regulation made no effort whatsoever to improve its overall efficiency, the aggregate growth in demand for services unrelated to management's actions combined with extreme economies of scale will result in a decline in average unit costs of service.

4. Under the profit-generating incentive of a plan, the carrier may attempt to increase its earnings by compromising the overall quality of its services.

Id. at 11-13.

Dr. Selwyn took the position that the entry and growth of competition in certain segments of the telecommunications market fundamentally alter the traditional role and goals of economic regulation and warrant re-examination of existing regulatory practices.

He further states the following:

> These factors, individually and cumulatively point to an expectation of increased earnings over time either because the utility can exploit its monopoly by imposing excessive prices or by retaining for itself all of the "normal" cost reductions that can be expected to arise through generally improving productivity and growth. The purpose of incentive regulation is clearly not to reward the utility for such exploitation of its monopoly through price gouging or for allowing the quality of its service to decline. Thus, even though the direct linkage between rates and costs is largely eliminated under incentive regulation, the overall system must be carefully tuned so as to reward (or to punish) the utility's management and shareholders only to the extent that the result of their actions would not otherwise be expected to occur in a truly competitive marketplace.

Id. at 14.

He contends that the goal of the Commission should be to adopt a plan that includes certain features that are intended to preserve the competitive result goal of economic regulation while still "de-linking prices and costs per se."

4. CUB/Cook

CUB/Cook oppose the adoption of an alternative form of regulation. Dr. Marvin Kahn, an economist and principal in Exeter Associates, Inc., examined Illinois Bell's proposal on behalf of CUB/Cook and AARP.

First, Dr. Kahn states that ROR regulation currently contains an adequate number of incentives. He states that companies must behave efficiently in order to earn the authorized rate of return; such a return is not guaranteed. Moreover, since rates are not changed between rate cases, he argues that "regulatory lag" allows a company to increase its earnings if it can increase its efficiency. He contends that the Commission cannot assume that Illinois Bell's plan would provide more incentives automatically than currently exist. For example, Dr. Kahn states that the pricing flexibility of its plan can be used by IBT to retard the entry into the market of more efficient competitors.

Second, he further contends that the IBT plan short-changes ratepayers because current rates include the cost of deploying such cost-saving equipment as digital switches, fiber optic facilities, SS7 and ISDN capabilities. According to Dr. Kahn, the cost of these facilities is included in rates with the expectation that the benefits expected in the future from these investments, including increased usage, would be passed on to ratepayers in the form of lower rates. He complains that under IBT's plan, these benefits instead would accrue to shareholders.

In addition, he asserts that these facilities already allow IBT to offer new products such as call-waiting, speed dialing, three-way calling, Auto Callback and Repeat Dial. He contends that the number of residential and business customers subscribing to such services is increasing rapidly. Dr. Kahn contends that, under IBT's plan, the future revenue growth attributable to such services would accrue to the shareholders instead of the ratepayers who have paid for the facilities.

He further testified that price regulation does not necessarily result in additional network modernization and that it eliminates or limits the extent of social input into the investment decision-making process and causes such decisions to be based strictly on profit considerations and without any regard for the maximization of social welfare.

He also disputes IBT's contention that the plan will increase the pace of technology deployment in the network. He maintains that Illinois Bell witness Dr. Cronin did not offer a link between price cap regulation and investment in telecommunications. Dr. Kahn criticized Dr. Cronin's analysis because it assumed that whatever infrastructure deployment is undertaken will be cost-effective.

He contends that his own quantitative analysis attempts to determine whether alternative regulation leads to additional network deployment. He examined technologies deployed in the network in 1990 and 1991 by Bell/Ameritech, other Ameritech companies, and Bell companies in other regions. He testified that his analysis indicated that the extent to which telecommunications technologies have been deployed in Illinois is, in every instance, on a par with or ahead of that in most other regions. He notes that this rate of technological diffusion is occurring without alternative regulation in place.

Moreover, he stressed that strategic decisions regarding technology selection are made at the regional corporate level. He testified that his analysis showed that the kind of regulatory structure in place was not significantly related to the deployment of technology. He states that while IBT witness Harris criticized his study, Dr. Harris did not conduct his own study to support the Company's position that incentive regulation would lead to greater infrastructure development.

Dr. Kahn also criticized IBT's plan to commit to spending $3 billion on network modernization over five years. First, he contends that the investments that IBT plans to makes are those that would allow it to provide broadband services including CATV services and that these investments would allow the Company to enter the interMSA market if Ameritech is successful in getting relief from the restriction placed on it at divestiture which currently precludes it from providing such services.

He asserts that the Commission does not have jurisdiction over the provision of CATV services, and that, to the extent that IBT's $3 billion expenditure will be spent to provide CATV services, the expenditure cannot form the basis for granting IBT's petition. In addition, he states that this Commission should not make a decision that it is in the public interest for IBT to enter the business of providing interMSA service.

CUB/Cook further contends that such an expenditure can only be made pursuant to a Certificate of Public Convenience and Necessity ("Certificate") granted under Section 8-406 of the Act. CUB/Cook states that the record in this docket does not contain enough evidence to meet the requirements of Section 8-406. In addition, CUB/Cook argues that the Commission should not approve a plan that neither contains an adequate description of where the funds will be deployed nor provides for the cost-effectiveness of such expenditures.

He also maintains that Mr. Gebhardt's testimony that the $3 billion investment would be funded from depreciation, retained earnings and cash flow is evidence that it is IBT's intention to fund its forays into broadband services with ratepayer funds rather than shareholder funds. Accordingly, Dr. Kahn insists that the Company's protestations that its plan will shift the risk of these investments onto itself and away from ratepayers must be disregarded.

Finally, he argues that the $3 billion commitment is nothing more than "business as usual" (BAU") for IBT. He states that, according to IBT Form M reports filed with the FCC, IBT had net capital expenditures ranging from $545 million to $583 million per year during the 1989-1992 time period. He refers to the BAU revenue projections of IBT witness Goens for the five-year period of 1994 through 1998. These projections indicate capital expenditures of almost $2.7 billion over that time period.

5. <u>DOD/FEA</u>

DOD/FEA contend that a competitive environment is developing rapidly for many of Illinois Bell's services and that a change in the form of regulation is appropriate. DOD/FEA assert that the development of competition in Illinois has been uneven geographically, but that the most rapid development has been in urbanized areas such as Chicago. Even in the Chicago area, however, DOD/FEA state, there has been limited experience with the interconnection of dedicated services, and even less with switched services.

DOD/FEA contend that price regulation of IBT's services is preferable to traditional ROR regulation at the present time. They assert that properly designed price regulation would improve the incentives for IBT to operate more efficiently, to innovate, to investment in new technologies, and to provide the Company with the additional pricing flexibility needed in the changing telecommunications markets. DOD/FEA also contend that price regulation would reduce the regulatory burden on the Commission and other parties. They opine that these benefits can be achieved while providing reasonable rates to customers and maintaining IBT's financial integrity.

6. <u>LDDS/ICPA</u>

LDDS/ICPA assert that current competitive conditions do not warrant any departure from ROR regulation. In their view, switched intraMSA traffic is not competitive because Illinois Bell has 99% of the traffic, while all other carriers combined have less than 1%. LDDS/ICPA assert that competition has not yet occurred in the local exchange marketplace, and that no customers have abandoned the IBT monopoly network. They contend that cellular service is substantially more expensive than IBT's local service; in any event, it is 50% controlled by Ameritech, and it depends on interconnection with IBT to originate and terminate calls. LDDS/ICPA also assert that potential competition from CATV, PCS and CAPS should not be considered because the Act requires that the plan be based upon changes which are "in fact" occurring. LDDS/ICPA are opposed to any change in regulation where significant changes and circumstances have not been proven, and LDDS/ICPA insist that, while competition is emerging, there is no real competition for IBT's services.

7. <u>MCI</u>

MCI contends that Illinois Bell faces much less competition than it claimed in its testimony. While some of the competition identified by IBT does exist, MCI asserts that not all of it has the kind of impact that competition usually has: namely, forcing Illinois Bell to try to find ways to lower its rates. In particular, MCI noted that cellular services cannot put a cap on IBT's local exchange rates as long as cellular rates are higher than local exchange and measured service rates combined. MCI also contends that not all of the new services identified by the Company currently exist. Third, MCI contends that, with only a few exceptions, the competitive alternatives identified by the Company rely on interconnection with IBT's local exchange facilities and, thereby, prevent other companies from becoming truly independent competitors.

8. <u>AT&T</u>

AT&T, in general, supports alternative regulation plans for LECs as long as there is sufficient price regulation over services for which competition is not sufficient to protect against the opportunity for anti-competitive conduct and uneconomic pricing.

9. <u>ICTA</u>

ICTA's primary concern in this proceeding is the effect that a premature shift in form of regulation will have on not only on consumers, but also other businesses such as members of the ICTA. The ICTA suggests that the Commission develop alternative regulation through a rulemaking rather than a utility specific docket. ICTA believes that the market conditions have not developed to a point that warrants a change in the form of regulation and that Illinois Bell's proposal fails to satisfy Section 13-505.1.

10. <u>Illinois Bell's Response</u>

With respect to the arguments of CUB/Cook, the Company takes the position that Dr. Kahn rejects all of the efforts by regulators in this country to improve the system of regulation. IBT further argues that he has not addressed the impact of competitive entry and technological change meaningfully and the difficulties those changes bring to the tasks faced by regulators. IBT argues that he ignores the capital recovery quandary faced by this Commission and the implications of that quandary for network modernization.

Dr. Harris testified that Dr. Kahn's position on efficiency incentives was based on "out-of-date" economics. Although Dr. Harris conceded that some incentives do result from regulatory lag, he also testified that these incentives are not as significant as Dr. Kahn claims and that they will disappear as regulators become increasingly unable to keep their half of the regulatory bargain.

As to arguments regarding competition, the Company takes the position that the parties have not characterized accurately the changes taking place in the industry. IBT also contends that the current level of competition is not the only issue, but that the current and future direction of the marketplace are equally important. Dr. Harris testified that the arguments for price regulation do not assume full competition; in that instance, no regulation would be the best policy. Rather, Dr. Harris explained that alternative regulation is the best policy during a transition from partial competition to full competition. He also testified that Illinois Bell's market share of intraMSA calling does not demonstrate market dominance, because its rates are much lower than the other IXCs in the market.

The Company emphasizes that the change to alternative regulation should be made before all of its services are fully competitive. Dr. Harris testified that there are considerable risks in delaying regulatory reform, citing the experience of the railroad industry which was driven into the ground by continued application of traditional regulatory policies even after the emergence of stiffening competition. The Company urges that it needs time to manage its way through the legacy of past regulatory practices and that this Commission should begin the process of transitioning to a nonregulated marketplace as quickly and completely as possible, consistent with protecting noncompetitive ratepayers' legitimate interest in preserving reasonable rates and adequate service.

11. COMMISSION CONCLUSION

Under the current form of regulation, the Commission will find it increasingly difficult to effectively balance the interests of ratepayers, IBT and the overall welfare of the people of the State. The ratepayer demands low telephone rates -- even at the expense of having less sophisticated communications capabilities. CUB/Cook's position in this case clearly illustrates this point. Illinois Bell seeks the ability to set its own depreciation rates and properly prepare itself for a competitive local exchange market. The welfare of the people of the State of Illinois requires that this Commission regulate IBT without hindering technological progress.

A properly designed alternative regulation plan is a more prudent way to regulate IBT at the present time. An alternative method of regulation is the only way for the Commission to protect the interest of the ratepayer and, at the same time, allow Illinois Bell to prepare itself for a competitive telecommunications market. Alternative regulation can guarantee lower telephone rates for the consumer and insulate them against the risks that IBT will face in a competitive market. Alternative regulation also ensures that the State of Illinois will remain at the forefront of telecommunications technology.

The Commission agrees with the testimony of those witnesses who assert that the intraMSA marketplace is likely to become increasingly competitive. The Commission would be very reluctant to adopt any alternative form of regulation at this point in time if it did not believe this to be the case. An alternative regulation plan is intended to be transitional in nature. Without a transition to a competitive market, such a plan would continue indefinitely. To have a mechanistic formula determine rates over a longer term could be problematic.

The Commission rejects the arguments of LDDS/ICPA and MCI that there should be no change in regulatory structures until full competition has developed in the intraMSA marketplace. One of the purposes of adopting alternative regulation is to allow Illinois Bell to adjust to a competitive market before such a market fully develops. The Commission is of the opinion that such a transitional period is necessary for the Company to remain viable in the long run. It would be detrimental to the interests of IBT's ratepayers and the people of this State if the Commission were to neglect this situation and allow IBT to become uncompetitive. An uncompetitive IBT would most likely lose its prime customers, leaving captive customers responsible for a greater share of costs. The Commission is of the opinion that accepting CUB/Cook's position in this docket, namely rejecting alternative regulation and making unwarranted rate cuts, would weaken IBT to such an extent that it would not be able to respond to competition and, with time, it would be before this Commission requesting relief.

The Commission is of the opinion, however, that the adoption of alternative regulation alone does not necessarily enhance competition. The Commission is committed to facilitating the development of a fully competitive local market. This Order is one of many steps that the Commission intends to take to modify the regulatory environment in order to achieve this goal.

The Commission also rejects the arguments of the critics of alternative regulation to the extent that these critics counsel rejection of any form of alternative regulation. In some cases, however, these critics raise valid concerns that we must evaluate in formulating a plan and in some cases make adjustments to the plan in light of the concerns. The Commission is of the opinion that these concerns do not warrant outright rejection of price regulation.

For example, the Commission disagrees with Dr. Kahn that ROR regulation contains adequate incentives to operate efficiently. The Commission believes that ROR regulation offers some incentives to operate efficiently: (1) the concept of regulatory lag that Dr. Kahn discussed; (2) the Commission adjustment of expenses that occurs during rate cases; and (3) the management audit process.

The question for this Commission is whether these incentives are adequate for a utility that is operating in an increasingly competitive industry. *The answer is no. ROR regulation, while* having performed reasonably well until now, is flawed because it does not offer enough incentives, and, in fact, contains some serious disincentives. A regulated utility, even one that is subject to prudent regulation, is not under the same pressure as a competitive firm to keep its costs to an absolute minimum.

The Commission rejects Dr. Kahn's contention that price regulation does not necessarily result in additional network modernization. The Commission is of the opinion that Illinois Bell will be under increased pressure to keep its network modern as competition increases. Alternative regulation will allow Illinois Bell to respond much more quickly to the market through increased investment than it could under ROR regulation.

The Commission also disagrees with Dr. Kahn's contention that future investment decisions will not be made with the intent of maximizing social welfare. While it is true that future investment decisions will be profit-motivated, the Commission is of the opinion that current investment decisions also are profit-motivated. In fact, the Commission believes that it cannot direct Illinois Bell to alter its investment decisions based on what the Commission feels would maximize social welfare. Does CUB/Cook contend that the Commission should tell IBT that, for example, a call waiting service is more important than a call forwarding service or vice versa? It is not for the Commission to decide whether one service should be implemented before another. CUB/Cook's argument is unrealistic and it goes to the heart of why the public will be better off in an unregulated competitive telecommunications market.

The Commission concludes that a change in the form of regulation applicable to Illinois Bell is appropriate. The Commission finds persuasive the testimony of the witnesses appearing for the Company, Staff, the AG and DOD/FEA that pervasive changes are taking place in the telecommunications industry that warrant a decisive change. Indeed, these changes appear to be taking place faster in Illinois than in many other parts of the country. The Commission believes that competition is likely to increase considerably in the future and that its regulatory policies should be directed towards a successful transition to a more competitive environment.

We are of the opinion that it would be unwise to continue to regulate Illinois Bell under the current ROR system. We believe that to ignore the changes that already have occurred and to continue down the same course would harm both ratepayers and the Company. The Commission believes that a well-designed alternative regulation plan can guarantee ratepayers lower future telephone bills, something that absolutely cannot be guaranteed under the current system. Such a plan at the same time can prepare Illinois Bell for a competitive telecommunications market. This, incidently, will benefit ratepayers because a truly competitive market will lead to lower rates, better service and a greater variety of available products.

C. Price Regulation Plan - Plan Components

Under price regulation, a regulated company's ability to change prices is controlled by an index rather than through general rate proceedings. Usually, the index has at least two principal components: (1) a measure of inflation for the economy as a whole (which can be referred to as I); and (2) some offset to inflation which measures productivity and/or other economic and policy considerations (which can be referred to as X). The typical price cap approach can be described as permitting a change in rates according to the formula: I minus X.

Some jurisdictions include a service quality measure intended to ensure that service quality does not deteriorate under price regulation. Some jurisdictions include an "exogenous factor" to reflect cost changes that are outside the control of the regulated company (e.g., changes in regulatory accounting, changes in the tax laws and so forth). The resulting index then is applied to the company's services which are grouped into categories or "baskets". Greater pricing flexibility generally is allowed within a category than between categories.

1. Price Index Formulas

One of the most significant issues in this proceeding has been the configuration of a price cap formula. Although the overall structures of the formulas proposed by Illinois Bell, Staff, the AG and DOD/FEA are similar, the individual values for the index components differ considerably.

2. Illinois Bell's Proposal

Relying on the testimony of Dr. Laurits Christensen, the Company contends that the Gross Domestic Producer Price Intex ("GDPPI") should be used as the measure of inflation and the X factor should be a productivity offset which would reflect the degree to which the company's historical productivity growth has outstripped productivity growth in the economy as a whole. The Company maintains that this differential is relevant because productivity growth in the economy as a whole already is reflected in the measure of inflation. The Company points out that this is the way the FCC constructed its price cap plans.

Dr. Christensen conducted a study of the company's historical Total Factor Productivity ("TFP") growth, which is the ratio of the firm's Total Output to Total Input. Total Output is the combination of all goods and services produced by a firm, measured in real terms. Total Input is the combination of all inputs used by a firm in producing the goods and services it sells, also measured in real terms.

He calculated the growth of Total Output for Illinois Bell from 1984 to 1991 as 27.8%, or an average rate of growth of 4.0% annually. He calculated Illinois Bell's growth of Total Input over the same period as 12.5%, or an average annual rate of growth of 1.8%. These figures imply an average annual TFP growth of 2.2% (4.0% minus 1.8%).

According to Dr. Christensen, an economy-wide output price inflation index, such as the Gross National Producer Price Index ("GNPPI") or GDPPI, already reflects TFP growth in the U.S. economy, i.e., the growth in the GDPPI is less than growth in economy-wide input prices by the amount of economy-wide TFP growth. Therefore, if the GDPPI is to be used to represent input price increases for Illinois Bell, then the productivity offset in a price cap formula should be Illinois Bell's TFP growth less the TFP growth for the U.S. economy. During the post-divestiture period Illinois Bell achieved TFP growth of 2.2% a year while the U.S. economy achieved TFP growth of 0.9%. The differential is 1.3%, which in Dr. Christensen's opinion would provide the basis for a 1.3% offset to the GDPPI in a price cap formula. He testified that this level of TFP growth was consistent with the results of other studies for the telecommunications industry. Illinois Bell asserts that its TFP study is undisputed in this proceeding.

The Company adopted Dr. Christensen's recommended 1.3% total offset in its price cap formula, but proposed dividing the factor in half in order to reflect recovery of it perceived depreciation reserve deficiency. This issue will be discussed in more detail below.

3. Illinois Bell's Depreciation Reserve Deficiency Adjustment

The Company proposes cutting its 1.3% productivity factor in half during the first five years of the plan. The Company explains that the purpose of this proposal is to achieve some type of "sharing" by ratepayers of what the Company claims is a $559 million depreciation reserve deficiency for which current ratepayers are legally and equitably responsible. Illinois Bell argues that by halving the productivity factor, ratepayers would pay approximately $50 million more over the first five years of the plan than they otherwise would have paid; yet this represents only about 10% of the total reserve deficiency. The Company states that, if this adjustment is not made, customers will not be obligated to pay anything toward remedying this deficiency and that this would be an unreasonable result. The Company argues that its depreciation reserve deficiency is a shortfall which represents a legal obligation on the part of Illinois ratepayers for capital already consumed and that adoption of alternative regulation does not, in and of itself, erase that debt.

The AG opposes the Company's proposal to cut the productivity factor in half. In its view, ratepayers who subscribe to Illinois Bell's noncompetitive services funded the investments which made past productivity gains possible in the first place, and should, therefore, receive the full benefit of expected productivity gains in the future. AG witness Dr. Selwyn testified that IBT's effort to recoup an investment recovery shortfall would be unsuccessful in a competitive market, where it would be written off at shareholders' expense. Dr. Selwyn took the position that Illinois Bell's proposal is "cherry picking" between ROR regulation and incentive regulation. In Dr. Selwyn's view, incentive regulation would not afford the Company the protection against errors in future capital recovery decisions, yet the Company proposes to divert potential ratepayer benefits that may arise under the new regulatory system in order to "make it whole" for previous management actions taken with virtual impunity in terms of exposure to business risk.

In summary, Illinois Bell's initial proposal for the price cap formula was the GDPPI minus 1.3%, prior to considering its proposed depreciation reserve deficiency adjustment. If the depreciation reserve deficiency adjustment is included, it becomes the GDPPI minus 0.7%.

4. Attorney General

The AG sponsored the testimony of Dr. David Roddy, who criticized Dr. Christensen's use of economy-wide TFP because it involved only theoretical assumptions concerning input price inflation. Dr. Roddy testified that he utilized the same data relied upon in Dr. Christensen's study and calculated that the annual historical Illinois Bell price inflation rate is approximately 2.1% for the 1984 through 1991 time period. Since the GDPPI grew at an average annual rate of 3.7% for this same time period, the prices of inputs that IBT purchases grew at a rate 1.6 percentage points less than did the GDPPI. Dr. Roddy recommends that, at a minimum, the GDPPI factor used in the price cap formula should first be reduced by 1.6 to reflect this more accurate input price information.

AG witness Dr. Selwyn also disagreed with Dr. Christensen's approach. He testified that the basic objective of a price cap formula is to establish a rate adjustment mechanism that severs or at least weakens the linkage between costs and revenues that exists under the "cost plus" philosophy of ROR regulation, while still reflecting "normal" cost and productivity changes that the utility is expected to experience. He said that under the price cap model, these cost changes are driven by variations in the prices of inputs used by the local exchange carrier ("LEC") in the production of its services, offset by the productivity change which results from changes in the manner in which it combines those inputs to produce its products and services. Dr. Selwyn stated that ideally the price cap formula should be structured to reflect the change in LEC input prices less an LEC productivity target, plus or minus a service quality adjustment.

According to Dr. Selwyn, the formula should not rely upon cost or productivity changes specific to the utility within the time frame in which the price adjustment is to take place, but instead should reflect some sort of exogenous productivity experience that is germane to the utility's operations. In principle, if the LEC can outperform the industry or some other appropriate benchmark, then the LEC's management and shareholders should reap most or all of the benefits; conversely, if the LEC fails even to match the benchmark performance level, its owners should suffer the relative losses that necessarily will result when a firm's costs rise faster than its prices.

In specific response to Illinois Bell's proposal, Dr. Selwyn recommended that the offsets in the rate adjustment formula should be increased to reflect higher realizable productivity levels and LEC input prices that are increasing at a considerably slower rate than price levels in the economy generally. He said that Dr. Christensen's use of the GDPPI assumes that input factor prices confronted by an LEC are increasing at the same rate, over time, as the average for all components of the Gross Domestic Product. He testified that, because of the significant technological advancements characteristic of LEC resources, it is likely that the GDPPI overstates the extent of actual input price movements for LECs; and he maintains that Dr. Roddy's study confirms this.

Dr. Selwyn also contends that Dr. Christensen improperly approximated LEC input prices by adding economy-wide productivity gain to the GDPPI. He said this improperly assumes that LECs obtain their inputs from the same pool and in the same proportions as all firms in the economy generally. According to Dr. Selwyn, most of an LEC's inputs come from the output of other sectors of the overall economy. Since most sectors are competitive, productivity gains therein will be reflected in the output prices charged by those sectors. LECs benefit from the overall productivity gain in the other sectors of the economy when they purchase products and services from those sectors. In his opinion, since the prices paid already will reflect productivity gains that occur in those other sectors, no further adjustment for economy-wide TFP is necessary or appropriate. To the extent that LECs are themselves able to achieve further productivity gains within their own operations, those gains are in addition to the gains achieved in the rest of the economy.

Dr. Selwyn maintains that the appropriate input price index for an LEC (absent a specific LEC industry input price index) must then be the GDPPI without any upward adjustment for economy-wide TFP. Since Dr. Roddy's study shows that IBT input prices are growing at an annual rate of the GDPPI minus 1.6%, Dr. Selwyn insists that the correct specification of the IBT price adjustment formula to reflect input price changes is GDPPI minus 1.6%, rather than the GDPPI plus 0.9%, which he maintains is implied by Dr. Christensen's approach.

With respect to the productivity offset portion of the traditional price cap formula, Dr. Selwyn maintains that Dr. Christensen's estimated 2.2% annual TFP gain for Illinois Bell is only the bare minimum. Dr. Selwyn points out that the 1984-1991 time period covered by the data used by Dr. Christensen necessarily predates the adoption of incentive regulation. He argues that the productivity factor should more than merely reflect historic IBT productivity gains; it also should incorporate a "stretch" component that would encourage the Company to improve its overall efficiency and thus recognize the salutary effects of incentive regulation itself in stimulating additional productivity improvements. He proposes that an additional 1% be added to the TFP offset to afford a "consumer productivity dividend" that would guarantee some minimum level of benefit to ratepayers from the implementation of incentive regulation in Illinois. The AG notes that the FCC added a 0.5% consumer dividend adjustment to its productivity factor. The AG further notes that the California

Public Utility Commission stated that "about 1-1/2 to perhaps 2% of the adopted productivity adjustment will arise from the heightened incentives in the new regulatory framework" in its price regulation plan. Dr. Selwyn argued that ratepayers are entitled to share in productivity gains resulting from new technology because they already have paid for this equipment.

In summary, the AG proposes a price regulation formula of the GDPPI minus 1.6% (reflecting IBT's lower than GDPPI price growth) minus 2.2% (IBT's historic TFP) minus 1.0% (Stretch Factor); this can be restated as the GDPPI less 4.8%.

5. Further Discussion: Input Prices

In his rebuttal testimony, Dr. Christensen, acknowledging the validity of Dr. Roddy's calculations, stated that from 1984 to 1991 Illinois Bell's annual input price growth rate was 2.1%, and the input price growth for the economy as a whole was 4.6% per year, a differential of 2.5%. He maintains that this is a more appropriate way of stating the results of Dr. Roddy's study because it identifies the difference between economy-wide input prices and Illinois Bell input prices, rather than the difference between the GDPPI (which reflects economy-wide productivity) and Illinois Bell input prices. He says that Dr. Selwyn inappropriately included the full 2.5% differential as an adjustment to his price cap formula, but in two steps: a 1.6% price impact and a 0.9% productivity impact.

Dr. Christensen argues that Dr. Selwyn erroneously assumes that an anomalous short-term differential between IBT input prices and U.S. economy input prices will continue into the future. Dr. Christensen analyzed the differential between input prices for IBT and the economy as a whole, and maintained that the differential was due almost entirely to three special circumstances: (1) the economy-wide decline in interest rates; (2) the Tax Reform Act of 1986; and (3) the slow growth in wage rates for IBT employees relative to wage rates for the entire U.S. economy. If these three factors were removed from the input price data, he maintains that IBT's input price growth would have been virtually identical to that of the overall economy (i.e., 0.3% lower, not 2.5% lower).

Dr. Christensen recomputed the capital input prices for IBT and the U.S. economy in 1991, assuming that the opportunity cost of capital had remained at the 1984 level for both Illinois Bell and the national economy. He concluded that if interest rates had not changed, the discrepancy between IBT input price growth and U.S. economy input price growth would have been reduced by 1.1% per year. He also calculated that if corporate taxes had comprised the same percentage of capital costs in 1991 as in 1984, the discrepancy in input price growth between Illinois Bell and the U.S. economy would have been an additional 0.5% per year less.

Dr. Christensen contended that, in order to justify a permanent adjustment to the formula, the Commission would have to assume that the next five years will be exactly like the 1984 to 1991 period. He explained that such an assumption does not mean that capital costs and taxes simply would remain stable; rather, it means that capital costs and tax rates would have to decline over the next five years at the same rate as they declined between 1984 and 1991. In Dr. Christensen's view, this will not happen: corporate tax rates increased rather than decreased in 1993, and interest rates have fallen so far in recent years that it is unlikely that they could go any lower. He claims that, viewed over the long run, the GDPPI is an accurate measure of the impact of inflation on Illinois Bell and that no adjustment to the GDPPI is warranted. Dr. Christensen cited his 1987 testimony to the FCC, in which he found that over the period 1948 to 1979, input prices for U.S. telephone companies grew at virtually the same rate as for the rest of the economy. For the full 31 year period, input price growth averaged 4.6% per year for the U.S. economy and 4.5% per year for the Bell System.

Although Dr. Christensen maintained that no adjustment to the formula was necessary, Illinois Bell proposed through the testimony of Mr. Gebhardt to address the issue raised by Dr. Selwyn by incorporating a transitional adjustment. Mr. Gebhardt believed that uncertainties over input prices might be a reason some parties favored sharing. First, the Company proposes to reduce the 2.5% differential to 2.0% in order to reflect the effect, as calculated by Dr. Christensen, of the increase in corporate tax rates which already has taken place. Next, the Company proposes that one-half of the remaining balance (or 1.0%) be reflected as a temporary, three-year adjustment to the GDPPI. During the fourth year (1997), the Commission would revisit the relationship between Illinois Bell's actual input price growth experience and the GDPPI fo purposes of determining whether the 1.0% adjustment should be modified or eliminated.

The AG opposes this proposal. According to the AG, Dr. Christensen previously relied only on historical data, has had no experience in forecasting price trends, has no track record on which his judgment may be assessed, and otherwise provides a rather simplistic analysis of the future. Dr. Selwyn claimed that structural changes resulting from the AT&T divestiture and price trends for new telecommunications equipment support his conclusion that this differential would be permanent. Moreover, he said that Dr. Christensen's statements concern only input prices and not productivity growth. Dr. Selwyn maintained that Dr. Christensen's selective interest in the future with respect to input prices but adherence to the past with respect to productivity amounts to nothing more than cherry-picking among arguments to maximize the benefit to his client.

Illinois Bell disputed the AG's rebuttal analysis. Dr. Christensen took the position that both he and Dr. Selwyn were making implicit predictions about the future and that Dr. Selwyn's clearly were unreasonable. Dr. Christensen also maintained that neither the divestiture nor trends in telephone equipment prices explain the input price differential that existed during that period and that they will not produce a permanent differential in the future.

6. Further Discussion: Consumer Productivity Dividend or Stretch Factor

The Company maintains that use of the historical productivity differential provides ratepayers an appropriate share of the productivity gains and cost savings arising from changes in regulation and technology. The Company maintains that future productivity gains will be hard to achieve because the changes in technology that have produced the most dramatic savings already are in place and because very significant workforce downsizing efforts already have been completed, both of which are reflected in the Company's financial data and productivity analysis.

The Company states that it will need to find new ways of achieving productivity gains just to meet its historic level of TFP growth, and that the incentives provided by price regulation will be significant to the Company's ability to do this. The Company notes that its productivity growth rate has been slowing down recently. Dr. Harris testified that there is no economic basis for requiring a flow through to ratepayers of productivity gains achieved solely as a result of price regulation; indeed, he testified that attempts to capture those gains actually would defeat the incentive function of price regulation. He also points out that loss of market share due to increased competition likely will have an adverse impact on the Company's TFP. The Company maintains that customers will benefit from cost decreases and efficiency gains achieved under price regulation as a result of the fact that the Company claims it is going into the plan with a $275 million revenue requirement shortfall.

IBT witness Gebhardt disputed Dr. Selwyn's claim that ratepayers have a "right" to future productivity gains because they already have "paid for" certain equipment improvements. Mr. Gebhardt argued that customers do not obtain an ownership interest in the Company's assets merely by paying for the service they receive. The rates they pay for service compensate the Company for its operating expenses and provide a reasonable rate of return, nothing more. Mr. Gebhardt also explained that, from a capital recovery perspective, Illinois Bell's customers have not even "paid for" the new technology as Dr. Selwyn claims. Mr. Gebhardt testified that, for example, customer rates have covered just over 50% of the last generation of switching technology and only a lesser fraction of the Company's investment in newer technology.

7. Staff View of the Price Cap Formula

Staff witness Charlotte TerKeurst noted that the theory of structuring a price regulation mechanism is not fully or precisely developed. On its face, the price cap formula states that X is the amount by which IBT's price growth should differ from inflation. She did not agree with Illinois Bell's proposal that the X adjustment factor should reflect only the difference between Illinois Bell's TFP growth rate and that of the economy as a whole. While the commonly used price cap formula can be derived from a model of a firm's TFP growth, she said that simplifying assumptions are made in reaching the price cap formula which limit its accuracy. She stated that the X factor is more accurately called a "general adjustment" factor since it reflects several factors that cause IBT's output prices to change at a rate different from that of a nationwide inflation factor. These factors include any difference in input price growth rates; differences in earnings levels between the Company and the economy as a whole; the TFP differential; changes in revenues per unit of output due to Ramsey pricing; and changes in unit costs due to demand changes, including increases in demand for new services or decreases in demand due to competitive inroads.

Ms. TerKeurst contends that the general adjustment factor should, as a general principle, be forward-looking and based on expectations regarding industry-wide rather than Company-specific operations. In Staff's view, an industry-wide approach would not reward a company's past low productivity growth nor penalize successful cost cutting by setting the future standard based on past performance.

Ms. TerKeurst maintained that there was value in structuring price regulation based on a model which estimates or forecasts expected year-to-year changes in a company's costs, using external measures and data to the extent reasonable. Such a model would be structured using some measure of the company's costs in a given year as the chosen starting point, with the mechanism then modeling how those costs are likely to change relative to external measures.

She expressed concern that, by its own forecasts, Illinois Bell's proposed price cap mechanism does not track its expected revenue needs very well on a year-to-year basis.

While noting that it preferred not to use Company-specific data, Staff analyzed Illinois Bell's forecasted revenue needs over the first five years of the plan and estimated that a general adjustment factor of 3.3% (based on the GDP Implicit Price Deflator) or 3.6% (based on the GDPPI) would approximate closely the estimated changes in Illinois Bell revenue needs over time. Staff cautioned that there are several sources of uncertainty in these estimates which reduce their reliability, including the inflation forecast, mismatches between the input and output growth rates, and certain significant changes which Illinois Bell made in its forecasts in the interval between its direct and rebuttal testimony. As a result, Ms. TerKeurst said that determination of an X adjustment factor is judgmental at this time. She said that her original analyses, reflected in her direct testimony, led her to conclude that a 5.0% adjustment would be reasonable. Because of the uncertainties in the proffered revenue needs forecasts, she leaned toward a general adjustment factor somewhat higher than the derived levels based solely on the current revenue needs forecasts. She proposed that the general adjustment factor be set at 3.8% if the GDP Implicit Price Deflator is used as the inflation measure, and that it be set at 4.1% if the GDPPI is used.

In support of the reasonableness of this result, Staff noted the productivity adjustment factors adopted by the California Public Utility Commission, in its 1989 price cap proceeding, of 4.5% for Pacific Bell and GTE California. According to Staff, between 1990 and 1992, Pacific Bell and GTE California actually achieved productivity rates of 4.9% and 6.2%, respectively, based on a National Economic Research Associates ("NERA") study of "implied" productivity derived from earned returns. Staff notes that the California Commission recently approved a settlement agreement for GTE California which included productivity adjustments ranging from 4.6% to 5.0% for 1994-1996. Staff also relied on the FCC's order involving interstate access services which allowed LECs to choose between a 3.3% and a 4.3% productivity adjustment. Staff noted that Ameritech chose 3.3% and claimed that since Ameritech had shared in 1991 and 1992 meant that Ameritech had exceeded the 3.3% productivity level in those years.

8. Response to Staff's View of the Price Regulation Formula

CUB/Cook criticize Staff's methodology because Staff conducted net present value ("NPV") analyses and used these as a way to "find" the productivity offset for its proposal. Staff took the revenue requirements provided by the Company, adjusted them for Staff's accounting disallowances, and arrived at a productivity offset it called the "X" adjustment and an upfront revenue reduction that would equate its sharing plan with the revenue levels expected under ROR regulation. In CUB/Cook's view, the calculations are based on invalid revenue projections for the 1994-1999 time frame. In particular, they contend that changes in Illinois Bell's rate structure which will come about as the result of its Customers First Plan create a substantial degree of uncertainty about future projections. They also assert that it would be an abuse of discretion to adopt Staff's proposal for this reason. CUB/Cook maintain that Staff's analysis is fatally flawed because, in developing its NPV analysis, Staff, like the Company, used inconsistent growth rates in projecting revenues and revenue requirements. Staff used the demand growth rate of 2.16% for projecting revenues and a much higher growth rate for projecting revenue requirements, resulting in a bias against ROR regulation. CUB/Cook did not make any recommendation as to an appropriate price regulation formula since they oppose adoption of an alternative form of regulation for Illinois Bell.

The Company replied to Staff's proposal by claiming that Staff's approach does not measure TFP and should not be used in this proceeding. The Company characterized Staff's method as "reverse engineering" because Staff used projected financial data to determine what productivity adjustment would produce the desired financial outcome in this case in terms of benefit to ratepayers. Dr. Christensen testified that Staff's approach is not supported by economic theory. As he explained, the proper methodologies for determining TFP are well developed in the economic literature and the "implied analysis" used by Staff based on earnings is not a proper TFP methodology.

The Company also criticized Staff's proposal because it does not use reasonable projections of IBT's financial condition over the course of the plan. The Company notes that Staff assumed that all of the accounting adjustments and disallowances that Staff is proposing in this proceeding, as well as a $20 million upfront rate reduction, will be approved, and used the resulting revenue requirements assumptions to "reverse engineer" IBT's productivity factor. The Company maintains that if Staff were to perform the same study using Illinois Bell's view of its revenue requirements, it likely would produce a negative productivity adjustment. Illinois Bell takes the position that a methodology which produces widely varying results, depending on which financial assumptions are relied on, is inappropriate. The Company also objected to Staff's increase of the adjustment factor above what was produced by the financial analysis, on the basis that "uncertainties" could and should be resolved as accounting issues.

Finally, the Company argued that this Commission should not base its decision regarding productivity on the experience of Pacific Bell and GTE in California or Ameritech at the federal level. According to the Company, there is absolutely no similarity between the conditions faced by Illinois Bell and the California LECs. Dr. Christensen testified that the LECs in California have experienced total output growth and TFP growth dramatically higher than Illinois Bell ever is likely to experience. For example, between 1984 and 1991, Pacific Bell's TFP grew an average of 6.7% annually while Illinois Bell's TFP grew only 2.2%. The Company notes that Dr. Selwyn, who was involved in the California proceedings, does not endorse use of the California LECs' productivity values in this proceeding. With respect to the fact that Ameritech has shared at the federal level with a 3.3% productivity factor, Dr. Christensen testified that the likely explanation was the difference between Ameritech's input price experience and the GDPPI during this period, rather than increased productivity.

9. Nationwide Inflation Measure

As shown earlier, IBT, the AG, and DOD/FEA contend that the GDPPI should be adopted as the measure of inflation because it is the most generally accepted measure of producer price inflation. The Company points out that the FCC used GNPPI -- the predecessor of GDPPI -- in both the AT&T and LEC price cap plans. The Company, the only difference between the GDPPI and the GNPPI is that the GDPPI excludes the effects of the United States' foreign operations. Dr. Christensen testified that GDPPI is becoming the standard and likely will be adopted by the FCC for use in its formula in the future. Dr. Selwyn agreed that the GDPPI is the right measure of economy-wide inflation to use in this case.

Staff recommended that the GDP Implicit Price Deflator rather than GDPPI be used as the measure of inflation in the price cap formula. Staff argued that GDPPI is a "fixed weight" index which measures price changes in a fixed "market basket" of inputs, and therefore does not capture the effect of inflation caused by shifts in the relative usage of different inputs, such as the substitution of less expensive input. According to Staff, the GDP Implicit Price Deflator reflects input changes and thus measures economywide inflation more accurately. Another reason Staff does not favor use of the GDPPI is that it must be adjusted periodically to update the weight of various components and, as a result, can cause comparability problems for years before and after the periodic adjustment of these weights. However, in its rebuttal case, Staff stated that it did not believe that the measure of inflation was a critical issue in the price cap formula. Either the GDPPI or the GDP Implicit Price Deflator could be used provided that the general adjustment factor was chosen in a consistent manner. Specifically, if the GDPPI is chosen, Staff maintained that the X factor should be approximately 0.33 percent higher than if the Implicit Price Deflator is used.

The Company responded that the GDP Implicit Price Deflator has not been used by any other regulatory agency in a price index formula and that the U.S. Commerce Department, which publishes the index, cautions that "its use as a measure of price change should be avoided". The Company also points out that the FCC considered and rejected the use of the GDP Implicit Price Deflator in both 1988 and 1990 in developing its price cap formulas. According to the Company, the disadvantage in using the GDP Implicit Price Deflator is that the index can change even if there is absolutely no change in the price levels in the economy, because it is adjusted to reflect the relative composition of the GDP.

10. Price Regulation Formula: Other Parties' Positions

DOD/FEA maintain that the Commission should adopt a productivity adjustment factor of 3.3% for Illinois Bell. They note that the FCC allowed companies to choose between a 3.3% and a 4.3% productivity factor, and that the California Commission adopted a 4.5% productivity factor. In addition, DOD/FEA contend that a 1.3% productivity factor would not provide sufficient incentives for Illinois Bell to improve its performance.

MCI, which opposes adopting any alternative form of regulation for Illinois Bell, characterizes the Company's proposal as a price floor. This intervenor maintains that IBT's proposed 0.7% productivity offset denies ratepayers the benefits of whatever productivity growth that traditionally there has been in the economy as a whole, offering consumers only half of the amount by which the Company's productivity growth has exceeded the economy's productivity growth historically. The net effect, according to MCI, is that the Company would continue to overearn into the foreseeable future without monopoly ratepayers seeing lowered rates. MCI also contends that the proposal is inconsistent with Ameritech's support before the FCC for a 3.3% productivity offset. MCI argues that if both proposals were implemented, Illinois Bell's intrastate rates would increase approximately 2.6 percentage points more per year than its interstate charges.

11. COMMISSION CONCLUSIONS

The Commission concludes that with respect to the establishment of a price regulation formula, it would be inappropriate to adopt the position of any party in its entirety. Each of the proposals regarding the price regulation formula has advantages and disadvantages. The Commission concludes that it will adopt a price regulation formula which selects various components on the basis of the most persuasive evidence presented in the record.

a. Staff Approach

Staff's price regulation recommendations have provided the Commission with valuable insights. Staff's analysis reflects a clear recognition that any plan for alternative regulation should offer specific advantages over traditional ROR regulation, and Staff's revenue needs analysis attempts to quantify the rate impacts which can be expected from a change to price regulation. Staff also recognizes that a considerable degree of judgment must be exercised by the Commission when establishing a price regulation formula.

However, the Commission has several significant concerns regarding the Staff's approach. First, there is no established economic theory which supports the establishment of a price regulation formula on the basis of a revenue needs analysis. While at first blush the approach may appear to offer greater precision in calculating an appropriate X-factor, that advantage is largely illusory. The revenue needs modeling approach relies on an analysis which is at least as complicated and as potentially contentious as traditional ROR regulation. It can be described fairly accurately as a traditional ROR analysis with a five-year projected test year period.

Furthermore, Staff has acknowledged that its modeling was highly dependent on Company-supplied data. The risks of the approach were dramatically demonstrated when Staff, which initially recommended a 5% X-factor, revised its position on rebuttal in response to forecast changes. There is unanimous opinion among the expert witnesses in this proceeding that a price regulation formula should be based on standards established through the use of economy-wide or industry-wide data. Staff has not demonstrated how its reliance on Company projections and data would be reduced over time or how its approach would incorporate economy-wide or industry-wide standards. As a result, we do not believe that the revenue needs modeling approach, in its present stage of development, provides a sustainable methodology for establishing the specific parameters of a price regulation formula. Therefore, we will not address the various parties' arguments regarding the appropriateness of the numerous Staff assumptions. We thereby avoid having to grapple with the additional complexities of evaluating five-year forecasts in an environment of increasing change.

Particularly in the Commission's first implementation of price regulation, we believe that it is important to establish a price regulation formula which is reasonably consistent with established economic theory. By doing so, we can assure ourselves that the plan we adopt can incorporate more readily any further developments in that theory, and the results from price regulation in other jurisdictions can be used as a frame of reference for the analysis of results in Illinois, and for the identification of any emerging or potential problem areas.

Our conclusion does not mean that we believe that the Staff approach is without value. On the contrary, because it is so consistent with traditional regulatory analyses, it provides a particularly insightful check upon the reasonableness of the price regulation formula we adopt.

b. <u>Measure of Economy-wide Inflation</u>

With respect to the selection of a measure of economy-wide inflation, we conclude that use of the GDPPI is preferable to the Staff's recommended use of the GDP Implicit Price Deflator. Although Staff has asserted that use of the GDP Implicit Price Deflator would represent an improvement over the widely prevalent existing approach, we are not persuaded. We note that the FCC specifically has rejected the use of this index; its progenitor, the U.S. Commerce Department, explicitly cautions against its use as a measure of inflation; and that Dr. Selwyn and Dr. Christiansen, both nationally recognized experts on price regulation, advocate use of the GDPPI. The FCC pointed out that the Implicit Price Deflator cannot be used to measure price changes on a period-to-period basis, since changes in the quarterly composition of GDP can affect the Deflator even if there were no changes in prices. If, for example, the price of a good remains stable, but the quantity increases, the GDPPI would remain constant and the Deflator would show the change as inflation. The GDPPI divides current prices times base period demand by base price times base period demand; the Deflator simply divides total current GDP by total prior period GDP.

Staff witness TerKeurst identified a potential period-to-period comparability problem associated with use of GDPPI and suggested that if the Commission elects to use GDPPI, the Company be required to include in its annual price regulation filing an identification and reconciliation of any periodic updates to the GDPPI weights. We agree that this suggestion is reasonable and it is adopted.

c. Input Prices in Price Regulation Formula

The uncontroverted evidence in this proceeding is that input prices for Illinois Bell have lagged significantly behind the GDPPI. Dr. Christensen confirmed Dr. Roddy's calculation that the GDPPI grew at 3.7% per year during 1984-1991, while IBT's input prices grew at the GDPPI minus 1.6%. This implies that IBT's input prices grew at a rate 2.5% slower than economy-wide input prices.

Illinois Bell suggests that this price experience is only a temporary anomaly, which will not continue into the future as a result of tax law changes, increases in interest rates, and an end to differential growth in wages paid to its employees compared to wage growth nationally. The Company contends that the GDPPI therefore remains an appropriate measure of Illinois Bell's expected input price growth in the future.

Although the GDPPI may ultimately prove to accurately predict IBT input price growth over an extended period of time, we do not believe that a particularly long-term view, such as the three decades measured in Dr. Christensen's pre-divestiture Bell System study is appropriate for our use. It is our hope that price regulation will be superseded by competitive market forces significantly sooner than in thirty years. Since Article XIII of the Act sunsets in 1999, a five-year time frame is sufficient for establishing the appropriate parameters of a price regulation formula.

We are also unpersuaded that Dr. Christensen's post-divestiture analysis provides a sufficiently accurate basis for the conclusion that the unadjusted GDPPI is likely to reflect adequately the input price experience of Illinois Bell or the telecommunications industry in general over the next five years. It is always possible to isolate various cost categories or historical events selectively and to contend that past overall cost trends will not continue into the future. The validity of those assertions is best tested after verifying that expected price trends in all factors of production have been analyzed. It is apparent that Dr. Christensen has not conducted such a comprehensive analysis. Therefore, we agree with the AG that an explicit adjustment should be made to the GDPPI to reflect the divergence between economy wide input price growth and the actual IBT input price experience.

However, we do not believe that it is reasonable to project that the full amount of the historical post-divestiture input price divergence will continue into the future. The propriety of some adjustment, at a minimum, to reflect the impact of known tax law changes on the telecommunications industry is supported by the record. We will adopt Dr. Christensen's calculation of a 0.5% impact from the tax law change, which was largely unrebutted in this proceeding.

Having made what we believe to be a reasonable adjustment to reflect Dr. Christensen's analysis, we reject Illinois Bell's suggestion that the remaining input price differential of 2.0% be halved, since the proposal is largely unsupported by any persuasive substantive rationale other than that of simply raw compromise. We also reject the Company's suggestion that its actual price experience be revisited in three years. The Company's own witness, Dr. Christensen, testified on rebuttal that it would be inappropriate to update the price index formula based on Illinois Bell's performance with respect to TFP and input price growth, because to do so would undermine the incentive structure that provides the primary rationale for adoption of the Alternative Regulatory Plan. We concur with this assessment. In addition, revisiting the issue in three years necessarily would invite reconsideration of numerous other issues which should be resolved with a greater degree of finality and certainty through this Order. We have no desire to invite frequent and lengthy proceedings, the avoidance of which is one of the purported advantages of price regulation. We conclude that an appropriate estimate of input price growth for the purpose of establishing a price regulation formula for Illinois Bell is the GDPPI minus 2.0%.

d. <u>Productivity Factor in Price Regulation Formula</u>

We further conclude that Dr. Christensen's calculation of Illinois Bell's differential TFP of 1.3% is appropriate for use as a measure of productivity in the price regulation formula. Accordingly, we reject Dr. Selwyn's proposal that the full amount of Illinois Bell's historical TFP (2.2%) should be used. Dr. Selwyn's approach appears to be inconsistent with the methodology employed by the FCC and other jurisdictions which use differential productivity growth rates. As the FCC has noted, the telephone industry has experienced lower input price growth and higher productivity growth than the economy as a whole, and this has been reflected in lower output price growth by the telephone industry. Our adoption of a price regulation formula which establishes an output price index for Illinois Bell that is essentially reflective of the historical differentials between economy-wide and Illinois Bell input prices and productivity mirrors this phenomenon.

e. <u>Depreciation Reserve Deficiency Adjustment</u>

In this Order we have determined a just and reasonable level of rates for Illinois Bell. This was done for two reasons. First, to evaluate CUB's rate reduction complaint; and second, to determine appropriate rates for the initial year of the alternative regulation plan. When we determined just and reasonable rates, we adopted what we believed was a reasonable treatment of the depreciation reserve deficiency. We also note Staff's calculations regarding the impact of adopting the Company's proposed 0.7% total offset, which incorporates the reserve deficiency adjustment, and conclude that it would not yield just and reasonable rates over the initial period of the alternative regulation plan. The Commission therefore rejects Illinois Bell's proposal to incorporate in the price cap formula any adjustment or allowance for a depreciation reserve deficiency. We have no desire to convert a depreciation reserve deficiency into a ratepayer benefit deficiency.

f. Consumer Productivity Dividend

Section 13-506.1 of the Act requires that an alternative plan of regulation identify specifically: how ratepayers will benefit from any efficiency gains; cost savings arising out of the regulatory change; and improvements in productivity due to technological change. We are persuaded that the adoption of an additional increment to the price regulation formula is the most direct and appropriate way to achieve these goals. Acceptance of Illinois Bell's argument that a continuation of historical productivity performance would provide sufficient ratepayer benefits is inconsistent with the notion that a change in the form of regulation would enhance efficiency incentives. By including a stretch factor or consumer productivity dividend component in the price cap formula, we ensure that ratepayers will receive the first cut from any improvements beyond historical performance which arise from technological and regulatory change.

Dr. Selwyn has suggested a 1% stretch factor, although he did not present any specific studies or methodology supporting his selection of that figure. We believe that a 1% consumer productivity dividend is too high, since it would require a near doubling of the previously achieved differential TFP. We conclude that the selection of an appropriate offset is largely judgmental, and that a 0.5% consumer productivity dividend is appropriate. We note that the FCC has adopted an identical 0.5% factor in its LEC price regulation plan.

g. Summary and Additional Rationale

To summarize, the Commission will adopt a price regulation formula equal to the GDPPI minus 2.0% (input price differential) minus 1.3% (productivity differential) minus 0.5% (consumer productivity dividend). The sum of the input price, productivity, and consumer dividend provisions can be referred to as the total offset (to GDPPI). The price regulation formula we will adopt can be restated as the GDPPI minus 3.8%.

Several facts support the overall reasonableness of the formula we have selected. First, the 3.8% total offset is within the range suggested by Staff's revenue needs modeling analysis. Staff determined that when using the GDPPI, an X factor of 3.6% would track Illinois Bell's revenue needs well over time. Staff then included an additional 0.5% to reflect forecast uncertainties, and recommended a 4.1% X factor. Although we have rejected the notion that a price regulation formula should be based on a traditional ROR regulation analysis, the similarity between the total offset we have adopted and Staff's recommended X-factor provides additional assurance that price regulation will not yield results markedly different from a plausible outcome of traditional ROR regulation.

The second fact that supports the overall reasonableness of the formula is that the FCC permits LECs to choose between a 3.3% and a 4.3% offset to the GDPPI. The 3.8% total offset we adopt is at the midpoint of this range. Many of the parties pointed to the FCC's price regulation formula in support of their specific recommendations regarding a total offset. There is no evidence in the record which would lead us to conclude that the FCC's price cap formula is theoretically deficient or leads to unreasonable results, particularly with respect to excessive prices or earnings. Furthermore, despite the parties' repeated references to the FCC formula, IBT has not raised any argument to rebut the essential fairness of the FCC's formula. In other words, there is no persuasive evidence in the record that IBT's actual input price and productivity experience and/or its prospective economic and financial situation is so unique that it must be viewed as an "outlier" to which application of the FCC formula, which is based on nationwide standards, has been or would be inappropriate.

Finally, the most current WEFA Group projections for the GDPPI reflected in the record are as follows:

1994	3.5 %
1995	3.5 %
1996	3.5 %
1997	3.4 %
1998	3.5 %
1999	3.7 %

If these GDPPI projections prove to be accurate, the price regulation formula we have adopted will yield a small annual decrease in Illinois Bell's noncompetitive rates. This is something which ROR regulation would be unlikely to accomplish because of the inherent upward rate bias associated with the fact that a utility ordinarily initiates its own general rate filings, and will do so only when it believes that some level of upward repricing can be justified readily.

We wish to emphasize that by making this comparison we are not suggesting that a price regulation formula is reasonable only if it leads to price decreases, or that regulators should adjust a price regulation formula in light of inflation projections to ensure that it will achieve price changes in the direction and of a magnitude deemed to be desirable. Our point is merely that the price changes we can expect from the formula over the next five years are not inherently unreasonable. This contrasts with the Company's original proposal for a 0.7% total offset to the GDPPI which presumably would have led to rate increases every year, absent significant deflation; a result difficult to reconcile with our determination herein of just and reasonable rates using the traditional ROR regulation analysis. Under traditional ROR regulation, once rates are established they can reasonably be expected to remain in effect for several years. Under Illinois Bell's original proposal, the modest rate reduction we have ordered would be overtaken quickly by rate increases through the operation of the price regulation formula. Therefore, replacing traditional ROR regulation with a formula that would prove the Company with almost automatic annual rate increases would not offer the ratepayer any readily apparent advantage.

The Commission further notes that the anticipated rate reductions for noncompetitive services are associated closely with our inclusion of the consumer productivity dividend in the price regulation formula.

D. <u>Earnings Sharing</u>

One of the most contentious issues in this proceeding has been the concept of "sharing", under which a portion of the company's earnings would be redistributed to ratepayers.

Illinois Bell proposes that the Commission adopt what it refers to as a "pure" price regulation plan. There also would be no direct regulation of the Company's earnings. There would be no cap on the Company's earnings and, similarly, no specific earnings floor which would permit the Company to seek rate relief. Accordingly, there should be no sharing of earnings, in view of the Company's complete and unprotected assumption of risk.

Through the testimony of its witnesses, and in its briefs, the Company maintains that sharing of earnings is inappropriate for five principal reasons. First, the Company contends that any sharing plan is, for all intents and purposes, a continuation of ROR regulation because the Commission would continue to monitor the Company's earnings. IBT witness Dr. Harris testified that earnings sharing brings with it "all the baggage of rate of return regulation," including control over depreciation rates, continued monitoring of Illinois Bell's investments and expenses, the potential for prudence reviews and continuing debates over how much Illinois Bell is earning and why. Second, as long as IBT's profits are subject to sharing, there would be significant external pressure on the Commission to ensure that the Company is investing wisely, operating efficiently, and is not "hiding" its profits to avoid sharing. There also would be external pressure to "recontract," i.e. to re-establish the parameters of the plan if Illinois Bell is perceived to be earning too much or too little.

Third, the Company contends that earnings sharing does not provide the same level of incentives to operate efficiently as does pure price regulation. Illinois Bell concedes that alternative regulation plans which include sharing can induce more efficient behavior than can ROR regulation, but claims that sharing plans, by their inherent nature, would not provide efficiency incentives comparable to pure price regulation because the Company cannot retain all of the fruits of its efforts. Fourth, the Company contends that sharing substantially dilutes regulatory cost savings because so many revenue requirement issues are retained. In the Company's view, sharing actually could result in higher regulatory costs than under ROR regulation because it would retain all of the old revenue requirements issues and would add new regulatory issues associated with the price index mechanism. Finally, the Company maintains that sharing probably would result in the Commission continuing to regulate Illinois Bell's depreciation rates, which the Company opposes. The positions of the parties on the depreciation issue are discussed in the next section of this Order.

Staff witness TerKeurst states that, in general, Illinois Bell prefers that regulatory controls and reviews be loosened more than Staff believes market conditions warrant. She believes that a price cap mechanism with a startup revenue adjustment and an earnings sharing mechanism creates a framework that can yield reasonable results in the short-, mid-, and long-terms. Indeed, Staff argues that an earnings sharing provision is a critically important component of price regulation for Illinois Bell, since the Company retains significant market power for many telecommunications services on which customers rely.

Staff contends that there is a substantial degree of uncertainty regarding both what revenue requirements would be under ROR regulation and what the outcome of price regulation would be, and so additional safeguards are needed to protect customers from risks that prices may be higher than actually would occur under ROR regulation and thus to ensure customer benefit. Staff views sharing as a safeguard against these uncertainties, noting that there are considerable uncertainty and judgment involved in constructing price index formulas, and that wide swings in earnings could be simply an indication of inaccuracies in the formula rather than an indication of management capabilities. Thus, Staff believes that sharing protects customers from the risks that the price index mechanism may overestimate the price changes which Illinois Bell needs. Staff also believes that sharing may make the price regulation mechanism more sustainable than a pure price regulation proposal, thus reducing the likelihood that the Commission will need to revisit this issue soon after adopting a plan. Staff believes that the benefits of sharing can be obtained while preserving the efficiency incentives of a pure price cap model.

Staff points out that the Company's plan also significantly changes the regulatory treatment of competitive services. Staff contends that the Company's proposal would permit it to exploit any market power it may retain for competitive services to the exclusive benefit of its shareholders. Staff believes that any excess competitive service profits should be shared with its noncompetitive customers under an earnings sharing mechanism. Staff notes that while only a small fraction of IBT's revenues currently are derived from competitive services, IBT has stated its intention to reclassify a majority of its services as competitive over the next few years if alternative regulation is adopted. Staff asserts that revenues which the Company derives from competitive services over which it has no significant market power should be free from any sharing obligation. Under Staff's view, Illinois Bell could petition the Commission for a finding that it lacks significant market power. Finally, Staff observes that the sharing mechanism it proposes is very similar to the sharing mechanisms adopted in California in 1989 for Pacific Bell and GTE California and by the FCC in 1990 for LECs' interstate access services.

Staff opposes Illinois Bell's request that the Commission no longer regulate its depreciation rates. It acknowledges that while depreciation rates would not affect prices under price regulation, Staff believes that continued oversight is required because depreciation rates are critical components of the LRSIC cost studies needed for imputation, aggregate revenue tests, and the earnings sharing calculations.

Under Staff's proposal, a benchmark rate of return would be set at 200 basis points above the adopted weighted average cost of capital. Sharing would start if the Company's overall rate of return exceeds 12.26%, based on Staff's recommended 10.26% mid-point of the weighted average cost of capital. A capped rate of return would be set 600 basis points above the adopted cost of capital. Any earnings between the benchmark of 12.26% and the cap would be shared on a 50/50 basis between shareholders and ratepayers. Any earnings above the cap would be returned entirely to customers through a one-time credit on their bills. However, Staff's sharing proposal does not incorporate a floor on earnings to protect shareholders in the event the price cap mechanism underestimates revenue needs nor does it provide a means by which ratepayers might share in underearnings. If earnings fall below the authorized rate of return, Illinois Bell would not be allowed any automatic rate increases but could petition the Commission for reconsideration of the price cap mechanism.

The AG also presented an earnings sharing proposal. Dr. Selwyn took the position that there was an expectation of increased earnings over time. Under the AG's proposal, Illinois Bell would be required to share with noncompetitive service ratepayers all earnings from noncompetitive services in excess of 50 basis points above the benchmark rate of return on a 50/50 basis. Aggregate Company intrastate earnings, including those from competitive services, in excess of 500 basis points above the authorized benchmark rate of return would be refunded, in their entirety, to ratepayers as part of an annual sharing credit. The AG contends that the 50/50 sharing provision is intended to assure ratepayers participation in Bell's efficiency gains.

According to the AG, the sharing would be limited to gains from noncompetitive services and, consequently, should limit the effect of any cross-subsidization of competitive services with revenues from noncompetitive services. Dr. Selwyn asserts that this would minimize cross-subsidy tactics which might arise if the Company were to accept lower earnings on some truly competitive services and then compensate for these lower earnings through excess monopoly earnings.

Implementation of this aspect of the AG's plan would require the allocation of investment-related intrastate costs and operating expenses between noncompetitive and competitive categories. The AG asserts that the Company is able to perform such allocations because it has been required to do so by the FCC Part 64 rules. As an alternative to this allocation proposal, Dr. Selwyn proposes the use of a "competitive services price index" which would limit increases in monopoly service price levels to those adopted by the utility for its competitive services, exclusive of Yellow Pages.

The AG then proposes that an overall earnings cap apply to both competitive and noncompetitive services in order to limit any excess profits. According to the AG, to the extent there is no actual competition present for services classified as competitive, this refund provision would have an effect similar to that of the marketplace in constraining earnings. Finally, the AG contrasts its sharing proposal with the sharing proposal made by Staff. The AG notes that Staff's proposal would not require sharing until earnings exceeded the authorized ROR by 200 basis points, as opposed to 50 basis points under its proposal. The AG believes that Staff's proposal does not focus adequately on the equity of ratepayer sharing of the benefits of efficiency. The AG believes that Staff's sharing plan may be too lenient in favor of Illinois Bell since the 200 basis point threshold is not projected to occur for the 1994-1999 period.

Since CUB/Cook oppose any alternative regulation plan, they do not discuss the merits of pure price regulation versus earnings sharing. CUB/Cook, however, specifically oppose Staff's earning sharing plan because Staff derived its productivity offset by means of an NPV analysis which relied upon projected revenues for the 1994-1999 time frame, and a demand growth rate of 2.16%. CUB/Cook contend that these revenue projections cannot be relied upon because of Ameritech's announced intention to restructure its rates in connection with its Customers First plan and because the 2.16% demand growth rate is too low. CUB/Cook oppose the AG's earnings sharing plan on the grounds that neither Dr. Roddy nor Dr. Selwyn attempted to prove that the AG's proposal met the standards set out in Section 13-506.1 for the adoption of alternative regulation.

DOD/FEA recommend that the Commission adopt a symmetrical earnings sharing plan with a no-sharing zone of 50 basis points above and below the target rate of return. Outside of this range, on both sides, there would be a 50-50 sharing between the Company and its ratepayers. Operating results would be subject to annual review. Compensation to ratepayers, if any, would be in the form of one-year rate reductions rather than one-time credits. In order to provide additional incentives to the Company, DOD/FEA recommend that no earnings ceiling be established.

DOD/FEA justify their sharing mechanism on two grounds which Staff also raised. First, DOD/FEA contend that since local service competition has not developed to the point where Illinois Bell is unable to extract monopoly profits from captive customers for some services, earnings regulation is the only tested procedure for identifying and controlling monopoly profits. Second, DOD/FEA believe that earnings sharing is warranted because there is considerable uncertainty as to the appropriate productivity offset level to use in the price index formula.

MCI contends that Illinois Bell's price regulation proposal should be rejected. However, in the event that the Commission wishes to experiment with some other form of price regulation, MCI recommends that the Commission adopt a "reverse taper" sharing mechanism in order to reduce any errors associated with misspecification of the appropriate productivity factor in the price index formula. MCI witness Dr. Nina Cornell explains that the best sharing plan would have consumers receiving the largest share of increased earnings that are close to the authorized rate of return, with the Company retaining a greater share the higher the achieved level of earnings, up to some cap. In MCI's view, giving the Company more of the "harder" to achieve earnings creates a greater incentive to seek out the productivity improvements that would drive such earnings growth. MCI also notes that, in Docket 89-0033, Illinois Bell supported an earnings sharing plan, and that, in MCI's view, circumstances have not changed which would justify a different result today.

LDDS/ICPA also oppose any type of price regulation. However, like MCI, they contend that, if the Commission does adopt some form of price regulation, it should adopt a sharing mechanism with a reverse taper. In their view, a reverse taper would enhance Illinois Bell's incentives to become more efficient because the Company would be able to retain a progressively greater percentage of profits as its earnings level increases. LDDS/ICPA note that this Commission adopted an earnings sharing mechanism four years ago in Docket 89-0033.

Illinois Bell responds to these positions in several ways. First, the Company argues that sharing should not be viewed as a "safety net" for any uncertainties in constructing a price index formula. The Company contends that although price index formulas do rely on predictions about the future to some degree, the Company contends that the current record provides a solid basis for establishing a reasonable price regulation plan. In the Company's view, its price index formula reliably reflects the conditions which the Company will face in the future because the formula is based on an inflation measurement which changes yearly, a productivity measurement which is based on seven years of historical data, and a service quality index which is based on recent Company performance. In addition, Illinois Bell presented detailed financial projections for the first five years of the plan that were examined by the Staff and the other parties. The Company contends that the protection against some fundamental error in the operation of the price index formula is the Commission's ability to monitor the operation of the price regulation plan after the first three years, to review whether the offset to inflation should be continued, and to determine whether a company-specific or industry-wide productivity factor should be used.

The Company also points out that Staff's sharing argument is based on the false premise that any earnings over 12.26% are likely to be due either to the Company's misuse of market power or to a misspecification in the price formula. Dr. Harris testified that high profits may mean simply that Illinois Bell did extremely well in the marketplace or is managing its business efficiently.

The Company states that it does not believe that there is any public perception that Illinois Bell's current rates are excessive, noting that its end user rates are low when compared to those of other LECs around the nation. Illinois Bell further points out that it has not had a general rate increase since 1985, and that its rates were reduced by $45 million in late 1989 as a result of Docket 89-0033.

Illinois Bell further argues that sharing plans simply do not provide the same level of incentives to operate efficiently as do pure price regulation plans. Although sharing plans can induce more efficient behavior than traditional ROR regulation, the efficiency effects depend very heavily on where the breakpoints are set for sharing and how much of the additional earnings must be shared. Dr. Harris testified that the Staff's proposed breakpoints and sharing levels certainly were reasonable, as sharing plans go. However, he also stated that sharing plans, by their inherent nature, cannot provide efficiency incentives comparable to those provided by pure price regulation, where the Company is assured that it can retain the fruits of its efforts. The Company argues that once the 50% sharing threshold is reached, the earnings incentives are reduced dramatically relative to the risks associated with the potential of actually achieving those earnings. The Company further contends that the positive disincentives to new investment from continued control of depreciation rates almost guarantee that the investments necessary to achieve those high levels of earnings will not be made.

Illinois Bell also argues that Staff's proposed $73 million revenue reduction, together with its $20 million upfront rate reduction, are equivalent to approximately 180 basis points of ROR (on its pro forma rate base). As a result, the Company states that it would have to improve earnings by 180 basis points merely to do as well as it is doing today under ROR regulation and that the sharing threshold under Staff's plan then really is only 20 basis points above that level of earnings. In other words, the Company argues that Staff's proposal, in reality, requires 50/50 sharing of virtually all earnings in excess of the authorized rate of return; and, therefore, it provides much less in the way of additional incentives to achieve efficiencies than it would appear to provide.

The Company also challenges Staff's assertion that competitive services should be included in the calculation of earnings sharing. The Company contends that, from the plain terms of Section 13-506.1, it is clear that the legislature intended that alternative regulation plans be applied to noncompetitive services and that the safeguards contained in Section 13-506.1 already protect noncompetitive service customers. The Company argues that, from a policy and legal perspective, it turns the purpose of alternative regulation on its head to justify an earnings sharing plan for both competitive and noncompetitive services based on a perceived need to control earnings on competitive services.

The Company states that nothing in Article 13 of the Act evidences any concern about earnings levels for competitive services. The Company also contends that Staff's proposal for a separate "market power" test is fundamentally inconsistent with the structure of the Act. Section 13-502(b) requires only that a functionally equivalent alternative service be available to customers in order to classify an LEC service as competitive. The Company points out that the legislature could have but did not impose, additional requirements that the LEC also prove the existence of "effective competition" or "lack of market power."

The Company also contends that Staff's proposal for a market power test is fundamentally inconsistent with the Commission's treatment of other carriers in the past. When AT&T classified its services as competitive under the Act in 1986 in Docket 86-0003, AT&T still maintained a significant market share for many of these services, yet was allowed to remove its competitive services entirely from earnings regulation without having to satisfy any market power test. The Company contends that establishing one standard for earnings regulation of competitive services for interexchange carriers and a different, more restrictive standard for LECs would be unreasonable, discriminatory, and unlawful.

IBT argues that there is no basis for Staff's concern that the Company is earning excessive profits on its competitive services because the Company's service cost studies show that its competitive service category is essentially in equilibrium. That is, competitive service revenues exceed the total of competitive service LRSICs, imputed costs, and allocated costs by a relatively small margin (a $6 million margin on a revenue base of $150 million, or 5.2%). The Company explained that, since competitive service revenues must equal or exceed competitive service "costs" under Section 13-507, this small, positive rate/cost ratio relative to the category as a whole is appropriate. The Company believes that if the Commission is concerned about potential abuse of pricing freedoms at some point in the future, that issue should be addressed directly when it arises and not indirectly now as part of a price regulation plan.

The Company further contends that sharing cannot be justified on the assumption that Illinois Bell has an expectation of higher earnings over the next few years. The Company states that it presented detailed financial projections for the first five years of the plan, which were examined extensively by Staff and other parties, that do not show the increased earnings which some of the parties contend will exist. The Company asserts that there simply is no basis for assuming that there is some financial windfall looming on the horizon. Moreover, the Company contends that, while costs for certain of its inputs such as switching have declined on a unit basis, other major portions of its network, e.g., its outside plant, have experienced increased costs. The Company asserts that its total accounting costs -- the relevant consideration in terms of earnings -- are increasing year-over-year and are increasing faster than its revenues. Therefore, the Company claims that there is no foundation for the argument that it is a declining cost company that will benefit inappropriately from price regulation.

Illinois Bell argues against adoption of any sharing plan, but it particularly opposes the reverse taper proposal of the LDDS/ICPA and MCI. Dr. Harris testified that this "fine-tuning" of sharing would not improve it, but actually would make the economic impact of a sharing plan even worse. He explained that Dr. Cornell's proposal would impose a very high tax in the form of a high sharing payout. The Company takes the position that this effectively would negate whatever incentive effects sharing otherwise would create.

COMMISSION ANALYSIS AND CONCLUSION

Whether to adopt a sharing provision as a component of an alternative form of regulation of noncompetitive services is one of the most significant decisions the Commission will make in this proceeding. When analyzing this and all other issues, we have assumed that the policy goals, considerations, and mandatory findings which the General Assembly has identified, are as relevant to an examination of the specific features of an alternative regulatory plan as they are to an evaluation of the entire plan.

As we evaluate sharing with respect to the public policy goals declared in Section 13-103, the considerations identified in Section 13-506.1(a), and the required findings of Section 13-506(b), we find that, on balance, it would be inappropriate to incorporate a sharing provision in the alternative regulation plan that we adopt in this Order.

When sharing is evaluated with respect to the first consideration of Section 13-506.1, that of reducing regulatory delay and costs over time, it is readily apparent that a sharing provision fails this test. The record evidence indicates that a sharing provision creates a high probability that many of the same issues - evaluation of investments, expenses, allowable returns - which consume the resources of everyone involved in ROR regulation, would continue to be the subject of dispute. Certainly no party has alleged that a sharing provision would reduce conflict, save money, or speed up the regulatory process.

When sharing is evaluated with respect to whether it will encourage innovation in services and promote efficiency (considerations 2 and 3 of Section 13-506.1 (a)), a sharing provision has evident disadvantages. The parties who advocate a sharing provision do not claim that it will promote efficiency; most parties readily concede that the efficiency incentives from a pure price regulation plan would be greater. At best they assert that the sharing benchmarks can be set in such a way that the efficiency incentives would not be reduced unnecessarily. That claim is not supported by any empirical evidence. The efficiency disincentives of earnings sharing plans apparently never have been measured. We note the wide variety of sharing plans presented in the record - progressive retention, reverse tapers, symmetrical sharing, dead-zones, capped sharing; all with sharing benchmarks established at varying distances from varying ROR targets. It would seem likely that obtaining the benefits of sharing while avoiding excessive efficiency disincentives is subject to considerable uncertainty. Sharing provisions purport to protect against the risks of "misspecified" price regulation formulas, yet they may merely add additional uncertainties and cloud the ability to assess the success or failure of price regulation.

Section 13-506.1(a)(5) requires a consideration of whether the economic development of the State would be enhanced. A number of parties, including some who advocate sharing, have noted that price regulation does not guarantee investment in Illinois. We agree, but we believe that the appropriate solution to that problem is to create an economic climate which is as conducive to investment in Illinois as possible, consistent with essential ratepayer protections. Investments whose returns are subject to an earnings sharing "tax," would be conspicuously less attractive than equivalent investments elsewhere which would not be subject to earnings sharing. Section 13-103(f) declares, as a legislative policy, that development of and prudent investment in advanced telecommunications networks that foster economic development of the State should be encouraged. We believe that Illinois' economic development objectives are best achieved through elimination of barriers to investment; earnings sharing is one such barrier.

Section 13-506.1(a)(6) requires a consideration of whether fair, just and reasonable rates for telecommunications services will result. This is a reflection of the policy goal of Section 13-103(a) and the required finding of Section 13-506.1(b)(2). These sections of the Act are the focus of those parties who advocate a sharing provision. However, a close examination of the record evidence indicates that including a sharing provision is not warranted by this rationale. The key contention is that earnings sharing avoids the risk that the parameters of a price regulation formula were misspecified, and protects against excessive monopoly profits.

We believe that the risks identified above are minimized by various features of the alternative regulation plan we have adopted. First, we are adopting a price regulation formula and pricing provisions which are conceptually very similar to price regulation plans elsewhere. Theoretical consistency with price regulation plans in other jurisdictions ensures that if Illinois Bell experiences unusually high earnings which are attributable to the extraction of monopoly profits from services subject to the price regulation formula, it only can be the result of a shortcoming or systemic failure of price regulation generally (which should be detectable by monitoring the results of price regulation plans elsewhere). There is no evidence in this record that any telecommunications carrier subject to price regulation has enjoyed excessive monopoly profits.

Second, we have adopted a formula which includes an explicit adjustment to the GDPPI to reflect the variance between the historical input price experience of the Company and the experience of the economy as a whole. This eliminates an assumption which can be a significant source of uncertainty or misspecification in other jurisdictions. Third, we have used the results of Staff's revenue needs analysis, a variant of the traditional rate of return analysis, as a check on the reasonableness of the formula. Fourth, we have adopted the low end of the reasonable return on equity range when establishing initial rates under the plan. This ensures that in the unlikely event that the price regulation formula unduly favors the Company, there is an additional cushion to absorb the error.

We also note that if a company earns above a specified sharing level, one cannot assume that the price regulation formula necessarily was misspecified. As Staff points out in its Reply Brief, Ms. TerKeurst testified that wide swings in earnings <u>could</u> simply be an indication of inaccuracies in the price cap formula, rather than an indication of the Company's management capabilities. Nevertheless, Staff and the other advocates of sharing apparently believe that the <u>possibility</u> that earnings above a certain specified level are the result of price cap formula inaccuracies or of the exercise of market power necessitates that, without further analysis, those funds be recovered from the Company. A sharing provision addresses a possibility by rendering it a presumption.

It must be recognized that a decision not to implement an earnings sharing provision does not increase the likelihood that monopoly profits will be obtained. Sharing provisions do nothing to prevent monopoly profits; they merely make highly debatable assumptions about their incidence and measurement, and then redistribute revenues after they are obtained. We believe that as telecommunications markets have become more complex, with varying degrees of actual and potential competition, generalized assumptions such as those embodied in ROR sharing provisions become increasingly untenable. Attention should be focused on the prices and market conditions of specific services in order to determine whether anticompetitive and anticonsumer abuses have occurred.

The Commission therefore rejects Staff's argument that earnings sharing is necessary in order to protect against the exercise of market power by Illinois Bell with respect to its competitive services. Staff's concerns appear to be largely motivated by IBT witness Gebhardt's testimony that in his view, at least 50% of the Company's revenues currently classified as noncompetitive are generated by services where customers have competitive alternatives, and that he expects this figure to increase to over 80% by 1999, with significant numbers of services moved into the competitive category over the next few years. We believe that Mr. Gebhardt's predictions may have been predicated on an overly optimistic assessment of the existence and rate of growth of market competition, and/or an overly expansive interpretation of the statutory standard for reclassifying services as competitive. We will address service classification issues in greater detail in Docket 88-0412.

In reality, revenues from competitive services constitute only five percent of the Company's total revenues. There is no evidence in this record that Illinois Bell is abusing the pricing flexibility afforded it by the Act. The Commission retains oversight authority over the reasonableness of competitive service rates under Section 9-250 and that section may be invoked in the future if Staff or the parties believe that the Company's pricing practices for competitive services are unlawful. In addition, the Commission has the authority under Section 13-502(b) to investigate, on its own motion or upon complaint, the propriety of any classification of any service and, pursuant to Section 13-502(d), may order refunds to customers for any overcharges which may have resulted from an improper service classification. The Company is encouraged to utilize Section 13-502 (e) when it believes that reclassification of a service is appropriate.

E. Depreciation Regulation

As an integral component of its price regulation proposal, Illinois Bell requests Commission approval of a plan to permit the Company to establish its own depreciation policies outside of the existing depreciation prescription process. The Company argues that continued regulation of depreciation rates will not solve the capital recovery dilemma it says the Commission is facing. IBT emphasizes that, under its proposal, the costs of any imprudent investments would be borne by its shareholders and not by its ratepayers. It contends that the decision whether to deregulate depreciation rates cannot be deferred for several years because by that time it may be too late to avoid confiscatory write-offs. The Company acknowledges that, as a practical matter, regulators are generally reluctant to relinquish control over depreciation rates under a sharing plan. That is because depreciation rates can have a significant effect on a company's earnings, and so regulators fear that a company will avoid sharing of earnings by accelerating depreciation. The Company reasons that this conflict between adequate capital recovery policies and sharing provisions is another argument against sharing.

Staff take the position that the Commission must continue to regulate IBT's depreciation policies in order to ensure that rates remain just and reasonable and to maintain the integrity of the LRSIC and imputation studies.

The Attorney General also proposes constraints on the Company's ability to set its own capital recovery policies as part of its earnings sharing plan. Under Dr. Selwyn's proposal, depreciation rates for existing plant would be capped at today's levels. The Company would be required to write off its existing $559 million reserve deficiency. On a going forward basis, the Company would be allowed to set its own rates for new plant, based on the life assumptions used in engineering analyses supporting the investment. However, it could do so once and once only; any future capital recovery shortfalls would also have to be written off. Within these constraints, however, there would be no Commission oversight of the Company's depreciation rates.

Dr. Selwyn took the position that firms facing market-determined maximum price levels for their services must frequently make extraordinary adjustments in the value of their assets. He testified that any write-off necessary to reflect changing technology or market conditions that were not anticipated at the time the acquisition decision was made should be charged against shareholders, as would be the case for any nonregulated firm. Dr. Selwyn took the position that his proposal would join the capital budget process and depreciation in an appropriate fashion. MCI adopted Dr. Selwyn's depreciation proposal.

In its Initial Brief, CUB argues that Illinois Bell's proposal to eliminate Commission oversight of its depreciation activities amounts to an invitation for the Company to manipulate its short-term financial results, while leaving the quality of the local network for the monopoly ratepayer at risk. CUB maintains that there is a danger that the Company will artificially inflate its depreciation expense levels in order to avoid automatic rate decreases under a price caps or earnings sharing environment. CUB witness Brosch asserted that all comparability between authorized and achieved earnings and rates of return is lost when a company is permitted to forego reporting depreciation accruals. As such, the Commission's ability to review the reasonableness of overall rate levels is severely impaired. CUB also notes that even if alternative regulation is adopted now, the Commission may wish to return to traditional rate of return regulation at some point in the future. Mr. Brosch asserted that IBT provides no guarantee that it will book depreciation expense accruals in the future to credit ratepayers with the amounts of depreciation being collected in tariffed rates.

CUB witness Currin recommends that once a reasonable level of depreciation expense is established under price regulation, the Commission's focus should primarily be on the establishment of minimum levels of depreciation expense, calculated as a function of access lines or revenues. Mr. Currin also recommended that upper limits on depreciation expense be established for IBT under price cap regulation. According to Mr. Currin, the Company's year-to-year depreciation expense could be increased by as much as 10% over the previous year and would provide for investment and customer growth, as well as provide IBT with sufficient flexibility for adjusting depreciation expense to reflect changing business developments.

Illinois Bell takes the position that none of the parties meaningfully addressed the capital recovery issue. To the extent that Staff perceives continued review over depreciation rates to be necessary because of their impact on earnings and, therefore, on the earnings available for sharing, the Company believes that the right solution is not to adopt earnings sharing at all. The Company further states that oversight of depreciation rates is not needed to ensure reasonable rates. Since Illinois Bell is not seeking an increase in customer rates needed to meet its capital recovery shortfall, there is no rate impact. The Company argues that continuation of the status quo, as Staff recommends, is simply not sustainable over the long run. Illinois Bell states that it is offering the Commission and the Company's ratepayers a way out of this dilemma on extremely favorable terms and that the opportunity should not be passed up.

IBT maintains that Dr. Selwyn's capital recovery proposal is totally unreasonable and unlawful. The Company states that it has used its best efforts to set appropriate depreciation rates in the past. It argues that its depreciation rates are too low in part because the marketplace and technology have been changing more rapidly than anyone predicted even five years ago. The Company further argues that its depreciation rates are also too low because regulators have consistently set them too low, deferring the cost of capital recovery to future ratepayers. Illinois Bell points out that, since 1984, both the FCC and this Commission have allowed much lower increases in depreciation accruals in virtually every represcription than what the Company had requested. For example, the Company points out that, had this Commission approved Illinois Bell's depreciation proposal in Docket 89-0033, its reserve deficiency today would be $360 million instead of $559 million.

IBT also argues that Dr. Selwyn is wrong that this shortfall would be written off in competitive markets. Dr. Harris testified that managers in unregulated firms can and do change depreciation rates as soon as they recognize that their current rates are too low; they then try to manage the recovery of their investments based on the new life expectations within the constraints that the marketplace imposes on their pricing. Dr. Harris stated that most firms do this successfully. Dr. Harris testified unequivocally that firms in competitive markets are not frequently required to make extraordinary adjustments, that investors expect a return of their capital and that they would take a very dim view of repeated write-offs. The Company argues that mandatory write-offs would violate long-established legal prohibitions on confiscation of utility property, since these investments were prudently made to meet its franchise obligations.

COMMISSION ANALYSIS AND CONCLUSION

In light of the Commission's decision to adopt price regulation without a sharing provision, it would be imprudent for the Commission to continue to set IBT's depreciation rates. The plan adopted in this docket insulates ratepayers from the effect of higher depreciation rates. There is little need to control depreciation rates under this method of regulation.

The Commission is of the opinion that a capital recovery dilemma exists. As new technologies emerge and old equipment becomes obsolete, Illinois Bell must have the ability to respond quickly. llinois Bell will not be able to compete effectively if it is hindered in its ability to implement new technologies quickly. Under rate of return regulation or price cap regulation with sharing, the Commission is reluctant to relinquish control over depreciation because of the effect that accelerated depreciation has on rates.

In making a decision as to the depreciation rate for a particular asset, the Commission must balance the interests of all ratepayers. Under ROR regulation, the Commission is reluctant to raise telephone rates when the increase is caused by increased depreciation of equipment which satisfies the needs of most ratepayers.

However, by controlling depreciation, the Commission implicitly controls the pace of IBT's investments, and the direction that the telecommunications industry is progressing. This is the heart of the dilemma that the Commission is now facing and it is one of the main reasons for adopting alternative regulation.

IBT will soon be able to offer new services that it was not able to offer to the public in the past. IBT will have to make additional investments to provide these services. The Commission cannot require the average ratepayer to pay for these investments and bear the risks that go along with such investments. If ROR regulation were to continue, the Commission will have the tendency to protect ratepayers at the expense of stifling progress. Under the plan that the Commission is adopting in this case, the Commission is protecting ratepayers <u>and</u> stimulating, rather than stifling, progress. Permitting IBT to set depreciation rates is an integral part of this plan.

The Commission rejects Staff's assertion that continued control over depreciation policies is necessary to protect the integrity of cost of service and imputation studies. There is simply no basis in the record to conclude that the depreciation policy flexibility IBT seeks involves any likelihood that it could be used to manipulate the results of the studies; or if such manipulations can and do occur they would be undetectable and irremediable. As stated in a later section of this Order, the Commission will closely monitor IBT's formulation and application of depreciation rates. The Commission will not tolerate any abuses that manipulate the results of the imputation and cost studies. Any detected abuses will result in a reevaluation of the alternative regulation plan pursuant to Section 13-506.1 (e) of the Act.

There can be little doubt that permitting the Company to establish depreciation policies would enhance the financial position of the Company at no cost to the ratepayer. Investments could be more readily financed and economic conditions, not regulatory considerations, would be the primary determinant of equipment replacements.

F. Service Quality

Illinois Bell proposes the inclusion of a service quality component in the price index formula that would result in an upward adjustment if the Company improves service and would result in a downward adjustment if service deteriorates. The purpose of this feature purportedly is to guard against any erosion in the Company's service quality levels and to create incentives for the Company to improve service quality by rewarding it if service quality is superior. Illinois Bell witness Ms. Rita Gaskins identified eight separate quality of service measures for tracking and monitoring the Company's performance: (1) percent installation within five days, (2) trouble reports per 100 access lines, (3) percent out of service over 24 hours, (4) percent dial tone speed within three seconds, (5) operator average speed of answer -- toll and assistance, (6) operator average speed of answer -- information, (7) operator average speed of answer -- intercept and (8) trunk groups below objective. Seven of these eight measures already are part of the Commission's service monitoring and reporting rules.

The Company proposes to base the service quality benchmark on its actual performance during 1990 and 1991. Under the Company's proposal, each of the eight measures is given equal weight in calculating the service quality component. For each measure, the Company receives a score of zero if it meets the benchmark, a score of +.25 if it exceeds the benchmark and a score of -.25 if it fails to meet the benchmark. The maximum downward service quality adjustment in any year is 2% and the maximum upward adjustment is 0.6%. Thus, the Company notes, its proposal has more potential for a negative adjustment than for a positive adjustment.

The AG supports Illinois Bell's service quality proposal with one important modification. Dr. Selwyn testified that the service quality adjustment should act only as a potential penalty and should not provide a potential reward to the Company. In Dr. Selwyn's view, if the "going in" level of service quality at the outset of the plan is appropriate, there would be no reason to reward Illinois Bell for improvements in service quality which go beyond current levels, particularly since improved service quality may require excessive cost increases. Accordingly, he recommends that only the penalty portion of the Illinois Bell formula be retained. MCI agrees with his position on service quality.

Staff also takes the position that the service quality adjustment should be downward only. In addition, Staff proposes more comprehensive modifications to the way in which Illinois Bell would compute the service quality component of the index. Staff concurs in the use of the eight quality of service measures identified by Illinois Bell. Under Staff's plan, each of the eight measures can range from zero to -.25. The maximum downward adjustment is 2%; there is no upward adjustment.

Staff's preferred approach, however, is to measure service quality performance separately in each of the six area codes in Illinois. Staff acknowledges that this is possible and useful only for measures 1 through 3 identified above. For these items, Staff proposes that the Company compute each service quality measure based on the Company's annual performance and report its performance separately for all area codes, each of which would be accorded equal weight. Of course, that equal weighting approach might focus the Company's attention on those more sparsely populated area codes where service quality is cheaper to attain. Under Staff's proposal the "percent installation within 5 days" measure can range from 0 to -.25. The performance for each area code would be calculated separately and assigned a score of 0 or -.05 depending on whether the annual performance in that area code met or fell below the benchmark standard.

For service quality measure 4, Staff recommends the continuation of semiannual reporting of "percent dial tone speed of answer within 3 seconds" on a statewide basis. The service quality adjustment for this item would be assigned a score of -.1 if the service level falls below the benchmark in one six month period, and a score of -.25 if the service level falls below the benchmark in both six-month reporting periods. Where it is not possible or useful to perform these calculations by area code (measures 5 through 8), the Staff proposes that the Company calculate a statewide score, but that it do so monthly. Each month, for each of these four service measures, the Company would receive a score of zero or -.01, depending on whether it met or fell below the benchmark standard, up to a maximum of -.25. Staff suggests that the benchmark standards set out in Section 730 of the Commission's rules be used rather than the standards proposed by the Company.

Finally, Staff recommends that special programs, such as the Communications Intensive Household ("CIH") program, be excluded from measurements of service quality in order to ensure that such programs are not allowed to degrade the quality of service to other customers with limited competitive alternatives.

The Company opposes the modifications proposed by Staff, the AG, and MCI because IBT asserts that they virtually would guarantee a negative service quality adjustment and would provide no financial incentive to the Company to improve service quality. The Company disputes Dr. Selwyn's view that the "going-in" level of service quality necessarily is appropriate. The Company states that many of its customers have evidenced an interest in receiving a higher quality of service and that some reward is appropriate if the Company is able to achieve it. The Company also contends that Staff's proposal is improperly biased because the Company would have no opportunity to balance negative months with positive months. Finally, the Company took the position that CIHs should not be excluded from the measurement of service quality because nothing about a CIH designation decreases the quality of service which the Company provides to its other customers. The Company agrees, however, that if a downward-only adjustment is approved, the Staff's proposal to use the service standards in the Commission's rules should be adopted.

COMMISSION ANALYSIS AND CONCLUSION

After careful consideration of this issue, the Commission concludes that it will not adopt a service quality component for the price cap formula. We recognize that one of the theoretical risks of price regulation is that the Company may, while seeking to maximize its income, reduce expenditures in certain areas in such a manner as to impact service quality adversely. However, we are not persuaded that the development of an elaborate scoring system as suggested by the parties, and its incorporation into the pricing formula, are the most appropriate way to guard against this eventuality.

The service quality measures set forth in 83 Illinois Administrative Code Part 730 are intended to be minimum standards which all LECs must meet. Incorporation of these standards into the price cap formula essentially would assume that they capture all relevant aspects of service quality adequately, and are established at appropriate levels. Although the standards were updated most recently in 1991, we already are concerned that they may require revisions. Illinois Bell's testimony that numerous customers have indicated an interest in receiving improved service quality and the Company's initiation of the CIH program support this conclusion. In addition, appropriate assessments of service quality require adaptation to the changing telecommunications environment. As new technologies and services are introduced, the Commission must refocus its attention on many associated service quality issues which may not be addressed completely by the existing standards. Emergency preparedness, the reliability of network interconnections between unaffiliated carriers, the increased likelihood of software-related failures coincident with the introduction of advanced technologies, and data transmission quality, are just a few of the service quality issues which the Commission intends to monitor.

Finally, we believe that the inclusion of a service quality component in the price regulation formula unnecessarily would confuse the difficult-to-quantify service quality issues with the market-oriented economic considerations underlying price regulation. The concept would introduce an additional element of uncertainty into the transition to price regulation and a potential complicating factor into the measurement of the impact of the change. A price cap formula which reflects only economic considerations will simplify administration of the alternative regulation plan and also should enhance public understanding and acceptance of the change in regulatory approach.

We conclude that the best way to ensure that an alternative form of regulation will maintain the quality of telecommunications services is to require that the plan include reporting of the service quality standards identified by IBT witness Gaskins and Staff witness Talbott. The reports should be provided in the format and with the frequency recommended by Mr. Talbott in his rebuttal testimony (ICC Staff Exhibit No. 13.01, Schedule 1 - MODIFIED), but without assignment of price cap formula adjustments for failure to meet benchmark factors. The Staff will be directed to report to the Commission, on a quarterly basis, its analysis of the reports submitted by the Company together with an identification and assessment of any other significant events or activities which may impact adversely the quality of service provided by Illinois Bell. Any marked deterioration of service quality, whether identified through the service quality reports required here or through the use of any new measures the Commission may develop in the future, will lead to a reassessment of the alternative form of regulation, pursuant to Section 13-506.1 (e).

G. <u>Exogenous Changes</u>

Price index formulas adopted in some jurisdictions have included a provision for "exogenous" changes, i.e., changes in costs over which the telecommunications carrier has no control. Ms. TerKeurst testified that it was reasonable to allow reflection in a price cap mechanism of certain very limited types of cost changes outside the Company's control. She stated that the ability to adjust rates in order to recognize exogenous cost changes would improve the accuracy and sustainability of the price index mechanism and would reduce the risks to both shareholders and customers. She testified that recognition of exogenous factors, if properly limited, would not be contrary to what happens in competitive markets where prices of different goods increase at different rates depending on industry cost variances. She stated that it would be premature to give up the ability to require flow-through of significant external cost decreases and that such an ability is entirely consistent with the goals of price regulation because it is an adjustment for factors which are not within the Company's control.

Ms. TerKeurst provided several examples of costs that could qualify for exogenous treatment under her proposal, including tax changes with disproportionate effects on the Company or telecommunications industry, separations changes and regulatory accounting changes, as well as IBT-specific items such as the ending of the Company's reserve deficiency amortization program in 1999, the Customers First plan and the reclassification of services from noncompetitive to competitive status.

She testified that the range of exogenous factors cannot be foreseen completely, but that the following guidelines would be appropriate in order to determine whether certain events qualified for exogenous treatment. First, in order to avoid double-counting, she stated that reflection of exogenous cost changes should be allowed only for costs that would not be picked up in the economy-wide inflation factor. Second, she contended that the financial effects should be verifiable and quantifiable in order to avoid protracted and controversial litigation. Finally, Ms. TerKeurst recommended that a threshold of positive or negative $3 million be established in order to limit regulatory oversight to only those factors which could affect Illinois Bell's earnings significantly. She proposed that rate changes due to application of statutory imputation requirements when a service is classified as competitive should be treated as an exogenous factor to reduce the price cap index used for noncompetitive services.

Mr. Gebhardt testified on behalf of Illinois Bell that the Company's price index proposal includes no provision for exogenous changes, for two reasons. First, the Company believes that exclusion of exogenous changes is more consistent with a competitive model because competitive companies have neither an automatic right to increase prices nor an obligation to decrease prices when there are changes in the external environment. Second, the Company states that the exogenous change factor issue has tended to be contentious in other jurisdictions. Debates over what kinds of changes should be incorporated in the index would increase the cost of regulation. The Company notes that AG witness Dr. Selwyn agreed with the Company that the price index formula should not include an exogenous change factor, although Dr. Selwyn's position is based on his perception that it has been abused by LECs in other states.

Mr. Gebhardt further testified that, in the event the Commission were to incorporate exogenous changes into the price index mechanism, it clearly must specify the types of cost changes that qualify for exogenous treatment in order to avoid future uncertainty and litigation. In particular, he testified that any exogenous change provisions should be limited to regulatory accounting changes and changes in separations; Dr. Selwyn agreed with this position.

Mr. Gebhardt testified that the Company would accept Ms. TerKeurst's proposal to treat the ending of the depreciation reserve deficiency as an exogenous change if two conditions are met. First, he stated that revenues must be increased equal to the revenue requirement going into the plan. If Illinois Bell assumes a substantial revenue requirement shortfall going into the plan, as the Company proposes, he contended that ratepayers would not be paying for the amortization of the reserve deficiency during the first five years of the plan and, therefore, would not be entitled to the amortization's full value in rate adjustments when it ends. Second, he argued that the reserve deficiency amortization associated with the analog switching account must be removed from the adjustment calculation and netted against the change in the digital switching account which contains the equipment that replaces the analog technology.

The Company takes the position that Staff's recommendation that service reclassifications be treated as exogenous events is not necessary. In the Company's view, most services to be reclassified are likely to pass both the imputation and cross-subsidy tests. When rate adjustments are required, they are not likely to be significant. However, if exogenous treatment of service reclassifications is required, Mr. Gebhardt maintains that only competitive service price increases that are required to pass the cross-subsidy test should result in an adjustment to the price index -- not adjustments which are required to pass the imputation test, because of the different legislative purposes underlying each requirement. The Company's position is premised on the fact that the purpose of the cross-subsidy test of Section 13-507 is to protect noncompetitive ratepayers; whereas the purpose of the imputation standard is to protect competitors. The Company also accepts special consideration of the outcome of the payphone complaint case (Docket 88-0412), whether as a known change, if it is decided before this case, or as an exogenous change, if it is decided after this case.

Second, Mr. Gebhardt testified that an adjustment for service reclassifications should not be required unless rates going into the plan produce revenues sufficient to meet the Company's stated revenue requirement. If the Company's current revenues are less than its traditionally determined revenue requirements, then noncompetitive ratepayers are not bearing the burden of those noneconomic costs at all -- shareholders are. He argued that, under these circumstances, an additional downward adjustment to the price index when a service is reclassified, and prices are increased to cover the Company's obligation under Section 13-507, would provide financial benefits to noncompetitive ratepayers to which they simply are not entitled.

COMMISSION ANALYSIS AND CONCLUSION

The Commission views the proposal for an exogenous change factor as a recognition that a price regulation formula is in essence, a gross simplification of a traditionally complex public policy-making process. It cannot be expected that a formula will always reflect changing circumstances and fairly balance competing interests with the same effectiveness as can occur through adjudicatory proceedings. However, it cannot be assumed that including an exogenous change factor in the price regulation formula is necessarily the best way to ensure that changing circumstances are fairly reflected under an alternative form of regulation.

The Staff proposal attempts to develop criteria for assessing the unknown. It would certainly be convenient if future events could be accounted for solely with reference to an identifiable and readily quantified change in the Company's cost structure. The price regulation formula could then be simply updated without litigation, as Staff posits. Unfortunately, our experience suggests that such situations are likely to be extremely rare. Even the examples which Staff identifies as qualifying for exogenous treatment under its proposal do not appear to be readily quantifiable and free of contention. Under the Staff proposal the Company would, on an annual basis, identify exogenous cost changes and propose adjustments to the price index. It is unlikely that the Company would request changes to reflect exogenous cost reductions with the same alacrity it would request reflection of exogenous cost increases. We agree with Dr. Selwyn that an exogenous change feature as recommended by Staff, invites abuse. However, we also believe that Illinois Bell's "set it and forget it" approach to the price regulation formula is equally unrealistic.

Ultimately, the Commission is responsible for ensuring that the conditions set forth in Section 13-506.1 (b) continue to be satisfied under an alternative form of regulation. The precise nature of events which may challenge the continued appropriateness of particular parameters of the alternative regulation plan we are adopting, cannot be specified in advance. At best, the Commission can address a few issues which are likely to arise in the future.

The Commission is persuaded that exogenous treatment of price adjustments required by aggregate revenue tests associated with a service reclassification is warranted in order to properly implement the cross-subsidy protections under the Act. However, we agree with Illinois Bell that price adjustments associated with the imputation requirements, which are intended to protect competitors, do not imply a need for offsetting noncompetitive rate changes. We note the Company's commitment to accept full exogenous treatment for the results of Dockets 88-0412 and 93-0044.

It is possible that the Customer's First Proposal (Docket 94-0096), if adopted in some form, may require changes to the price regulation formula or other substantive provisions of the alternative regulation plan. We will not attempt to speculate at this time regarding what changes, if any, would be needed.

We are also unpersuaded that the public interest requires that we determine, at this time, an appropriate treatment for the ending of the depreciation reserve deficiency amortization in 1999. This matter is an appropriate subject for discussion during the proceeding which evaluates the results of the initial term of the price regulation plan.

H. Basic Residence Service Rate Freeze

Section 13-506.1 (c) provides that an alternative regulation plan must provide that, for the first three years that the plan is in effect, basic residence service rates shall be no higher than those rates in effect 180 days prior to the filing of the plan. The statute defines basic residence service rates as the monthly recurring charges for the carrier's lowest priced primary residence network access lines, along with any associated untimed or flat rate local usage charges.

On July 27, 1993, the Commission directed the parties to address a number of issues in the rebuttal phase of this proceeding. Among the issues, the parties were asked to identify the benefits and drawbacks of a Commission-approved alternative regulation plan which would freeze residential rates at current levels until the year 2000.

IBT witness Gebhardt responded that he assumed that the residential rates to be frozen were basic residential rates as defined in Section 13-506. He stated that a freeze on basic residential rates could be perceived by customers as a significant benefit, because the Company otherwise might tend to increase basic residence rates to the maximum allowed under the price cap index formula. He maintained that the principal drawback of a rate freeze proposal is that it would perpetuate the existing rate/cost relationship inbalance for residential access and the pricing disparities between residence and business rates for the duration of the freeze. He said that, assuming that the price index allowed rate increases, the Company would be required to forego revenues in the amount of $144 million over the period of the plan. He then stated that Illinois Bell would be willing to accept such a freeze only in the context of a reasonable overall plan of pure price regulation applicable to noncompetitive services.

Staff witness TerKeurst identified most of the same advantages and disadvantages as Mr. Gebhardt delineated. She noted that to the extent that basic residential rates may be below LRSICs, the freeze could preserve an existing subsidy that may be broader than needed to maintain universal service. If the regulatory plan also includes a price cap index mechanism, other services might increase more than they would if residential rates were not frozen.

COMMISSION ANALYSIS AND CONCLUSION

The Company's proposal provides that there will be no increase in tariffed rates for basic residential services for the first three years of the plan. These include residence network access lines for Access Areas A, B, and C; Band A residence usage service; and flat rate residence usage service in those exchanges where usage-sensitive service is not yet available. We conclude that IBT's proposal complies with the requirement of Section 13-506.1(c).

However, we believe that the three-year basic residential rate freeze is a minimum provision mandated by law, which an alternative regulation plan must contain in order to be considered and approved by the Commission. We believe that we have the authority to extend the term of the basic residential rate freeze if we conclude that it is necessary in order to ensure that the conditions set forth in Section 13-506.1 (b) are met.

We conclude that it is appropriate to extend the period during which basic residential service rates will be frozen, to the full five-year initial period of the alternative regulation plan that we are adopting. A residential rate freeze will help to ensure that telecommunications services will be available to all Illinois citizens at a just, reasonable, and affordable rate, consistent with the goals identified by the General Assembly in Section 13-103 a), and will help to ensure the achievement of the conditions identified in Sections 13-506.1 (b) (1), (2), (6), and (7). Residential ratepayers at all income levels can be assured that basic telephone service will continue to be available to them at today's prices for the next five years, regardless of the results of the price regulation formula. We note the Company's stated intention to raise residential access line rates to the maximum permitted under the alternative regulation plan. By extending the residential rate freeze, the Commission thereby intends to guarantee that adoption of price regulation cannot harm the residential ratepayer.

The rate freeze will protect access to the telecommunications network and a base level of universal service for every citizen of Illinois during a period in which the Commission must turn its attention toward reexamining the appropriate scope of universal service, and must grapple with the complex social and economic issues associated with new technologies and emerging competition. By extending the rate freeze an additional two years, we believe we also are enhancing the opportunity for the General Assembly to consider the issues mentioned above and to assess the effectiveness of the policies we have adopted, in preparation for the sunset of the Universal Telephone Service Protection Law of 1985 on July 1, 1999.

With respect to the price/cost disparity, we agree that it is unfortunate that some disparity also will be frozen in place, but we believe that the preservation of universal service represents a matter of public interest which overrides rigid adherence to pure cost-based pricing. We believe that social subsidy issues are likely to become increasingly and almost unavoidably common in the future. Since this Commission has been quite aggressive in eliminating cross-subsidies and price/cost disparities where feasible in the past, the extension of the rate freeze does not pose as much difficulty in Illinois as it might pose in other jurisdictions.

I. <u>Service Baskets</u>

The price index formula herein described would be applied to the Company's services which are grouped into categories or "service baskets": (1) Residential Basket, consisting of Band A through Band D usage, including volume discounts, touch-tone, Starline, multi-ring, custom calling, advanced custom calling, and non-recurring charges); (2) Business Basket, consisting of business network access lines, Band A through Band D usage, including volume discounts, touch-tone, network ISDN, custom calling, advanced custom calling, ACBS, remote call forwarding, WATS, and non-recurring charges); (3) Carrier Basket, consisting of switched access, special access, cellular access and LIDB, and (4) Other Services Basket, consisting of directory services, Chicago Name and Address, payphone, directory assistance, private line, and operator services. E-911 service is excluded from the plan. Intrastate toll service also is excluded, at least initially. Staff recommends that the Company's proposal with respect to service baskets be adopted. DOD/FEA also agree with the Company's selection of service baskets.

LDDS witness Joseph P. Gillan testified that Illinois Bell's alternative regulation plan cannot be expected to result in just and non-discriminatory access rates because the plan accepts any rate/cost imbalances in Bell's existing rate schedule and allows prices to drift farther from costs, constrained only by a marginally adjusted rate of inflation. He contended that the Company has both the incentive and the ability to shift rates between services within the same service basket in order to increase the price of services required by its competitors and to decrease the price of services for which those competitors compete. As an illustration, Mr. Gillan alleged that Illinois Bell could reduce local transport rates to undercut its competitors, while raising switching rates to recover the lost revenues. He opposes the Company's service basket proposal because, he contends, it permits the Company too much pricing flexibility which could be used to harm its competitors.

With respect to the issues raised by LDDS/ICPA, Mr. Gebhardt testified that Mr. Gillan's concerns are addressed to Illinois Bell's access charges and more specifically to its intrastate local transport rates. The Company has filed restructured local transport rates with the Commission which mirror rates approved by the FCC. He further emphasized that Staff plans to request the Commission to initiate a proceeding that would investigate these rates. If any change in access rates is found to be appropriate by the Commission at the conclusion of such an investigation, the Company commits to using such altered rates as a basis for the carrier price index set forth in the plan.

Mr. Gebhardt also responded to Mr. Gillan's concern over pricing flexibility. Mr. Gebhardt contended that the pricing formula set forth in the plan allows the Company appropriate flexibility for responding to competitive pressures within the access basket of services, while at the same time setting a price cap for that basket and for individual services. He asserted that the Company would not use the flexibility afforded by the price index plan in order to raise any intrastate carrier access rate above the interstate level and that all Commission prescriptions of carrier access rate levels would be observed, unless an appropriate petition were filed and granted.

Staff witness Rettle recommended that Illinois Bell be allowed to offer temporary price promotions for individual services and to offset those promotional rate decreases with increased rates for other services within the same service basket. However, she recommends one safeguard for such temporary price promotions for services in the residential basket. Staff is concerned that the Company could increase basic service rates to offset a temporary price promotion. Therefore, she proposes that the Company be prevented from increasing rates for residential network access lines and Band A usage in order to offset temporary price promotions for other residential services.

Staff does not recommend that this procedure be followed for other baskets since they do not include highly price-inelastic services like basic residential service. No party objected to Staff's recommendation.

Under the Company's proposal, basic residential service would be excluded from the operation of the price index during the price cap period. In other words, the Company would not consider revenues attributable to basic residential service when calculating how much IBT would be permitted to increase or decrease its prices at the beginning of each year as a result of the change in the price index formula.

Staff takes the position that all noncompetitive services, including basic residential service, should be included in the price index calculation because the costs of providing the services are expected to change regardless of whether the prices change. If the price index decreases rather than increases in some years, Staff contends that the effect of excluding basic residence service would be to preclude rate reductions which properly should be made. However, Staff recognized that if the price index increases in any of the first three years, the price increase allowed for the residential basket could be obtained only from non-basic residential services.

The Company objected to Staff's recommendation that basic residential service revenues be included in the determination of allowable price changes during the first three years of the plan. Mr. Gebhardt testified that Staff's proposal would be inconsistent with the legislative purpose underlying the cap on basic residential rates. He explained that, in the event rate increases were allowed, Staff's plan would permit the Company to increase the price of non-basic residential services in order to recoup the revenues foregone as a result of the rate cap on basic services. He analyzed the relative effects of excluding or including capped services on allowed rate increases over the period of the plan and concluded that Illinois Bell would be able to increase residential rates by $38 million more if capped services were included.

The Company maintained that since network access constitutes approximately 60% of the total residence basket, there also is an issue regarding the feasibility of obtaining rate increases of an offsetting magnitude from the remaining 40% of the included services. Mr. Gebhardt recognized that Staff's proposal also would increase the magnitude of any reductions required by the price index, which he believed was the motivating factor behind Staff's recommendation. However, he testified that it would not be the Company's intention to reduce rates for network access. The Company does not believe that it would be realistic or appropriate to reduce the relatively small number of non-capped residential services by offsetting amounts based on the whole category of residential revenues.

COMMISSION ANALAYSIS AND CONCLUSION

The Commission concludes that all of the Company's revenues should be included in the calculation of the price index, as Staff recommends. The concerns raised by Mr. Gebhardt were primarily based on the assumption that the price regulation formula would yield Illinois Bell regular rate increases. Given our selection of a total offset of 3.8%, and current GDPPI projections, this is unlikely to be the case. Accordingly, Staff's recommendation is adopted.

The Commission is of the opinion that with respect to the composition of the service baskets, the Company's proposal is reasonable. The Company's longstanding practice of mirroring FCC-approved access charges, its commitment not to raise any intrastate carrier access rate above the interstate level, and its legal obligation to comply with whatever decisions are rendered by the Commission in other proceedings involving carrier access charge rate levels and rate structures, largely address LDDS/ICPA's concerns regarding the need for additional baskets to embrace access services.

However, with respect to pricing flexibility within the baskets, Mr. Gillan has identified an issue which concerns the Commission and which has not been addressed in great depth in the record. Illinois Bell's proposal would allow it to make annual price adjustments to individual services in the baskets within a band of plus or minus 5% of the price cap index. In other words, if the index increased by 3%, the Company could raise the price of a service in a particular basket by as much as 8%, provided corresponding equivalent adjustments in the opposite direction were made to prices of other services in the basket. This 5% pricing flexibility feature creates the possibility that the Company could raise prices on those services for which it faces inelastic demand while decreasing prices for services for which it faces elastic demand. We note that if the price of two services which are equivalently priced going into the plan, and the Company is able to raise one price of one service by the maximum 5% each year, while lowering the price of the other service by the maximum 5% each year, at the end of five years the first service would be priced more than 60% higher than the other service.

We believe that the Company should be allowed some reasonable pricing flexibility to respond to the marketplace and gradually to restructure rates that are not economically rational. However, the Company should not interpret our endorsement of an alternative regulation plan as an abandonment of our long-standing commitment to marginal cost-based prices, nor as an approval of Ramsey pricing. The Commission wishes to make clear that by approving an alternative regulation plan, we will not abdicate our responsibility to scrutinize the pricing practices of the Company, and we will suspend proposed price changes where warranted, even if the proposed price changes are in technical compliance with the price regulation formula.

J. Cost-of-Service Issues

1. LRSIC Studies

The Company, through the testimony of Richard Hillstrom and William Palmer, presented the long run service incremental costs ("LRSICs") developed for both noncompetitive and competitive services provided by Illinois Bell. The Company also presented Dr. Richard Emmerson as its expert service cost witness. The LRSICs were developed to serve as inputs for the Aggregate Revenue Test which is required by Section 13-507 in order to ensure against the cross-subsidization of competitive services by noncompetitive services.

In developing the LRSICs for IntraMSA Calling and Switched Access Services, Illinois Bell utilized the Network Cost Analysis Tool ("NCAT") model. In order to determine the incremental volume sensitive usage costs, a 10 percent static demand change to the usage records in the data base was applied. MCI witness Dr. Nina Cornell contends that the costs developed actually are long run incremental costs ("LRICs") rather than LRSICs, with the result that the Company potentially has understated its costs. Dr. Cornell maintained that the NCAT model uses marginal costs as a surrogate for total demand in analyzing usage service cost. She said that determining the additional costs incurred by adding a certain quantity of output on top of an existing level of demand results in LRICs rather than in LRSICs.

Staff witness Ms. Meena Thomas reviewed the methodology and computations involved in the development of the LRSICs and found them to be adequate to serve as inputs in the Aggregate Revenue Test. Her evaluation of Illinois Bell's LRSIC studies was based on the LRSIC standards proposed by Staff in Docket 92-0211. Staff contended that it is reasonable to use a 10 percent static demand change, since the Company demonstrated that the costs per minute and per message remain the same whether a 10 percent demand change or a 100 percent demand change is applied to a given number of usage records. This is true because any percentage change in usage demand results in a proportional change in total investments for setup and duration, thereby resulting in the same volume-sensitive unit costs. Furthermore, Ms. Thomas observed that costs developed by NCAT are then multiplied by the total demand for the service in question, consistent with Staff's proposed cost of service rule in Docket 92-0211. Therefore she disagreed with Dr. Cornell's characterization of NCAT as an LRIC rather than an LRSIC cost analysis tool.

In its Reply Brief, AT&T agreed that Illinois Bell's LRSIC studies were appropriate, but only because the Company demonstrated by its sensitivity test that the per unit cost remained static and that the static unit cost then would apply to the total service demand.

Sprint witness Jamison argued that the LRSIC of a service should reflect shared costs, including common overhead costs. The Company identified shared costs which are incremental to two or more services and assigned these costs to the individual services within the group based on the ratio of the LRSIC of individual service in the group to the total LRSIC of the group of services sharing the cost.

IBT witness Palmer maintained that Mr. Jamison's contentions ignore Section 13-507, which requires the allocation of only common overhead and residual costs to competitive services in the aggregate and noncompetitive services in the aggregate. Staff and the Company maintain that LRSIC, or the total incremental cost of a service as defined by IBT witness Emmerson, includes the future costs avoided (or added) by discontinuing (or offering) an entire service, holding constant the production levels of all other services produced by the firm. They explain that Mr. Jamison has defined the total incremental costs as including all of the service-specific fixed costs and volume-sensitive costs. Shared costs, as defined by Mr. Jamison, reflect all costs incremental to the set of services sharing the costs and are unaffected by a subset of these services. Staff and the Company maintain that, based on Mr. Jamison's own testimony, it would be inconsistent with his definition of total incremental cost of a service to include costs that are shared costs and that are not directly attributable to the service in question.

Staff and the Company further agree that Section 13-507 recognizes that LRSICs for a group of services would include costs shared by that group of services. The apportionment of common costs, such as common overhead costs, is to be made between the groups of competitive and non-competitive services in the aggregate. Common expenses should not be included in the LRSIC of any individual service. Thus, it would be consistent with Section 13-507 and the cost principles contained in Staff's proposed rule in Docket 92-0211 if shared costs are recovered from the group of services sharing the costs, and common overhead costs are recovered in the aggregate from competitive and non-competitive services.

COMMISSION ANALYSIS AND CONCLUSION

The Commission concludes that the Company's LRSIC studies do, in fact, compute the LRSIC of a service. Dr. Cornell's contention is not supported by the preponderance of the evidence. Furthermore, we conclude that the treatment of shared costs and common overhead expenses in the Company's LRSIC studies complies with Section 13-507 and with Staff's proposed rule, and is supported by the record.

2. Imputation Tests

Pursuant to Section 13-505.1 imputation tests are required for certain services of telecommunications carriers that provide both competitive and noncompetitive services. Basically, imputation tests are safeguards against anti-competitive pricing. These tests are intended to determine whether the rates that a carrier charges a competing carrier for certain noncompetitive service elements are discriminatory. They are used to analyze whether competitors of a carrier, who are also customers of that carrier, are being prevented from providing services at competitive rates.

Section 13-505.1 provides guidance as to which carriers need to perform imputation tests and how such tests are to be performed. In accordance with Section 13-505.1, IBT performed imputation tests for the following services: (1) Usage Sensitive Services ("USS"); (2) Message Toll Service ("MTS"); (3) non-payphone Operator Service; (4) 800 service; (5) WATS; (6) Centrex; and (7) payphone interexchange calling services.

3. Scope of Service for Imputation Tests

After reviewing the imputation tests IBT conducted, Staff witness Ms. Elizabeth Wisniewski maintained that the Company needed to conduct additional imputation tests in order to achieve the goal of safeguarding against anti-competitive pricing. She asserted that attempting to define what constitutes a service by examining a carrier's rates, service functionalities, or service titles alone may not achieve the fundamental goal of imputation. She said that these considerations can provide meaningful guidance, but that the determination of the level of disaggregation for imputation tests (i.e., what services or elements of services should be subject to imputation) should mainly be driven by the goal of guarding against anti-competitive behavior. In other words, evaluating whether a competing carrier possibly was being prevented from providing services at competitive rates due to the rates it is charged by IBT for essential, noncompetitive inputs to the competing carrier's service. Under this analysis, the determination of what constitutes a service must be made on a case-by-case basis. Any determination, however, must be consistent with the definition of telecommunication services contained in the Act. In particular, She recommended that IBT be required to conduct separate imputation tests for its Additional Aggregated Discount Plan and Growth Incentive Discount Plan (collectively "AAD/GID"), contained in Part 2 Section 19 of IBT's tariff, as well as separate tests for its dedicated and nondedicated 800 service offerings.

IBT witness Panfil conceded that, although the Company and Staff are not in complete agreement as to how to define the term "service," the determination of the scope of a service for purposes of imputation can be made only on a case-by-case basis. Mr. Panfil disagreed with Staff's contention that separate imputation tests should be conducted for AAD/GID and dedicated and non-dedicated 800 services. Sprint witness Jamison contended that imputation should be required at the service level where "service" is defined as any option that a customer can obtain separately.

a. 800 Services

Ms. Wisniewski argued that functional differences exist between dedicated and non-dedicated 800 offerings and that a possible difference exists between the level of competition for these two offerings. Accordingly, she contended that separate imputation tests for dedicated and non-dedicated 800 offerings should be provided.

IBT witness Panfil testified that the distinctions between dedicated and non-dedicated 800 offerings are inconsequential as far as imputation is concerned. He pointed out that while some differences exist between these two offerings, both provide functionally equivalent service to the end user and both compete for the same general body of customers. In addition, both are offered by all major competitors. He further observed that when the Company presented imputation tests to the Commission in Docket 83-0142, the Company treated 800 service as a single service. Both MCI and AT&T were parties to the Stipulation and Agreement which set forth the imputation test provided by the Company in that docket and neither objected at that time. He further testified that, in his view, nothing was added to subsequent statutory language and no change in circumstance has occurred which would require the Company to change its 800 service imputation testing methodology. Finally Mr. Panfil stated that, in any event, the Company passes an imputation test for 800 service whether that service is viewed on a disaggregated basis (for dedicated and non-dedicated offerings) or on an aggregated basis.

With regard to IBT's 800 service offerings, Ms. Wisniewski stated that the stipulation in Docket 83-0412 provides useful guidance regarding imputation, but by no means sets forth a definitive rule for how imputation must be conducted pursuant to the imputation requirements of the Act which were codified in 1992. LDDS witness Gillan agreed with Ms. Wisniewski's conclusion that separate tests must be conducted for dedicated and non-dedicated 800 service offerings.

AT&T takes the position in its Initial Brief that the Company should be required to perform separate imputation tests for its dedicated and non-dedicated 800 service offerings. AT&T contends that disaggregation of Illinois Bell's 800 service imputation test to this level provides a safeguard against anti-competitive pricing because the levels of competition affecting these two offerings could be different.

<u>COMMISSION ANALYSIS AND CONCLUSION</u>

The Commission is persuaded that it would be appropriate to require that separate imputation tests be performed for dedicated and non-dedicated 800 services. Staff has identified a relevant difference between a dedicated and non-dedicated service that could result in different sets of customers desiring these different services. The lower-priced dedicated 800 service may attract larger customers, while the higher-priced non-dedicated service may attract smaller customers. We agree with Staff that the possible difference in the level of competition for these two markets warrants separate imputation tests for these offerings.

b. <u>AAD/GID</u>

An issue also arose with respect to the Company's large user discount offering. The Company began extending a large user discount after the close of the test year in this case. The Company applies this discount to the largest users of its usage sensitive service. The interexchange carriers in this docket (MCI, LDDS/ICPA, and AT&T) as well as Staff all contend that the Company should perform a separate imputation test for its large user discount schedule. MCI in its Initial Brief cites the testimony of Company witnesses in the large user discount complaint case, Docket 93-0044, contending that the Company fails an imputation test for a large user discount and that the large user discount constitutes a predatory pricing scheme.

Sprint witness Jamison made a recommendation with respect to the large user discount schedule that also encompassed the Company's usage-sensitive service business and residence customers. First, he recommended that the Company's USS/MTS imputation analysis be broken down into one for business customers and another for residence customers. In addition, he recommended that the Company perform a separate imputation test for its large user discount schedule. He contended that such separate tests are necessary to ensure that smaller customers are not covering costs that should be covered by larger customers.

LDDS/ICPA argue in their Initial Brief that the Company's discount schedule constitutes evidence of anti-competitive conduct on the part of the Company and monopoly manipulation of an essential access service.

Staff contends that the issue of the discount schedule must be addressed in the current docket rather than in Docket 93-0044. Staff witness Wisniewski testified that the Commission must address the issue in this docket in order to ensure that imputation requirements of the Act are complied with prior to the implementation of an alternative regulation plan. Staff further argued that the Company should be required to perform a separate imputation analysis for the discount schedule because of the risk that the Company otherwise could engage in anti-competitive behavior with respect to this offering.

Mr. Panfil disagreed that imputation tests need to be conducted for AAD/GID. He noted that the issue of imputation for AAD/GID is the subject of litigation in Docket 93-0044; and, therefore, it is inappropriate to include the effects of these discount schedules as a "known change" in this docket.

Mr. Panfil pointed out that the Company's large user discount schedule was added to Illinois Bell's tariffs after the commencement of this docket and the end of the test year. He testified that, given the uncertainty surrounding the outcome of Docket 93-0044, it would be inappropriate to include the effects of the discount schedule in the Company's imputation analyses in the instant docket. He stated, however, that the Company appropriately would include the discount schedule in any future imputation test based on the outcome of Docket 93-0044. In its Initial Brief, the Company requests that the Commission take administrative notice of the fact that extensive testimony has been filed in Docket 93-0044 and that hearings took place on January 25-26, 1994.

The Commission concludes that it is unnecessary to rule upon imputation issues associated with AAD/GID in this docket. The Commission takes administrative notice of the fact that the matter is being fully litigated in Docket 93-0044, and that LDDS/MCI, AT&T, Staff and IBT have submitted testimony in that proceeding. Furthermore, we expect to issue a decision in that docket in a time frame reasonably proximate to our Order in this proceeding. If we determine that the large user discount schedule should be subject to a separate imputation test, we will require the Company to make any necessary rate changes so that the Company can pass an imputation test at any level of disaggregation we direct. In addition, we will require the Company to treat such changes as exogenous changes to be used as a starting point for the appropriate price indices found in the plan.

c. <u>Local Calling Area offering</u>

Staff witness Wisniewski argued that IBT's Local [Area Offering (also known as local calling area ("LCA") offering] relating to business usage, described in Part 2, Section 19 of IBT's tariff, requires an imputation test pursuant to Section 13-505.1. IBT did not include this offering in its USS or MTS imputation tests. According to Staff, such flat rate calling plans exist throughout Illinois, and the Commission needs to ensure that they pass imputation tests since they are interexchange switched services.

IBT witness Panfil argued that requiring an imputation test for LCA is too literal an interpretation of the Act. He noted that these offerings have been in existence for decades and claimed that an economically sound imputation test cannot be performed on the interexchange portion of a flat rate service since no causal link can be established between any portion of the revenues and the interexchange portion of flat rate calls. In any event, he asserted that flat rate interexchange or LCA calls are <u>de minimis</u>, representing less than 0.05 percent of IBT's interexchange USS calls. He further testified that other LECs have a far larger stake in whether such a flat rate calling plan is subject to imputation, and that, therefore, the issue of whether such a calling plan is subject to imputation ultimately should be decided in a docket where other LECs have a full opportunity to participate. He stated that the Company naturally would abide by any decision reached in such a docket.

In its Reply Brief Staff argues that two of the three other LECs (Centel and GTE) that are subject to imputation requirements are currently involved in rate cases (Docket 93-0252 and 93-0310) and Staff is currently addressing this issue for both of these companies. Staff states that it does not intend to discontinue its analysis of the LCA issue in any of these cases to open a generic docket.

COMMISSION ANALYSIS AND CONCLUSION

Our review of the record discloses no discussion of the LCA issue in either Docket 93-0252 or 93-0310. We conclude that although Staff essentially is correct that there does not appear to be a materiality exception in the statute's imputation requirements, this appears to be an issue with potentially disruptive impacts on other LECs for whom this type of service is far more significant. We conclude, therefore, that we will adopt the Company's suggestion that we initiate a generic docket that will explore the issue on a statewide basis. Such a docket will afford all potentially affected LECs an opportunity to participate and will ensure that the Commission has a full record upon which to base a decision that takes into account these offerings.

d. Pick-a-Point Service

Staff witness Wisniewski asserted that IBT's Pick-a-Point Service also requires a separate imputation test, since it provides customers an optional rate plan that differs from either MTS or USS.

Mr. Panfil responded that the Company's Pick-a-Point rate plan is optional for MTS customers, giving these customers a 30% discount from tariffed MTS rates on selected exchanges no more than 28 miles from their homes. Pick-a-Point is a noncompetitive plan that has been offered to customers since 1980. It was treated as part of the Company's MTS imputation test in Docket 83-0142. Mr. Panfil observed that no party objected at that time to the Company's treatment of its Pick-a-Point plan.

In response, Ms. Wisniewski again asserted that the stipulation provided guidance regarding imputation, but noted that the Commission cannot be hamstrung by an agreement that was reached long before the enactment of the imputation requirements embodied in the Act. Moreover, she stressed that IBT has not adhered to the strictures of the stipulation, as evidenced by the Company's incorporation of advertising, marketing and billing costs in its imputation analyses. The Act, furthermore, did not grandfather existing services.

The Commission concludes that the Company's Pick-A-Point service should be subject to a separate imputation test. The Company places too much emphasis on a stipulation entered into years before imputation became a statutory requirement. It is far more important to enforce the Act's requirements by defining services for purposes of imputation in a consistent and logical manner, than to honor a stipulation which can only reflect the market situation and various party's expectations at that time.

IBT has stated its desire to reclassify or discontinue offering LCA and Pick-a-Point if the Commission determines that imputation is required for these offerings. Staff notes that any difficulty IBT may have in performing imputation for these offerings may be addressed through the use of proxy data and that discontinuance of these offerings may not be necessary. The Commission encourages the Company to fully explore this option.

4. <u>Local Transport Termination Rates</u>

Witnesses for MCI, Sprint, and LDDS/ICPA criticized the way in which the Company had imputed "local transport termination" charges to itself in its imputation test for USS, MTS, WATS, and 800. MCI witness Dr. Cornell stated that, unless Illinois Bell routes a call through a tandem, the Company imputes only one local transport termination charge to itself. She testified that Illinois Bell should be required in all instances to impute to itself both originating and termination usage-sensitive transport rate elements for each interexchange call. She further maintained that the Company should be required to impute to itself a mileage-sensitive component to each end of the call as well, at least for calls going between two wire centers.

MCI witness Dennis Ricca, on rebuttal, also addressed the local transport termination charge issue. He testified that Illinois Bell had failed adequately to impute the charges for interconnection of transport facilities with a switch, thereby improperly imputing to itself only one rather two local transport termination charges. Sprint witness Jamison agreed with MCI's position, as did LDDS/ICPA witness Gillan.

Staff disagreed with MCI, Sprint and LDDS/ICPA. Ms. Wisniewski advanced the position that the imputation of one local transport termination charge properly reflects Illinois Bell's own network routing arrangements and, therefore, is consistent with the language in Section 13-505.1 which permits the Company to perform an imputation test based on its own network routing.

IBT witness Panfil defended the imputation of one local transport termination charge for direct trunk calls under the Company's usage services imputation tests. He responded to Mr. Ricca's argument that the Company had not imputed charges adequately for interconnection of transport facilities with a switch. He noted that such a charge is included in a separate local switching rate element which the Company imputes twice for a direct trunk call. He further maintained that for a direct trunk call, the Company imputes only one local transport termination charge because no intervening tandem office is involved for such calls. By contrast, routing arrangements for interexchange carriers require two separate local transport termination charges because one such charge is needed in order to have a call transported between Illinois Bell's originating central office and the interexchange carrier's intervening point of presence, and another such charge is required in order for the call to be transported back from the interexchange carrier's point of presence for completion over IBT's network. Accordingly, he testified that, while interexchange carriers pay two local transport termination charges for such a call, the Company appropriately imputes only one such charge to itself for a direct trunk call. He stated that the Company does impute two local transport termination charges to itself for a non-direct trunk call routed through a tandem switch.

With respect to the local transport termination charge issue, the Commission observes that a direct trunk call over the IBT network involves only an originating central office and a terminating central office. By contrast, a call using an interexchange carrier involves the transport of a call from an IBT originating central office to the interexchange carrier's intervening point-of-presence and then the transport of the call back again to the IBT terminating central office.

The Commission concludes that this fundamental difference in network design is reflected properly by Illinois Bell. Accordingly, the Company properly imputes only one local transport termination charge to itself for a call routed on a direct trunk (reflecting the origination of a call in one central office and the termination of that call in another central office) even though interexchange carriers properly pay two local transport termination charges (reflecting the origination of a call in a central office and its termination at the interexchange carrier's point-of-presence, and the origination of a call at that point-of-presence and its termination at an IBT central office). The Company's imputation methodology conforms with Section 13-505.1, which permits imputation based on the LEC's "own routing arrangements."

5. Economies of Vertical Integration

In performing its imputation tests, the Company reduced imputed costs to reflect economies it experiences in providing usage services itself and in avoiding the billing of switched access customers. Both Mr. Jamison and Dr. Cornell objected that Illinois Bell controls the billing costs which it incurs in serving its competitors and therefore has an incentive to maximize resulting "economies" which it can recognize in its imputation studies. In addition, Mr. Jamison testified that it is not proper for Illinois Bell's imputed price floor to reflect economies of vertical integration where these are economies that competitors actually cannot achieve through vertical integration. Moreover, Dr. Cornell criticized the fact that when Illinois Bell recognized an economy of vertical integration for billing, it used what Illinois Bell contended were the lower costs of billing end users. She contended that the proper cost to use is that for billing interexchange carriers and that these costs should be lower than those incurred to bill end users.

AT&T and LDDS/ICPA also object to the Company's recognition of economies of vertical integration. LDDS/ICPA take the position that by recognizing such economies, the Company is imputing less than the "premium rates" required under Section 13-505. Similarly, AT&T contends that Section 13-505.1 does not include any language which would permit something other than the tariffed rate to be substituted for the Company's incremental cost in an imputation test.

Ms. Wisniewski also disagreed with the Company's recognition of economies of vertical integration. She asserted that while the Company's economic efficiency argument is appropriate for theoretical debate, the Company failed to demonstrate how IBT's adjustment comports with the Act and its legislative directives.

Dr. Emmerson testified on behalf of the Company that if an LEC has economies of vertical integration and, for example, incurs more costs when providing access to interexchange carriers than when providing usage directly to end users, then such economies should be recognized in any proper imputation test. Fellow witness Panfil also testified in support of recognizing such economies and responded to the contention that the Company would have an incentive to create an artifically high cost if it were permitted to recognize these economies. He contended that no evidence exists that the Company has done so, and further observed that Mr. Jamison himself admitted that the Company continually is cutting costs in anticipation of competition.

Mr. Panfil also responded to Mr. Jamison's criticism that the Company should not be permitted to recognize vertical economies that competitors cannot achieve. Mr. Panfil testified that Illinois Bell should not be handicapped by its competitors' inefficiencies. He also responded to Dr. Cornell's contention that the Company's billing costs for interexchange carriers are higher than for billing end users, noting that interexchange carrier bills are far more complicated than end user bills.

In its Initial Brief, the Company contends that its recognition of economies of vertical integration is consistent with Section 13-505.1, specifically subparagraph (3) which permits the Company to recognize "other identifiable long run service incremental costs associated with the provision" of a service. The Company contends that costs saved in providing this service directly to end users fall within the category of "other identifiable" costs which should be reflected in an imputation study.

Section 13-505.1 provides, in pertinent part:

The imputed costs of a service for purposes of this test shall be defined as the sum of:

1) specifically tariffed premium rates for the noncompetitive service elements, or their functional equivalent, that are utilized to provide the service;

2) the long-run service incremental costs of facilities and functionalities that are utilized but not specifically tariffed; and

3) any other identifiable, long-run service incremental costs associated with the provision of the service.

The Commission is persuaded that it would be inappropriate to permit the Company to subtract avoided billing costs from imputed switched access costs on the basis of economies of vertical integration. We note that the statute refers to the <u>sum</u> of the three cost categories. While it is possible to add a negative number (reflecting cost savings rather than costs), we believe that the better view is that the "other LRSIC" category is intended to protect competitors by ensuring that the total calculation of imputed costs is fully inclusive of costs; it is not intended to serve as a miscellaneous offset to tariffed premium rates and facilities LRSICs.

6. Period of Cost Studies

Consistent with fellow Staff witness Thomas' recommendation that IBT's cost studies should reflect end-of-test year demand quantities, Ms. Wisniewski requested that the Company's imputation tests reflect the same data. IBT provided end-of-test year data, and Ms. Wisniewski concluded that the revisions did not have a substantive effect on the imputation tests. Staff maintains that the Commission should require IBT to conduct future imputation analyses using end-of-test year data. Staff argued that it is more appropriate to use end-of-test year quantities in the Aggregate Revenue Test because the period for which the test is performed is a historical test year and the more accurate end of test year demand quantities are available.

IBT witness Palmer stated that using end-of-year quantities does not significantly impact the outcome of the test. Nonetheless, he pointed out that use of mid-year quantities is consistent with the Company's cost study methods and provides the most appropriate estimate of quantities and costs during a test year.

With respect to the issue of whether the Company should have used end-of-test year or mid-test year quantities in its Aggregate Revenue Test, it is uncontroverted that no matter which quantities are used, the Company passes the Aggregate Revenue Test. However, since it is the Staff which will have primary responsibility for reviewing the results of the studies, it is important that the Company provide data in the format which Staff prefers. Staff's recommendation is adopted.

7. Impact of imputation study deficiencies

IBT witness Panfil asserted that the Commission's ultimate decision as to how imputation tests are to be performed should not be an obstacle to the approval of the Company's alternative regulation plan, since any revisions to imputation tests could be done pursuant to the Commission's final order in this docket. Staff agreed that imputation concerns can be addressed without affecting the timing of the implementation of its alternative regulation plan should the Commission approve the plan. MCI & AT&T believe that it would be unacceptable to implement an alternative regulation plan prior to satisfying various imputation concerns. Satisfactory passing of the imputation cost test is part of the determination of whether Illinois Bell's rates are just and reasonable at the outset of the plan and whether access customers would be disadvantaged by the plan. According to AT&T, implementation of the plan must be conditioned on appropriate rate levels at the start of the plan and on services being priced to satisfy imputation cost tests.

The Commission finds that the imputation issues identified in this proceeding reflect technical differences of opinion among expert witnesses, and do not raise fundamental questions as to whether Illinois Bell's rates under an alternative regulation plan would be just and reasonable. We will require the Company to revise its tariffs in accordance with our determinations on these issues and present a modified aggregate revenue test and imputation studies which demonstrate compliance with the statutory requirements when initiating the alternative regulatory plan.

8. Aggregate Revenue Test

The Company conducted an Aggregate Revenue Test, as required by Section 13-507, in order to ensure against the cross-subsidization of competitive services by non-competitive services. Section 13-507 requires that competitive services in the aggregate, or as a group, must generate revenues which cover their total LRSICs, imputed costs and their allocated common overhead expenses, and residual revenue requirement. The Company contends that its competitive services pass the Aggregate Revenue Test and that such services, therefore, are not subsidized by its noncompetitive services.

MCI witness Dr. Cornell argued that the Company's Aggregate Revenue Test was deficient because it failed to allocate its residual costs based on the Company's revenue requirement, as opposed to the lower, actual level of the Company's revenues. She maintains that this is a fatal flaw because the Company's allocation of noneconomic costs in the aggregate revenue test falls short by $300 million.

The Company responded to Dr. Cornell's contention that the Aggregate Revenue Test should allocate common overhead and residual costs based on a revenue requirement. Mr. Panfil contended that *Dr. Cornell has based her recommendation on a totally erroneous* assumption: that the Company has proposed price changes in order to eliminate any revenue requirement shortfall. He argued that this is not the case, but that if the Company does recover higher levels of residual costs in the future by generating a higher level of revenues, that such a higher level of recovery will be reflected in annual Aggregate Revenue Test updates to be filed with the Commission. The Company argues that the Commission should not require it to allocate shortfalls that it does not recover or revenues that it does not receive. The whole purpose of the Aggregate Revenue Test is to ensure that noncompetitive ratepayers do not bear a disproportionate burden of the Company's noneconomic costs. To the extent those costs are not being incurred, the Company argues that no apportionment needs to be made to protect ratepayers.

Staff witness Rettle concluded that the Company's Aggregate Revenue Test appropriately allocates the difference between LRSICs and current revenues (as opposed to the difference between LRSICs and a higher revenue requirement), because the test was performed in the context of the Company's proposal for an alternative form of regulation, and IBT is not seeking any rate increase.

The Commission agrees with the Company and Staff that, in the context of an alternative regulatory plan, an allocation of noneconomic costs (formerly known as common overheads and residual revenue requirement) under Section 13-507 should be based upon the difference between the Company's revenues (and not its revenue requirement) and the Company's LRSICs. MCI's proposal would have the unwarranted effect of putting upward pressure on competitive service prices, thereby disadvantaging the Company's customers. In addition, the Company has committed to reflecting in its annual Aggregate Revenue Test updates any additional revenues which it receives.

a. <u>Touch-tone</u>

Staff witness Thomas reviewed the Aggregate Revenue Test and agreed with the methodology that the Company used. Staff identified some computational errors in IBT's direct case which subsequently were corrected by the Company in its rebuttal testimony. Subsequently, Staff again reviewed IBT's Aggregate Revenue Test. Upon her second review of the test, however, Ms. Thomas argued that the Company has reflected a reduction in revenues erroneously, based on the Company's proposal to eliminate touch-tone service revenues over the first three years of its plan. She argued that reflecting this reduction in revenues is inappropriate because the Company has presented its cost data in the context of an historical test year and because the Commission has not yet approved the elimination of touch-tone rates. She maintained that, since Mr. Palmer's Aggregate Revenue Test consisted of demand quantities and rates that existed in the test year, September 1991 to August 1992, his test must include touch-tone revenues which existed during that time frame and which the Company continues to collect. If and when the Commission approves the elimination of touch-tone rates, Staff agreed that the Company should exclude that service from the test revenues <u>at that time</u>.

IBT witness Palmer said that he excluded revenues for touch-tone services from the Aggregate Revenue Test because IBT will phase out touch-tone charges in the first three years of the alternative regulatory plan, consistent with Staff witness Roth's rate design proposal. Mr. Palmer pointed out that no one has opposed the Company's proposal to eliminate all such revenues during the first three years of the plan.

The Commission's decision to implement a revenue reduction through elimination of the tariffed charge for touch tone service moots this issue. Accordingly, the Company need not revise its Aggregate Revenue Test to reflect Staff's concern.

b. Semi-Public Payphone Revenues

Staff witnesses Thomas and Wisniewski recommended that the Company be required to modify the payphone revenues included in its Aggregate Revenue Test to reflect only rotary payphone revenues for semi-public sets as opposed to higher touch-tone revenues.

Staff maintains that the Company incorrectly derived revenues by using touch-tone payphone rates in order to develop revenues for payphones that are currently rotary. This results in increasing the payphone imputation test margin by approximately $1,000,000.

With respect to semi-public payphone touch-tone revenues, IBT witness Palmer argued that the Company's use of such revenues comports with Staff's proposed elimination of semi-public rotary sets in Docket 92-0275 (the Rulemaking concerning payphone service). He testified that the Company uses forward-looking revenues which reflect proposals that would impact revenues realized over the course of the alternative regulation plan.

In response, Staff asserts that the use of forward-looking revenues lacks any foundation in the Act or in Commission rules. Staff says that acceptance of this approach would allow the Company to manipulate its revenues freely based upon purely speculative future Company actions.

We conclude that it is inappropriate to include touch-tone revenues on the basis of the Staff proposal in Docket 92-0275. We note that the First Notice Order has not been issued in that proceeding. Any adjustment to the Aggregate Revenue Test to reflect a mere proposal in a pending rulemaking is premature and speculative. The Company should confine its imputation and Aggregate Revenue Tests to a reflection of existing Commission policies at the time such studies are conducted.

9. Depreciation And Cost Of Equity In Cost of Service Studies

Illinois Bell witness William Palmer proposed that on January 1, 1995, and on the first of each year thereafter, Illinois Bell would file updated values for its cost of capital and depreciation rates for use in its LRSIC studies. Staff witness Peggy Rettle responded that Illinois Bell has not specified the methods it would use to estimate capital costs and depreciation rates. In her opinion, allowing the Company to establish its own depreciation rates without Commission approval would lead to inappropriate LRSIC study results. She pointed out that according to the proposed cost of service rules (Docket 92-0211); Proposed Part 791 Section 80 (a) and (b)), the Commission must "make a finding of, or adopt a methodology for determining" the "projected life of plant at age zero" and the "carrier's cost of equity" in a proceeding under Section 13-506.1. She said that, if the Commission were to adopt the Company's proposal, the methods for estimating the cost of debt and equity and setting depreciation rates must be determined in this proceeding.

Ms. Rettle proposed that for purposes of LRSIC studies and the Aggregate Revenue Test, the company be required to use whatever cost of equity and depreciation rate determinants are adopted by the Commission in this proceeding. She argued that no compelling evidence had been presented that the cost of equity and depreciation rates both be updated each year. Ms. Rettle supported Ms. TerKeurst's recommendation that if the 30 year Treasury bond yield rises 250 basis points above its yield at the time the Commission enters its order in this proceeding and stays at that level for at least three consecutive months, then a review of the cost of equity should be conducted. Ms. Rettle stated that the Company would continue to be free to file for depreciation rate represcription at any time.

The Company responded that consistent with the rule, it had in this proceeding proposed a method for determining cost of equity and depreciation for use in future LRSIC studies. IBT proposes that it be permitted to use a forward-looking cost of equity determined through use of a DCF and CAPM methodology as it used in this proceeding.

COMMISSION CONCLUSION

Consistent with the Commission's decision to permit the Company to set its own depreciation rates, we approve the proposal that it use remaining life depreciation rates using the projected life of plant at age zero. The Commission will closely monitor IBT's formulation and application of depreciation rates. If the Commission observes that IBT has abused the flexibility that is afforded to them in this plan, the Commission will reevaluate the appropriateness of the alternative regulation plan adopted in this docket.

However, the Commission concludes that the Company's proposal regarding cost of equity determinations for the purpose of LRSIC studies is too ill-defined. IBT's proposal seems to be based upon the assumption that cost of capital issues can be decided in an objective fashion without any controversy. As can be seen in the rate of return portion of this order, this is not the case. Applying the DCF and CAPM methodology requires the subjective analysis of experts. IBT's position would necessitate extensive litigation over the issue of cost of equity any time that new studies are prepared. On the other hand, the Commission is of the opinion that Staff's proposal is more reasonable in that the point at which a review is necessitated can be determined objectively.

K. IntraMSA Presubscription

MCI sponsored the testimony of Mr. Dennis Ricca, who maintains that, because Illinois Bell strips off and carries all 0+, 1+ ten-digit and seven-digit dialed intraMSA calls, the people of Illinois have been denied the benefits of competition for a large percentage of their intrastate calls. He opines that IBT's application did nothing to open its protected monopoly intraMSA market to effective competition and that, until effective competition is allowed, the Company's plan is unacceptable. He presented an implementation plan for intraMSA equal access according to which customers are provided an opportunity to presubscribe to an interexchange carrier for their interMSA toll traffic and are allowed to eliminate the need for complicated access codes. This witness contended that the dialing parity implemented through his plan is necessary in order to ensure effective competition. He asserted that intraMSA presubscription is technically feasible, economical, consistent with the Act, and in the public interest.

LDDS/ICPA witness Gillan also testified in support of intraMSA presubscription and asserted that increased competition for interexchange services could improve Illinois Bell's productivity and consumer responsiveness. He also stated that smaller business subscribers and residential customers could be expected to benefit most from intraLATA dialing pattern reform because MTS-type products are designed to appeal particularly to these markets, yet they are most dependent upon 1+ dialing and switched access to be successful. This witness advocated a "2-PIC" option in which a customer designates two primary interexchange carriers which then receive the customer's 1+ inter-and intraMSA traffic respectively.

AT&T also supports intraMSA presubscription in its Initial Brief. However, AT&T contends that if presubscription is not ordered in this docket, the Commission should require the Company to comply with intraMSA presubscription if ordered in some future docket, even if changes to the Company's alternative regulation plan would become necessary as a result.

On behalf of Staff, Ms. TerKeurst took the position that while presubscription would increase competition, it is not a prerequisite to alternative regulation. She testified that intraMSA presubscription deserves the Commission's serious consideration in another docket.

On behalf of Illinois Bell, Mr. Gebhardt responded to Mr. Ricca's presubscription proposal. He testified that he did not believe that the benefits of Illinois Bell's alternative regulation plan should be held hostage to intraMSA presubscription, and that the Commission has a number of appropriate forums available to consider these issues.

The Commission agrees that there is persuasive evidence indicating that intraMSA presubscription could enhance competition considerably in certain telecommunications markets. However, Section 13-506.1 does not condition the approval of an alternative regulation plan on the establishment of intraMSA presubscription. The decision in this proceeding is not intended to determine every aspect of the telecommunications regulatory framework in Illinois. IntraMSA presubscription is a complex issue, involving numerous interrelated policies and implementation details which need to be considered on a statewide basis, with input from a number of parties who did not participate in this proceeding. Accordingly, on February 8, 1994, the Commission initiated Docket 94-0048, a rulemaking proceeding intended to consider intraMSA presubscription and related changes in dialing arrangements pursuant to Section 13-403.

L. Annual Reporting

Staff notes that any new price regulation plan must be monitored carefully in order to ensure that the price cap mechanism is applied properly and that the benefits intended to result from such policies are fully realized. Through the testimony of Ms. Judy Marshall and other witnesses, the Commission Staff proposed a comprehensive list of reporting requirements.

AG witness Dr. Lee Selwyn recommended that the following issues be addressed through ongoing monitoring and review of the incentive regulation system: overall earnings by competitive and noncompetitive categories; price movements for services; realized productivity changes expressed in TFP and with respect to specific efficiency criteria; deployment of new technology (with a description of new services based thereon, prices being charged for the services and rates of penetration being achieved); growth of actual competition for competitive services; and data on the quality of service/response to customer complaints for both competitive and noncompetitive services.

The Commission adopts a modified version of the Staff's proposals. We reject Dr. Selwyn's proposal because much of the information will be required in the annual reports. In addition, the Commission has stated previously that it does not believe that the reclassification of services as competitive will occur as rapidly as Illinois Bell predicted. To the extent that Dr. Selwyn's recommendations focus on competitive services, the Commission is not persuaded that requiring the additional information is demonstrably cost-beneficial in conjunction with the adoption herein of the alternative regulatory framework for non-competitive services.

We also reject Illinois Bell's argument that the adoption of price regulation without earnings sharing eliminates the need for reporting of the financial information identified by Staff. Although rate of return no longer will be the focus of regulatory control for the duration of this alternative regulatory plan, the data still may provide useful evaluative information. For example, unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective. In addition, rate of return information may provide insights into various social subsidy issues which are likely to arise in the future.

Illinois Bell shall be required to make an annual rate filing no later than October 1 of each year of the plan. At that time, Illinois Bell shall provide the following information:

(a) the price index for the following calendar year, with supporting data showing the GDPPI for the previous 12-month period (July to June) and the percent GDPPI change for that 12-month period;

(b) the actual price index ("API") for each service basket, including the effects of proposed rate changes and adjustments for new services added, existing services withdrawn, and services reclassified as competitive or noncompetitive;

(c) tariff pages to reflect revised rates;

(d) supporting documentation demonstrating that any proposed rate changes are consistent with the requirements of the price index mechanism;

(e) a demonstration that Illinois Bell would be in compliance with Sections 13-507 and 13-505.1 of the Act if the proposed rate changes went into effect.

(f) an identification of any changes to the GDPPI weights and an assessment of the effects of such changes, and any necessary modifications to the PCI.

Staff and all interested parties will have an opportunity to file written comments in response to each annual filing and the Company will have an opportunity to file reply comments. The Commission will approve a price index prior to January 1 of the following year for use during that year.

In addition, Illinois Bell will be required to file annual reports with the Chief Clerk of the Commission. The reports shall provide information on a calendar-year basis and shall be due on March 31 for the preceding calendar year. The reports shall be based on final audited data. The annual reports shall include the following information:

(a) Total Company and Illinois jurisdictional rate base;

(b) Total Company and Illinois jurisdictional operating revenue and expenses;

(c) Other income and deductions, interest charges, and extraordinary items (with explanation);

(d) Current capital structure;

(e) Calculated total Company and Illinois jurisdictional return on net utility rate base and total Company return on common equity; and

(f) Statement of Sources and Applications of Funds;

(g) Description of projects and amounts invested in new technology (regarding the Company's $3 billion infrastructure investment);

(h) Calculation of the current price cap index and actual price index including the formula used, the current and prior index, the current inflation factor and its source, the current general adjustment factor, and any current exogenous factors;

(i) A description of new services including the price of each and its effect on the calculation of the API;

(j) Demand growth by revenue basket;

(k) Summary of price changes initiated under the alternative regulatory plan;

(l) A demonstration that Section 13-507 of the Act has been complied with; and

(m) A summary report on Illinois Bell's quality of service.

The Commission further adopts Staff's recommendation that Illinois Bell be required to submit an application for review of the adopted alternative regulatory mechanism by March 31, 1998, at the time it submits its annual report for 1997. In addition to a four-year summary and analysis of the information in the annual reports filed by March 31 of 1995, 1996, 1997, and 1998, the application for review of the price cap mechanism shall address at least the following issues:

(a) Whether the inflation index and the manner in which it is applied provide an adequate reflection of economywide inflation.

(b) An assessment of productivity gains for the economy as a whole, for the telecommunications industry, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified. This assessment should address both Illinois Bell's total factor productivity growth rates and the realized general adjustment factor in the price cap formula implied by Illinois Bell's earned rates of return.

(c) Whether the adopted monitoring and reporting requirements should be retained or adjusted.

(d) The extent to which Illinois Bell has modernized its network and additional modernization plans for the near term.

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

(f) A listing of any services which have been withdrawn during the period.

(g) A listing of all services which have been reclassified as competitive or noncompetitive during the period.

(h) A summary of new services which have been introduced during the period.

(i) Information regarding any changes in universal service levels in Illinois Bell's service territory during the price cap period.

(j) Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals.

IV. RATE EVALUATION

As stated earlier in this Order, this proceeding involves all of the issues associated typically associated with general rate cases under traditional ROR regulation. This is because the Company submitted conventional cost of capital, accounting and other testimonies associated with general rate cases in order to demonstrate that its current rate levels are reasonable and are an appropriate starting point for a price cap regulation plan. CUB's rate reduction complaint also requires the Commission to evaluate whether IBT's current rates are just and reasonable.

A. Test Year

The test year in this proceeding comprises twelve months of actual data from the period beginning September 1, 1991 and ending August 31, 1992. The test year revenue and expense levels employed herein reflect levels as of the end of that period.

V. REVENUES AND EXPENSES

A. Telephone Directories

Directories in Illinois Bell's service territory are provided pursuant to a Directory Agreement executed in 1984 among the Reuben H. Donnelley Company ("Donnelley"), Illinois Bell, Ameritech Publishing, Inc. ("API") and AM-DON, a Partnership between Donnelley and API. This Directory Agreement was reached after IBT and Donnelley had filed lawsuits against each other when negotiations between them had broken down. The Agreement was approved by the Commission in Docket 84-0359. In 1990, Donnelley and API renegotiated their part of the partnership agreement, creating an entity known as DonTech. Unlike AM-DON, which was formed in an acrimonious atmosphere and in which the two parties performed separate functions with separate staffs, DonTech involved the merger of API's and Donnelley's respective personnel and facilities under common management.

The 1984 Directory Agreement originally was to expire on December 31, 1994. However, in 1993 Illinois Bell exercised its option to extend the Agreement through December 31, 1999.

Under the terms of the Directory Agreement, Donnelly performs primarily directory advertising sales functions, API performs primarily directory manufacturing functions, and Illinois Bell performs listing and billing functions. Illinois Bell receives a guaranteed minimum payment of $75 million per year; 7.5% of each year's incremental growth in directory revenues; and reimbursement of its costs to produce and provide white pages directories to its customers.

Staff witness Mr. Samuel S. McClerren has proposed a $51 million upward adjustment to the test period revenues received by Illinois Bell from its directory relationships. It is Staff's position that Illinois Bell did not participate in directory negotiations, thereby missing an opportunity to increase its revenues. Mr. McClerren testified that IBT is receiving substantially less directory revenues per access line than the other four Ameritech Operating Companies; did not seek to increase its revenues from directory operations during negotiations in spite of a 68% increase in AM-DON's gross revenues from 1984 to 1989; and abrogated its potential bargaining leverage by allowing Ameritech to guarantee to Donnelley that Illinois Bell would exercise its exclusive option to renew the 1984 Directory Agreement.

Mr. McClerren maintains that Donnelley was concerned with the possibility of having to compete with a local telephone company and that Illinois Bell therefore should have capitalized on this concern and have sought to increase the payment it was entitled to under the 1984 Directory Agreement. He says that it is clear that the non-regulated income of API, or more appropriately Ameritech, has benefited from the AM-DON and DonTech agreements at the expense of the regulated income of IBT.

Mr. McClerren offers two methods for calculating his proposed $51 million directory revenue imputation. Under the first method, he derives the ratio of Illinois Bell's 1984 directory revenue ($75 million) to 1984 gross directory billings ($207.37 million), and then applies this ratio (36.2%) to gross directory billings for 1989 ($348.24 million). The result ($126.06 million), less the guaranteed, fixed amount approved by the Commission and actually received by the Company ($75 million), is the $51 million that Mr. McClerren proposes to add to test period revenues. Under his second method, Mr. McClerren relies upon Illinois Bell's Directory Task Force Report's comparison of 1991 directory revenue per access line for Illinois Bell and the other four Ameritech Operating Companies. Mr. McClerren multiplies the difference between the amount Illinois Bell received and the average amount that the other Ameritech Operating Companies received by the number of access lines in Illinois Bell's service territory. This calculation also produces approximately $51 million.

Illinois Bell submitted the testimony of two witnesses in response to Staff's proposed imputation: Messrs. George R. (Bob) Willenborg and Efrem Sigel. Mr. Willenborg testified that the directory revenues that Staff seeks to impute to Illinois Bell are derived almost exclusively from Yellow Pages operations -- the only significant source of revenues to Donnelley, API, AM-DON or DonTech in the context of the Directory Agreement. He notes that, while the directory relationship falls within Commission scrutiny as an affiliate relationship, the directory affiliates themselves are not regulated. Mr. Willenborg argues that Yellow Pages are not a regulated service, have never been provided by Illinois Bell, and thus imputation is inappropriate.

Mr. Willenborg described the history of Yellow Pages directory publishing in Illinois Bell's service territory. Donnelley has been the exclusive publisher of Yellow Pages directories for over 70 years. As publisher, Donnelley has owned the content of and has held the copyright to the Yellow Pages directories, and owns and maintains all advertising records and customer contacts. In contrast, Illinois Bell never has owned or controlled Yellow Pages assets or the revenues that are derived from them. Rather, it always has been in the position of providing certain products and services (listing information, billing and collection, data base functions, and the right to co-bind the Yellow Pages with the White Pages) to Donnelley, AM-DON or DonTech for compensation pursuant to written directory agreements approved by the Commission. Historically, and under the current Directory Agreement, only the net amounts received by Illinois Bell for services rendered and products delivered, after covering directory expenses has been taken into consideration, have been used by the Commission in determining the Company's intrastate rates.

Mr. Willenborg maintains that the Staff's proposal is foreclosed by the Commission's approval of the 1984 Directory Agreement. He argues that the fixed $75 million-plus payment to Illinois Bell was found by the Commission to be in the public interest regardless of the Yellow Pages profits or losses that ultimately might materialize for Donnelley and API.

Mr. Willenborg also suggests that Staff's calculations are flawed. In his opinion, applying the 1984 ratio of directory revenue to gross directory billing, to the 1989 gross directory billings, utilizes inappropriate time frames and data. He believes that Mr. McClerren should have used 1986 (the first full year that the Directory Agreement was in effect) as a starting point. Moreover, Mr. Willenborg argues that Mr. McClerren's calculations make no provision for cost increases that have occurred since the mid-80s: the use of gross directory billing figures in the ratio calculation captures increases in sales but does not reflect changes in costs avoided by Illinois Bell or incurred by its affiliates. In addition, Mr. Willenborg notes that virtually none of the data Mr. McClerren relied upon comes within the September 1, 1991 through August 31, 1992 test year at issue in this docket.

Mr. Willenborg also disputes Mr. McClerren's second method of comparing Illinois Bell's 1991 directory revenue per access line to the average directory revenue per access line obtained in 1991 by the other four Ameritech Operating Companies. Mr. Willenborg suggests that the situation in Illinois is quite different from that prevailing in the other Ameritech states, where the telephone operating companies historically had been the Yellow Pages publisher. They owned the content of and held the copyright to the directories, and handled Yellow Pages advertiser contacts. This is not the case in Illinois. For these reasons, Yellow Pages historically have provided a larger subsidy supporting local rates in the other four states. In Mr. Willenborg's opinion, the unique circumstances in Illinois fully account for the difference in directory revenues per access line identified by Mr. McClerren.

Mr. Willenborg disagrees with Mr. McClerren's claim that Ameritech bargained away valuable benefits (in the form of the option to renew) belonging to Illinois Bell during the course of the 1990 DonTech negotiations by guaranteeing to Donnelley that Illinois Bell would exercise the option. Mr. Willenborg points to his and Mr. Sigel's testimony that the "value" that can be placed on the option is de minimus, given the downturn in the Yellow Pages marketplace. Even more importantly, Mr. Willenborg argues, the Ameritech guarantee was given at the end of negotiations, in a pro-forma manner, after all of the other provisions had been agreed upon. Thus, Mr. Willenborg states, the guarantee was not a significant element of the deliberations. In addition, he points out that Illinois Bell formed a Directory Task Force that studied Illinois Bell's directory situation. Utilizing industry comparisons, the Task Force independently determined the value of the Directory Agreement and recommended that the Company should continue in its current arrangement. He has testified that the Ameritech guarantee relating to the option was not at all a factor in Illinois Bell's decision to renew the Agreement.

Mr. Sigel described the Yellow Pages marketplace as it existed in 1984 and 1990 as well as the outlook for the 1990s. He stated that in 1984 the Yellow Pages market was perceived as a growth field, but by 1990 growth had slowed considerably and a number of new ventures had failed. Mr. Sigel said that he expects future growth to be in line with the national economy, although there is a significant possibility that Yellow Pages advertising will weaken further due to inter-media competition and the effects of several recent court decisions in antitrust and copyright law, which have been adverse to the telephone companies.

In its opening brief, Staff offers several responses to the Illinois Bell positions set forth above. First, Staff argues that Commission approval of the 1984 Directory Agreement does not relieve the Company of its responsibility for reviewing and renegotiating a contract when circumstances change dramatically, as Staff says they had by 1990. Second, Staff argues that IBT's position that the services it renders to the directory operations are not worth the $75 million it receives annually ignores the fact that API's responsibilities did not change from 1984 to 1989, yet API's net income increased 83% from $36.8 million in 1986 to $67.4 million in 1989. Third, Staff maintains that the Directory Task Force Report was not an analytical management tool but rather was a justification for a decision made in the 1990 DonTech negotiations. In this regard, Staff points to the fact that Ameritech already had guaranteed Donnelley that Illinois Bell would exercise its option; that the Report was flawed in that it omitted discussions of jurisdictions that impute directory revenues and included data on a company that is not comparable to Illinois Bell; that the Task Force did not test the marketplace to determine if other firms were interested in jointly producing a directory; that Illinois Bell did not research important data such as the cost of services provided by API; that the Task Force was convened in response to a recommendation in the Reconnaissance Management Audit rather than established of the Company's own volition; and that the Task Force did not allot itself enough time to reach a meaningful result. Staff contends that IBT's exclusion from the 1990 negotiations, even though Ameritech bartered for API with IBT's exclusive option to extend the agreement, is a compelling example of Ameritech's preference for API's non-regulated revenues over IBT's regulated revenues.

COMMISSION ANALYSIS AND CONCLUSION

The Commission rejects Staff's imputation of $51 million to Illinois Bell's test year revenues. As we understand it, Staff's position is essentially that the historical increase in directory revenues created a duty on the part of Illinois Bell to either renegotiate the terms of the Directory Agreement when DonTech replaced AM-DON in 1990, or refuse to exercise its option to extend the term of the Agreement in 1993 unless a greater proportion of total directory revenues could be obtained to the benefit of regulated operations. For a variety of reasons, we find Staff's argument unpersuasive.

First, we are troubled by Staff's failure to cite any legal authority or precedent for the existence of the duty they assert exists or for the Commission's authority to impute for the benefit of regulated operations, income earned by unregulated entities through unregulated activities. The only authority Staff cites for its proposal is Section 7-101 of the Act. To paraphrase, Section 7-101(2) provides that the Commission shall have jurisdiction over affiliated interests having transactions with public utilities to the extent of access to all accounts and records of affiliated interests relating to such transactions, and shall have authority to the extent of requiring affiliated interests to file reports with respect to the transactions. Section 7-101(3) requires the utility to submit contracts with an affiliated interest to the Commission for approval, and the Commission can condition its approval in such manner as it may deem necessary to safeguard the public interest. Section 7-101 does not confer authority on the Commission to reallocate revenues from an affiliated interest to a regulated entity.

In Docket 84-0359, the Commission applied the public interest standard of Section 7-101 and, consistent with the recommendation of Staff, approved the 1984 Agreement. The Commission specifically stated that it "recognizes that the $75 million figure was not based on a historical trend but on negotiation which, from Illinois Bell's perspective, was designed to achieve the highest guaranteed annual amount." (Order, p. 3) Despite this, Staff's desire to reopen consideration of the already approved contract is essentially motivated by a hindsight review of an historical trend

- the divergence over time of the relative shares of directory revenues between API and Illinois Bell. The Order in Docket 84-0359 explicitly noted that the Company had an exclusive right to extend the term of the 1984 Agreement, but we did not require resubmission of the contract for evaluation in the event it was renewed.

We particularly note that Staff apparently does not argue that the Company's decision to extend the contract was improper, but only that Illinois Bell failed to extract sufficient compensation for doing so. We do not believe that the decision to extend the contract is a separable issue from the use of the option to renew as a bargaining advantage. In other words, although an option may present a tactical opportunity, one cannot value the option apart from a consideration of the entire set of circumstances surrounding the decision to renew. Staff has selectively isolated one element of the directory relationships, and attributed to it a commercial value which is not supported by, indeed appears to be wholly unrelated to, any reasonable attempt to present or properly assess the complex factors underlying any business transaction.

For example, Staff criticizes Illinois Bell's decision-making process with respect to such matters as the independence of the Task Force, certain calculations in the Task Force Report, and the length of the Task Force deliberations. These assertions would certainly be highly relevant if it had been alleged that extension of the contract was improper, but that is not Staff's argument. Moreover, we find credible Mr. Willenborg's testimony that the Ameritech guarantee was developed at the end of negotiations after all the dollar issues and responsibilities had been worked out, and that Donnelley wanted the guarantee simply because it wanted assurances that Ameritech would not direct Illinois Bell to refuse to renew the Agreement as a device to undo the DonTech partnership. Mr. Willenborg, who chaired the Task Force, testified that IBT independently determined the value of the Directory Agreement and independently elected to extend that agreement through the end of 1999, and that the Ameritech guarantee was not a factor in the decision to renew. We have reviewed the Task Force Report and conclude that it constitutes a comprehensive and bona fide evaluation of relevant business considerations. This is in contrast to Staff, which presented no evaluation whatsoever of the options available to the Company in the event the Agreement was not extended. The Company's testimonial and documentary evidence outweighs Staff's allegations which are unsupported by the evidence.

As noted above the Commission was fully aware of, and specifically approved, the existing arrangement whereby directories are provided through a multiple entity partnership, with Illinois

Bell compensated for the customer listing information and for the billing and collection services it provides. Staff makes no argument that the value of those services is now $51 million more than it was in 1984; nor, assuming that such considerations would be appropriate, does Staff make any attempt to value the services provided by any of the partnership entities. Staff merely cites the history of increased revenues from directories and without citing any legal authority for the proposition, maintains that Illinois Bell is entitled to a larger share of those revenues.

It is undisputed that IBT does not own or control directory assets or the revenues derived from them, and that this situation is unique to Illinois. Staff acknowledges the fact but dismisses it with the assertion that it does not fully explain the difference in directory revenues per access line between Illinois Bell and other Ameritech Operating Companies. Nevertheless, Staff makes no attempt to quantify what part of the difference it does explain.

Finally, the Commission finds wholly unpersuasive Staff's contention that Illinois Bell, by enterring the 1990 negotiations between API and Donnelly, or by forcing renegotiation of the Agreement in 1993, could have extracted an additional $51 million in revenues solely in exchange for extending the agreement. That determination could be made only after analyzing the legal and economic environment at the time of the decision(s), the strengths and weaknesses of the various parties' bargaining positions, and the resulting array of contractual benefits, risks, and responsibilities. That is, again, an analysis that the Staff did not undertake.

In conclusion, the evidence does not support an adjustment to Illinois Bell's revenues in connection with its directory relationships, and the magnitude of Staff's proposed financial penalty - over a quarter of a billion dollars in revenue requirement over five years - is particularly unfounded.

B. Interest Synchronization

Staff and CUB/Cook contend that IBT's test-year income taxes should be adjusted in order to reflect the synchronized levels of interest costs associated with its rate base. Staff witness Thomas Q. Smith stated that tax benefits which accrue to customers should be based on the interest expense included in IBT's revenue requirement, not on its actual interest expense. He testified that tax savings generated by the interest deduction component of the revenue requirement should accrue to the utility's customers because they are responsible for meeting the Company's revenue requirement. He reasoned that the tax benefits of the interest deduction component should be based upon the product of the

Company's rate base and its weighted cost of debt. However, he testified that any interest synchronization adjustment would have to be revised in light of the rate base and weighted cost of debt determined by the Commission in this proceeding.

CUB/Cook similarly claim that it is important to synchronize interest because deductible interest expense is a primary determinant of income tax expense. CUB witness Brosch argued that ratepayers should receive an income tax expense reduction keyed to the level of interest expense that they are asked to reimburse through the ratemaking formula, specifically the weighted cost of capital times the rate base.

IBT witness Goens criticized the proposed interest synchronization and characterized it as speculative in nature. He explained that the fixed point in time chosen for defining the rate base and capital structure for purposes of interest synchronization does not yield the true yearly interest payment needed to support the rate base. Therefore, he proposed that actual interest costs be used since they are available and represent the actual expense amount incurred during the test year.

The Commission accepts the adjustment proposed by the Staff and CUB/Cook. The Commission consistently has ruled that the interest deduction tax benefits that accrue to customers should be based on the interest expense that is included in a utility's cost of debt component of the capital structure.

C. Leveraged Employee Stock Ownership Plan

Staff witness Smith proposed a $5.6 million adjustment (on a grossed-up basis, using Staff's conversion factor) to reduce Illinois Bell's federal and state tax expense because of the deductions earned by Ameritech and the dividends it paid to the Ameritech Leveraged Employee Stock Ownership Plan ("LESOP"). In his analysis, Mr. Smith noted that Illinois Bell's equity indirectly is supported by a portion of Ameritech's equity, and Illinois Bell's customers therefore pay a return on a portion of Ameritech's equity. Accordingly, he reasoned that those customers earned tax savings generated by that return.

Company witness Goens responded that tax savings or expenses related to the Ameritech LESOP should be treated in a manner consistent with the underlying transactions giving rise to the savings or expense. Mr. Goens contended that dividend payments on allocated Ameritech shares held in the LESOP trust are made by Ameritech and thus any resulting tax savings should be retained by Ameritech rather than transfered to ratepayers. In its Initial Brief, the Company further contends that Ameritech investors expect Ameritech's management to deploy capital in growth opportunities that will maximize the shareholders' equity value. Capital deployment decisions made by Ameritech are based on sound financial principles and directed toward regulated and unregulated activities. Dividends that are paid out of the net earnings belong to investors, as do any tax savings accruing from the LESOP.

The Commission agrees with the Company that tax savings or expenses related to the LESOP are treated most properly in a manner consistent with the underlying transaction. In this case, the underlying transaction consists of dividend payments on Ameritech shares held in the LESOP trust; accordingly, any resulting tax savings are not properly the basis for a ratemaking adjustment to Illinois Bell's federal tax expense. Instead, any tax savings should be retained by Ameritech and its shareholders.

D. <u>Charitable Contributions</u>

Both CUB/Cook and Staff made proposals with respect to the Company's charitable contributions ("contributions") expense. On behalf of CUB, Mr. Brosch proposed that none of the Company's contributions expense should be recognized by the Commission. Alternatively, he proposed that Illinois Bell's allowed contributions should be limited to a percentage based on Ameritech's non-regulated companies' contributions.

Staff witness Mark A. Burchyett recommended a $178,000 decrease in contributions for the test-year operating expense. He stated that the level proposed by the Company for the test year ($5,101,000) was not representative of the Company's normal yearly expense for contributions. He normalized the contributions by using IBT's 1992 actual contributions because he felt that they reflected the current contributions expense of the Company more accurately.

Mr. Burchyett also recommended a $33,000 reduction in contributions allocated to the Company from affiliates Ameritech Corporate ("AIT") and Ameritech Services ("ASI") for the amount donated to out-of-state organizations. He noted that the Company's 'Guide to Giving' states that the Company should "donate to organizations that directly benefit the communities in our service territory." He concluded that the Company had not authorized these out-of-state contributions and, therefore, the Illinois ratepayers should not have these expenses embedded in their rates.

Company witness Goens responded to CUB/Cook's total disallowance recommendation by pointing out that it is inconsistent with the intent of Section 9-227 of the Act. With respect to Mr. Brosch's alternative recommendation that would limit Illinois

Bell's allowed contributions to a lower level, Mr. Goens pointed out that the Company has established that its test year contributions are reasonable when compared to those of other corporations. IBT's contributions represent 0.95% of its pre-tax income, compared to a national average of 1.97%.

With respect to Mr. Burchyett's recommendation that the test year contribution level be supplanted by the corresponding (but lower) calendar year 1992 level, Mr. Goens commented that Mr. Burchyett had agreed that IBT's contributions were reasonable when compared to those of other companies. With respect to Mr. Burchyett's recommended adjustment because of out-of-state donations made by AIT and ASI, Mr. Goens pointed out that IBT representatives meet regularly with their counterparts at these affiliated companies in order to discuss charitable contributions. He further pointed out that since it is acceptable for Illinois Bell to make contributions to organizations outside of the state, it also should be acceptable to have these types of donations allocated to Illinois Bell by these affiliates.

The record indicates that Illinois Bell's charitable contributions are reasonable in amount -- especially when compared to those of other companies. Full recovery of these contributions is consistent with the Act and with our prior Orders. There is no legal basis for the Commission to adopt Staff's recommendation to disallow out-of-state contributions by Ameritech and Ameritech Services. Accordingly, the Commission hereby rejects Staff's and CUB's proposed adjustments.

E. Advertising and Promotion

IBT included $477,000 of advertising expenses in its revenue requirement. Staff witness Ms. Maria Slattery and CUB/Cook witness Brosch proposed parallel adjustments of $378,000 to IBT's intrastate advertising expense. Specifically, Ms. Slattery and Mr. Brosch both propose eliminating all costs contained in Account 6722.5, which represents IBT corporate advertising that is not assigned to a specific market segment.

Ms. Slattery concluded that these costs should be excluded from test year expense, since their purpose is to promote the corporate image and goodwill of the Company and because Section 295.10 of 83 Ill. Adm. Code Part 295 indicates that promotional, political or goodwill advertising should not be included as an operating expense in the test year.

Mr. Brosch testified that the expense included for this advertising in Account 6722 did not promote any specific IBT service and therefore did not provide a tangible benefit to the

Company's customers. He further claimed that these ads are designed to enhance the public image and perception of Ameritech and its subsidiaries and therefore do not directly increase the sales of any of its services.

Illinois Bell witness Ray Lewis testified that Illinois Bell's advertising expense drives $2 to $3 in additional revenues for every $1 spent on advertising. With respect to Ameritech Corporate advertising expense, Mr. Lewis and fellow IBT witness Willenborg explained how it benefits Illinois Bell. Such advertising presents case histories of how Ameritech companies such as Illinois Bell have been able to solve complex communications challenges for their customers. Mr. Willenborg also explained that all of Illinois Bell's more complex communications products currently are branded with the Ameritech name, at the same time generating usage revenues that are collected by the Company. He further explained that, in the future, all Illinois Bell products will be offered under the Ameritech name. Finally, he discussed the benefits that the Company derives from the Ameritech Senior Open because it provides a major marketing forum for contact with large customers that, for example, resulted in the signing of a $20 million contract.

With respect to Illinois Bell's corporate advertising, IBT witness Goens argued that Staff's recommended disallowance based on rules for electric and gas utilities is misplaced because, by their terms, these rules do not apply to telecommunications carriers. He also criticized Mr. Brosch's recommended disallowance for IBT's corporate advertising based on the Docket 89-0033 Order on Remand, and pointed out that the Order on Remand disallowed only certain Ameritech (but not Illinois Bell) corporate advertising expense.

The Commission accepts the adjustments of Staff and CUB/Cook. Whether or not Section 295.10 of 83 Ill. Adm. Code Part 295 applies to Illinois Bell, it is within this Commission's discretion to apply the standard from this section to any type of utility. The Commission agrees with Staff and CUB/Cook that the purpose of the advertising in question is to promote the Company's corporate image and goodwill. Accordingly, the Commission does not find this advertising to be a reasonable expense for the ratepayers to bear.

F. Payroll

Illinois Bell witnesses discussed several plans that impact its management and non-management headcount. The first is the Company's management workforce resizing program; the second is the Company's non-management Supplemental Income Protection Plan ("SIPP"); and the third is the management force reduction announced by Ameritech on August 20, 1993. The Company proposes to amortize these expenses over a three-year period and include the unamortized portion in rate base.

CUB\Cook witness Brosch testified that IBT should not be allowed to amortize these expenses and he recommended a disallowance of the full $9.9 million rate base amount associated with the Company's workforce resizing programs. According to Mr. Brosch, because IBT stockholders have been saving so much in payroll and overhead costs since the end of the test year, it appears that IBT's claimed one-time severance and other SIPP program costs would be exceeded by what the stockholders have saved due to the Company's reduction of more than 2000 employees since the test year ended.

Essentially, Mr. Brosch claims that in IBT's last rate case, rates were set that recover costs for 2000 employees that no longer work for the Company. Therefore, contends Mr. Brosch, IBT continues to collect rates reflecting the payroll costs for those employees, but is not experiencing this payroll expense. Mr. Brosch recommends that IBT not be allowed to include severance and separation costs in this rate case, since they have been "over profiting" from not having these employees on the payroll in the first place.

Staff witness Garret Gorniak contends that expenses for the SIPP and the management work force resizing program which were implemented in August 1993 should not be amortized over the Company's suggested three-year period. He opined that the amortization period should be five years in order to prevent the Company from recovering significantly more than the actual cost of its workforce resizing programs. In addition, Mr. Gorniak testified that the unamortized portion of these costs (referred to by the parties as "buyout" costs) should not be included in the Company's rate base. Mr. Gorniak reasoned that buyout costs related to the Company's workforce resizing program should be shared by ratepayers and shareholders. He further reasoned that ratepayers will share the cost of the buyout through their rates (which are based upon the costs of the Company's services) while shareholders will share the buyout costs through the lost time value of the costs that are amortized.

The effect of Staff's proposed adjustment for the SIPP is a reduction of $891,000, which can be derived from Staff's exhibits. The Company has accepted Staff's buyout expense of $9,247,000. Amortization of this amount over three years would yield an intrastate expense of $2,228,000 versus Staff's expense for a five-year amortization period of $1,337,000. The difference is Staff's adjustment which reduces IBT's test year expense for this category by $891,000.

The effect of Staff's proposed adjustment on expense for the management work force resizing from October 1992 is a reduction of $1,333,000. The effect of Staff's proposed adjustment for the management work force resizing program in August 1993 is a reduction of $750,000. The effect on expense for the ASI Resizing in August 1993 is a reduction of $431,000.

IBT witness Goens responded that the Company's proposed three-year amortization period comports with past Commission practice relating to similar amounts such as rate case expense and therefore should be adopted. Furthermore, he criticized Staff's proposal not to include in rate base the unamortized balance for the Company's workforce resizing programs. He asserted that Staff's proposal constitutes a sharing mechanism that is both novel and unsupported. Mr. Goens contended that, in fact, the cost associated with workforce resizing already is shared by shareholders because they are not able to recover all the expended funds in the test period. He explained this absence of immediate recovery represents a lost opportunity cost on funds that could be spent elsewhere. Therefore, Mr. Goens argued that the unamortized portion should be part of the rate base in order to compensate for this lost opportunity cost. He pointed out that his proposed inclusion of these costs in the rate base is consistent with the treatment of unamortized costs in previous cases, such as Docket 89-0033, Order on Remand.

The Commission is of the opinion that CUB\Cook's adjustment must be accepted. The Commission cannot allow material non-recurring expenses to be included in setting initial rates for an alternative regulation plan. The starting point in such a plan is crucial. Including a material non-recurring item at the beginning of the plan could lead to the Company recovering this amount indefinitely. The Commission cannot allow this.

In light of the fact that IBT has recovered the costs of these plans through payroll reductions that have occurred since its last rate case, the Commission is of the opinion that IBT will not be harmed by accepting CUB\Cook's adjustment. The Commission thus concludes that these expenses must not be incorporated in setting a starting point for an alternative regulation plan. The Commission rejects Staff's arguments that accepting such an adjustment constitutes single issue ratemaking. This argument might have merit in a normal rate case, but it does not apply here in light of the different concerns that the Commission faces in this docket.

G. State Income Tax Rate

In his direct testimony, Staff witness Smith raised the issue of whether IBT's state income tax expense should be calculated based on the statutory rate or on the unitary rate. He testified that IBT's test year state tax expense was not "reflective of a normal ongoing level of operations" and noted that application of the Company's most recently known unitary tax rate yields an expense based on Illinois law and he advocated the application of the most recent known rate.

During rebuttal IBT witness Goens criticized Mr. Smith's calculation of the state unitary tax rate. Mr. Goens argued that Mr Smith: (1) had not removed the prior period adjustments from either the taxable income or the state income tax expense corresponding to the 1991 calendar year when calculating the unitary rate; (2) had omitted the "flow-through" of deferred income taxes in his calculations; and (3) had erred because his use of the unitary rate yields a different amount than use of the statutory rate.

Mr. Smith, in countering these arguments, testified that prior period items were reflected properly in his calculations. He also noted that the state income tax expense, that he used in his calculations, was provided by the Company for comparison with its 1991 taxable income shown on the tax return. He concluded that any items which applied to a period other than 1991 should have been removed and averred that if items for other years were included, it was also logical that comparable 1991 items were excluded. He noted that even if the specific items were not exact, they still reflected one full year as reported to the Illinois Department of Revenue. He also noted the fact that IBT offered no alternative calculation.

He concurred with Mr. Goens' assertion that Staff had failed to add back the flow-through of deferred income taxes properly. In recalculating his unitary tax adjustment, Mr. Smith corrected the flow-through error.

He also agreed with Mr. Goens' assertion that the unitary and statutory rates are different. However, Mr. Smith noted that tax liability in the State of Illinois was not only the result of the statutory rate but also the result of factors such as property, wages and sales. He reasoned that since these factors measure an entity's activities in Illinois relative to its activities outside of Illinois, taxable income adjusted for these factors would determine an entity's tax liability in compliance with Illinois law. He concluded that application of the unitary rate was appropriate because it reflected IBT's actual tax liability.

The Commission rejects Staff's adjustment. The Commission agrees with IBT that use of the test year unitary rate is more appropriate than Mr. Smith's use of the 1991 rate.

H. State Unitary Tax Rate

Mr. Smith calculated a 6.27% unitary tax rate for Illinois Bell, resulting in a proposed decrease of the Company's state tax expense by approximately $1.2 million on a grossed-up basis, using Staff's conversion factor. He contended that Illinois Bell's test year state tax expense did not reflect normal ongoing levels of operation. He further contended that the use of his proposed unitary rate was appropriate because it reflected Illinois Bell's actual tax liability. While Mr. Smith concurred with the Company that the unitary and statutory tax rates are different, he reasoned that the Company's tax liability is not only the result of the Company's statutory rate but also the result of other factors, such as property, wages, and sales. He argued that taxable income adjusted for these factors accurately determines an entity's tax liability in compliance with Illinois law, and therefore use of the unitary rate is appropriate.

Illinois Bell witness Goens agreed with Mr. Smith that the Company's tax liability in Illinois is a result not only of the statutory rate but also property, wage, and sales factors. However, Mr. Goens contended that, based upon these factors, the calculated rate for the test period is 7.18%, unlike the rate Mr. Smith calculated using 1991 data. Mr. Goens criticized Mr. Smith's calculations for not removing adjustments from either the taxable income or state income tax amounts that were booked during calendar year 1991 but which correspond to prior periods.

The Commission finds that the Company's calculated 7.18% tax rate for the test period accurately reflects the Company's effective income tax for the Company's ongoing level of operations. The Commission observes that Mr. Smith's proposed unitary tax rate of 6.27% is flawed because it includes transactions applicable to prior periods and therefore calculates a hypothetical tax expense and tax rate based on out-of-period data. Accordingly, the Commission will adopt the Company's calculated rate for the test period.

I. Life Line Link-Up Expense

Staff witness Burchyett recommended that unrecovered Life Line Link-Up expenses be disallowed from test-year operating expenses. Staff's proposed adjustment, if adopted, would reduce test-year expense by approximately $954,000 on a grossed-up basis using Staff's conversion factor.

In support of his proposed disallowance, Mr. Burchyett noted that these expenses were incurred during the period of December 1989 through February 1991, and therefore were out-of-period expenses which should not be allowed. He contended that the Company had deferred these expenses without Commission approval, referencing a letter dated June 17, 1992, from the Commission's Director of Accounting which denied approval of deferred accounting treatment of these costs and suggested that the Company petition the Commission for deferred treatment. Mr. Burchyett claimed that the Company has not responded to this letter in a timely fashion. He further testified that FASB 71, cited by the Company in support of its request to treat Life Line Link-Up costs as a test year operating expense, does not dictate to regulators how these types of expenses should be treated. Rather, FASB 71 simply speaks to how regulated enterprises should account for regulators' authorizations.

In responding on behalf of Illinois Bell, Mr. Goens cited the response of the Staff's former Director of Accounting to the Company's request for deferred accounting treatment which stated: "If Illinois Bell Telephone Company wishes to obtain approval for deferred accounting of these costs, it should file a petition with the Commission seeking authority to defer these costs." Mr. Goens testified that the inclusion of unrecovered Life Line Link-Up costs in its alternative regulation plan filing constitutes such a petition. He cited to FASB 71 and asserted that this accounting rule indicates that accountants and investors alike expect recovery of Commission-ordered assets and expenses. He contended that the Company has deferred Life Line Link-Up costs on the basis of the FASB 71 promise of recovery. Alternatively, he asserted that the Company is willing to accept a deferral and amortization of these unrecovered costs over a three-year period, with the unamortized portion of these costs added to the rate base.

As stated above, the Commission will not allow a material non-recurring expense to be included in establishing a starting point in an alternative regulation plan. For the same reasons as stated hereinabove, the Commission accepts Staff's adjustment. IBT's argument that FASB 71 promises a recovery does not apply because of the different circumstances present in this docket.

J. <u>Membership Dues and Fees</u>

Staff witness Burchyett recommended a $28,000 reduction to the Company's dues and fees for the percentage of expenditures made to the United States Telephone Association ("USTA") and the Taxpayer's Federation of Illinois for lobbying expenses. In addition, he recommended an additional $35,000 reduction to dues and fees attributable to the reduction in employee levels through

November, 1993. He argued that as employee levels decrease, there should be a corresponding decrease in the reasonable level of expenditures for dues and fees. He claimed that the levels of dues and fees charged by Illinois Bell to operating expenses from 1988 to 1992 had decreased approximately 16.5% while the number of employees over the same period of time had been reduced by 15.1%. Therefore, Mr. Burchyett argued there is a direct relationship between expenditures for dues and fees and the number of employees.

Company witness Goens responded that Mr. Burchyett was mistaken in claiming that the level of the Company's membership expenses had declined. Mr. Goens testified that, in fact, the Company's records show that Company membership expenses increased from $714,000 in 1988 to $733,000 in 1992. Accordingly, no direct relationship exists between membership dues and fees on the one hand and a reduction in employee levels on the other hand. The premise underlying Mr. Burchyett's recommended adjustment therefore is not valid.

The Commission finds that no relationship necessarily exists between the level of employees on the one hand and a reasonable level of membership dues and fees on the other hand, as demonstrated by Mr. Goens' testimony. While the Commission accepts Staff's proposed adjustment of $28,000 for lobbying expenses attributable to the USTA and the Taxpayer's Federation of Illinois, the Commission finds that Illinois Bell's dues and fees expense level otherwise is reasonable.

K. Lobbying Expense

CUB/Cook and Staff both propose adjustments to Illinois Bell's Lobbying/Government Relations expense levels.

CUB witness Brosch reviewed the Company's job descriptions for Government Relations personnel and concluded that the entirety of functions outlined in these job descriptions was political in nature and, thus, he proposes that the entire expense -- amounting to an additional $371,000 -- be excluded from the Company's allowable test year expenses. He stated that IBT's definition of lobbying pursuant to Ameritech Accounting Rule Number 90-110 is too narrow and has the improper effect of retaining significant above-the-line costs incurred by Illinois Bell in furthering its political interests.

Mr. Burchyett recommended that an $80,000 reduction to test year operating expenses for lobbying activities be made. He proposed adjustments to the total salaries of the Company's Government Relations Department as well as to the Department's operating expense.

In explaining the rationale for his proposed adjustment to the total salaries of the Government Relations Department, he testified that, in its response to Staff Data Request MAB 3.27, the Company had stated that the basis for allocating the Government Relations Department's employee salaries included employee wages only and did not include benefits, team incentives, or merit awards. In his opinion, the allocation should be based on the total compensation of the employees of the Government Relations Department. Therefore, he proposed to reduce test year operating expense by $68,000 for the allocation of those employees' total compensation.

He also recommended a $12,000 reduction for that portion of the Government Relations Department's operating expense which should have been allocated to lobbying expense. Mr. Burchyett reasoned that the department's operating expense should be allocated to lobbying expense in proportion to the time spent on lobbying by that department.

In response to Mr. Brosch's proposed adjustment, Mr. Goens contended that Mr. Brosch is attempting to expand the definition of lobbying set forth in Section 9-224 of the Act. Mr. Goens pointed out that, upon cross examination, Mr. Brosch expansively testified that lobbying expenses should include "all activities undertaken for the purpose of directly or indirectly influencing the legislative process of state and local governments". Mr. Goens argued that this view of lobbying goes far beyond the Section 9-224 definition.

Mr. Goens further testified that Illinois Bell has made a good faith effort to record all lobbying expenses as non-operating expenses, booking 63% of its Government Relations Department expenses to a below-the-line lobbying account in the test year, in contrast to the 35% allocation reflected in the Order on Remand in Docket 89-0033. He pointed out that Government Relations personnel do far more than just attempting to influence the passage of legislation as outlined in the Lobbyist Registration Act. These employees also attempt to expedite resolution of constituent complaints and become involved in the resolution of workers compensation and union issues. Mr. Goens pointed out that these expenses clearly have nothing to do with lobbying. He also responded to Mr. Burchyett's proposed adjustment, noting that actual lobbying expenses include expenses for employee salary benefits of the type Mr, Burchyett discussed. Specifically, he testified that such expenses (in the amount of $58,507) have been included in Account 7370.6, and are comparable to the $68,000 estimate provided by Mr. Burchyett.

The Commission accepts Staff's adjustments. We agree that the basis for allocating the Government Relations Department's employee salaries should include their total compensation. In addition, we are of the opinion that Staff's allocation of the Government Relations Department's employee salaries is the most reasonable allocation. CUB/Cook's proposed allocation, however, is based upon a definition of lobbying that is inconsistent with 25 ILCS 170/1, et seq., which is incorporated by reference in Section 9-224.

L. Other Post Retirement ("OPEB") Expenses

Illinois Bell witness Goens proposes that the Company be allowed to amortize its deferred Transition Benefit Obligation ("TBO") relating to Statement of Financial Accounting Standards No. 106 (SFAS 106). This amortization is included in both operating expenses (discussed here) and rate base (discussed in that portion of this Order). He testified that the OPEB adjustment primarily represents the TBO portion of unfunded post-retirement employee benefits. On January 1, 1991, pursuant to an FCC order, the Company adopted SFAS 106, which requires an accounting change from the "pay-as-you-go" method to the accrual method of recording OPEB costs. Mr. Goens testified that the Company is amortizing the resulting TBO over an 18-year period.

Mr. Goens further testified that by the end of 1993, IBT will have incurred three years of this TBO amortization. He states that the Company has deferred an amount equal to these three prior years of amortization and asks the Commission for permission to amortize this deferred amount over a five-year period beginning January 1, 1994. The Company requests a definitive decision from the Commission regarding the recognition of this deferral. Mr. Goens notes that other state regulators have approved such treatment.

Staff witness K. Allen Griffy testified that the amortization of the SFAS 106 TBO is a normal operating expense which should be recognized in the year incurred and, therefore, should not be deferred. He argued that the TBO amortization represents a change in operating expenses which is not reflected in rates and concluded that such changes in operating expenses represent out-of-period costs which are not recoverable by the Company. Staff therefore has proposed the removal of Illinois Bell's amortization of its deferred TBO relating to OPEBs from operating expenses for the test year. CUB witness Brosch raises essentially the same arguments.

The Commission accepts the adjustment proffered by Staff and CUB/Cook. As stated previously in this Order, the starting point in an alternative regulation plan is critical. We will not allow IBT to amortize the OPEB TBO expenses incurred during the 1991 through 1993 time period. These are out-of-period costs and their inclusion would distort the starting point of this alternative regulation plan.

M. SFAS 112 Expenses

Mr. Goens testified that, effective January 1, 1992, Illinois Bell adopted the provisions of SFAS 112 which relate to certain post-employment benefits such as worker's compensation, disability, and health care continuation coverage, and which require that a one-time charge be recorded in the year of adoption to reflect the transition obligation related to the post-employment benefits. In order to avoid having the full impact of this extraordinary item recognized in whole or in part in the test year as a known and measurable change, Illinois Bell requests that the one-time charge be amortized over a five-year period commencing January 1, 1994. Mr. Goens notes that historically the Commission has treated costs which it views as extraordinary, such as rate case expenses and accrued compensated absences adopted with the Uniform System of Accounts ("USOA") through amortization, and that the Commission has supported the Company's efforts to adopt all new SFAS pronouncements since the implementation of the USOA. The Company therefore has reflected expenses associated with one year's amortization in the test year. Mr. Goens also notes that the Company had not requested the establishment of a deferred asset for the SFAS 112 expenses.

Staff witness Griffy and CUB witness Brosch both disagree with the Company's proposal and have removed the amortization of the Company's transition obligation relating to SFAS 112 from test year operating expense.

In support of his position, Mr. Griffy argues that regulatory accounting should follow the guidelines of Generally Accepted Accounting Principles ("GAAP") whenever appropriate. He reasons that since SFAS 112 includes no provision for amortization of the transition obligation, conformity with GAAP requires that the Company's proposed amortization be disallowed for regulatory purposes. He also concludes that the Company's SFAS 112 transition obligation represents a non-recurring, one-time charge against operating income, and that since this obligation was not a regularly recurring item, it should be excluded from test year operating expenses. He also notes that the Commission has not always allowed amortization of non-recurring expenses and avers that non-recurring expenses were removed from test year operating expenses but not amortized in several recent dockets. Finally, he recommends the disallowance of the Company's amortization of the transition obligation relating to SFAS 112. Mr. Griffy argues that SFAS 106, which relates to OPEB costs, differs from SFAS 112 regarding the amortization of transition obligations. Therefore, adherence to GAAP requires different regulatory treatment for the transition obligations under the two separate FASB pronouncements.

Mr. Brosch states that the proposed amortization is inappropriate because it constitutes single-issue and retroactive ratemaking, and because he has seen no evidence that the Company actually has suffered a significant adverse financial impact as a result of the one-time charge to earnings.

For the same reasons stated in Section L above, the Commission accepts the adjustment of Staff and CUB/Cook.

N. Ameritech Corporate and Ameritech Services Wage Differential

Staff has proposed adjustments concerning allegedly excessive wages paid to employees of Ameritech Corporate ("AIT") and Ameritech Service ("ASI") and allocated to Illinois Bell during the test period. Staff has analyzed the wages paid by these IBT affiliates to their employees in order to assess the reasonableness of those wage levels compared to the wages paid by Illinois Bell to its own employees. The wage studies also compare wages paid to former Illinois Bell employees who transferred to these IBT affiliates.

Staff witness Norsworthy performed the study that referenced wages paid to former IBT employees who transferred to AIT. He concluded that there was no justification for salary increases on the basis of new duties, cost of living, or raises. Initially, he concluded that slightly over 6% of the wage costs incurred by AIT and charged to IBT during the test period were not accompanied by commensurate benefits. Subsequent revisions to the employee wage data included in the consultant's sample revised the excess wage ratio to 5.13%.

IBT witness Willenborg argues that Staff's position serves to highlight how speculative and poorly thought out Staff's wage adjustments are. In addition, he stresses that Staff failed to consider, or consciously ignored, numerous important factors. Mr. Willenborg states that Mr. Norsworthy never properly took into account: different employee levels; how employees go through progression to reach a position rate; justification for raises given at the time of transfer; transfers into or out of the Illinois Bell Marketing Incentive Plan where a portion of the monthly salary is withheld; variances due to merit; differences in population mix; or the impact of consolidation efforts and a corporate-wide job evaluation process on promotions.

Mr. Willenborg also argues that, if Staff's studies are adjusted to reflect all the factors that should be considered, the differences in pay levels between IBT, AIT and ASI are essentially zero. He notes that the published 1991 and 1992 wage schedules for

ASI and IBT employees are identical, and that there are only minor differences at the lowest pay levels between the Company and AIT. He further states that, when properly compared, the promotion salary rate for employees transferred to ASI is no greater than the promotion salary rate at IBT. Mr. Willenborg believes that no wage disallowance is justified.

The Commission does not accept Staff's proposed adjustments relating to AIT and ASI wages. The record does not justify Staff's conclusion that the adjustments are necessary. The Commission agrees with IBT that Staff did not consider all of the factors involved in making wage level decisions. This adjustment is speculative and, therefore, cannot be accepted.

O. <u>Ameritech Corporate Project Code 01 Expenses</u>

Staff Witness Warinner proposes an adjustment to IBT's allocation of costs to its Project Code 01 ("PC01"). PC01 is the account to which AIT employees are to charge costs that are of benefit to all Ameritech subsidiaries, but which cannot be assigned directly or allocated by some cost-causative method. PC01 costs are apportioned on a monthly basis to the subsidiaries through AIT's general allocator which utilizes a three-month moving average of the ratio of each subsidiary's operating expenses to the total operating expenses of all subsidiaries combined.

Mr. Warinner states that the problem with AIT's exception time reporting system is that there is no documentation of an employee's time unless it is reported as exception time. He testified that all costs billed by a nonregulated entity to a regulated affiliate should be supported by a written record which would provide an appropriate source for review of the cost and its applicability to the regulated affiliate. Without a written record, the regulated affiliate cannot determine the reasonableness of the cost or how it applies. Therefore, he recommends that AIT replace its exception time reporting system with a positive time reporting system. He goes on to recommend that the Commission require that all charges to IBT from affiliates be supported by written records that can be reviewed for both reasonableness and appropriateness.

He concluded that AIT's cost allocation methodology does not allocate costs to AIT's corporate-related activities properly. In assessing AIT's methodology for allocating costs to affiliates, he found that AIT's methodology inappropriately assumes that all AIT services and costs are performed on behalf of affiliates. During the test period, he found that a protion of the total test period costs were incurred for corporate-related activities not properly allocable to affiliates. His analysis of the test period allocation of executive, accounting, internal audit, and other corporate overhead costs indicates that little, if any, of these costs are allocated to AIT's nonregulated activities, thereby causing an over-allocation of costs to affiliates including IBT.

He proposed an adjustment to reallocate PC01 costs to nonregulated activities within AIT, using an allocation methodology which AIT had used prior to implementing its new cost accounting and allocation system in 1988.

On rebuttal and during cross-examination, Mr. Willenborg asserted that a disallowance of no more than $225,921 is appropriate. He notes that, although Mr. Warinner has proposed a $3,884,760 adjustment, he also has offered an alternative theory and calculation, reclassifying certain expenses and reducing the adjustment to $1.6 million. Mr. Willenborg further observed that the methodology Mr. Warinner used to arrive at his proposed PC01 disallowance effectively allocates almost 43% of AIT's total costs to just four activities: Complete Card, New Ventures, Wireless, and Advertising and Promotions. The corollary of this presumption is that only 57% of AIT's efforts are devoted to the activities of its five wholly-owned telephone companies -- with tens of billions in assets, and tens of thousands of employees -- and its other operating units. In Mr. Willenborg's opinion, this conclusion underscores the unreasonableness of Staff's proposed disallowance.

Mr. Willenborg stated that, based on his review of all activities that actually support AIT operations, approximately $6.9 million should be categorized as "corporate operating costs." He believes that this figure is conservatively high. He also avers that it is most appropriate to allocate "corporate operating costs" using the same methodology (based on payroll costs) that is used to allocate "true overheads", such as PC98 costs. However, he comments that, even though Mr. Warinner concurs that "corporate operating costs" should be allocated in a manner similar to "true overheads" and even though Mr. Warinner has not in testimony or during cross examination criticized the payroll cost-based allocation used for "true overheads," he uses total costs inappropriately in his calculations.

Staff disagrees with both the level and the efficacy of Mr. Willenborg's review of "corporate operating costs". In its Initial Brief, Staff argues that admissions by Mr. Willenborg establish that: the true level of "corporate operating costs" is not obtainable from Ameritech records and that Mr. Willenborg's figures are merely estimates; his use of responsibility center costs prior to allocation of general payroll overheads to PC98 understates "corporate operating costs"; executive and supervisory costs are understated; allocation based on total expenses rather than wages is appropriate.

In order to determine the appropriate level of test period Corporate operating expenses, Mr. Warinner developed an analysis of similar operations at Illinois Bell. Using the ratio of IBT accounting, general, and administrative expenses to total IBT expenses for the test period, he estimated the "corporate operating expenses" at Ameritech. However, Mr. Willenborg testified that Mr. Warinner's approach was deficient because of the completely different character of the two companies' operations.

Regarding the Complete Card project, Mr. Willenborg testified that it should receive an allocation of "corporate operating costs" based on the ratio of Complete Card's payroll costs to Ameritech's total payroll costs, as is true for other activities. He also proposes that Complete Card be treated as a subsidiary for the allocation of the PC01 costs remaining after the elimination of "corporate operating costs," receiving an allocation based on the ratio of its total expenses to all Ameritech subsidiary expenses, including those of Complete Card. Finally, he notes that the $44 million Complete Card test period expense figure is not representative of costs on a going-forward basis because it includes significant one-time start-up charges. He suggests that the expense be normalized based on budgeted amounts, and offers $22 million as a more appropriate ongoing figure. However, he also observes that use of the payroll allocation methodology moots the issue of what constitutes appropriate start-up costs for the allocation of "corporate operating costs" to Complete Card because the wage portion of the start-up costs is quite small.

Mr. Warinner responds that Complete Card represented a $44 million business activity during the test period, but that Mr. Willenborg's proposal amounts to an allocation of accounting and general and administrative ("G&A") costs at a rate of only 0.7% of total operating costs. With respect to Mr. Willenborg's suggestion that Complete Card can be treated as a separate subsidiary, Mr. Warinner notes that Complete Card was left in Ameritech because that was much simpler than forming a new corporation, and that if Complete Card were spun off as a separate subsidiary, it would require a much greater outlay of cash for accounting, supervision and G&A support than the business activity currently is being charged. He also expresses concern with Mr. Willenborg's proposal to normalize Complete Card costs because Ameritech's prior annual budgets for this activity consistently have been understated. For this reason, he recommends that the test period Complete Card costs of $44 million be recognized instead of Mr. Willenborg's proposal to reflect the 1993 estimated level of $22 million.

The difficulty that the Commission encounters in deciding this issue is that both IBT's and Staff's arguments are grounded in speculation, because no audit trail exists to determine accurately what types of costs have been recorded in PC01. The Commission thus requests that IBT adopt Mr. Warriner's suggestion that: (1) AIT replace its exception time reporting system with a positive time reporting system; and (2) that all charges to IBT from affiliates be supported by written records that can be reviewed for both reasonableness and appropriateness.

The record clearly indicates that there has been an overallocation of costs to IBT, and the Commission finds IBT's recalculation of the allocation to be unconvincing. The Commission is of the opinion that Staff's proposal is more reasonable, and accordingly, accepts Staff's adjustment.

P. Ameritech Services, Inc. Depreciation

Staff argues that ASI has been charging Illinois Bell for depreciation in excess of the rates prescribed by the Illinois Commerce Commission. For the test year Staff contends that year, excess depreciation charges amounted to $2,750,000.

ASI is a jointly-owned subsidiary of the five Ameritech Operating Companies ("AOCs") and was established in order to consolidate certain administrative and overhead functions which the AOCs otherwise would provide individually. In return for these services, ASI bills IBT a share of its costs (including depreciation) incurred in providing the services. The depreciation rates ASI applies, however, are higher than those prescribed by the Commission for IBT's use, and result in excess charges being attributed to Illinois ratepayers.

Staff contends that ASI was established, not in order to undertake any specific non-regulated business activities per se, but, rather, in order to consolidate certain administrative and overhead functions which the AOCs otherwise would need to provide individually. Accordingly, Staff states that ASI continues to be subject to the Commission's regulatory oversight and, thus, is bound by the depreciation rates prescribed by the Commission. Staff argues that IBT should not be permitted to avoid Commission-imposed depreciation rates by shifting the provision of services to an affiliate.

In response, Mr. Willenborg testified that ASI is a non-regulated company that provides services not only to IBT but to other AOCs as well. He pointed out that ASI is not subject to prescription of its depreciation rates by any state regulator. He argued that the test of whether ASI's depreciation rates are reasonable is not whether they comply with prescribed rates for any AOC, but whether the decisions it makes allows ASI to provide services for IBT in a cost-efficient manner. He called attention to the fact that the Staff audit itself concludes that ASI provides services to Illinois Bell very efficiently.

Mr. Willenborg further testified that the auditors' analysis of ASI's depreciation rates compounds their erroneous conclusion by considering depreciation rates in isolation and by not considering the fact that ASI's depreciation rates reduce ASI's asset base. He stated that this keeps ASI's return requirement to IBT at a lower level than it otherwise would be if depreciation rates had been at the lower Staff-prescribed rates.

The Commission accepts Staff's adjustment. The Commission agrees with Staff that IBT should not be permitted to avoid Commission-imposed depreciation rates by shifting the provision of services to an affiliate. Whether or not ASI is subject to the prescription of its depreciation rates by this Commission is irrelevant. The Commission has the authority to limit the expenses that IBT passes on to its ratepayers.

Q. <u>Anti-Trust Litigation Fees</u>

Staff witness Garret Gorniak proposed the removal of a $93,000 anti-trust litigation expense from the Company's test year expenses. He stated that the Company failed to present evidence regarding the nature of these expenses or why ratepayers should bear the burden of these expenses.

IBT's Mr. Goens testified that the test year litigation expenses associated with ongoing, anti-trust activities are substantially less than in any recent calendar year but nonetheless are unavoidable. He noted that the Commission found that such expenses properly were included in test year expense levels in its Order on Remand in Docket 89-0033.

The Commission agrees that the Company's anti-trust litigation expenses are unavoidable consequences of IBT's former relationship with AT&T. Accordingly, the Commission concludes that these expenses properly are includible in the test year.

R. <u>Rate Case Expense Amortization</u>

OPC witness Catherine Larson suggested a five-year amortization of the Company's rate case expenses. Staff witness Maria Slattery disagreed and concluded that the proposed test year expense represents a normal level of rate case expense. She therefore did not propose that it be amortized.

Nonetheless, both the Company and Staff address how rate case expenses should be amortized if the Commission were to deem these expenses to be extraordinary and therefore subject to amortization. Ms. Slattery contended that if amortization were required, the Commission also should require a sharing of these expenses by ratepayers and shareholders through exclusion of the unamortized portion from rate base. According to this view, ratepayers would share the burden of the rate case expenses through rates over a three-year amortization period and shareholders would share that expense to the extent they incur lost opportunity costs by not recovering the rate case expenses in one lump sum. Staff argued that such an approach was appropriate since both ratepayers and shareholders benefit from the rate case.

Mr. Goens adopted the position that his employer's rate case expenses are not extraordinary and therefore should not be subject to amortization. However, he contended that if amortization were to be approved by the Commission, the entire rate case expense of $2,028,000 should be amortized over a three-year period, and that any unamortized portion should be added to rate base.

The Commission agrees with Staff and the Company that the test year rate case expense represents a normal level of expense for which amortization is not necessary.

S. Normalization Adjustments

Several adjustments were proposed for the normalization of AIT expenses during the test period. First, the Staff consultant proposed the elimination of AIT lease costs for the termination of a contract for AIT space rented at 10 South Wacker.

IBT asserted that the Staff consultant's adjustment is overstated by the difference between the amount accrued on AIT's books during the test period and the amount actually paid. IBT claimed that an adjustment for $1,900,000 already had been recognized by AIT to reduce lease costs assigned to IBT for ratemaking purposes. Finally, the Company asserted that there is an offset by additional lease cost incurred for space leased from IBT at 220 West Randolph.

In response, the Company countered that this proposed adjustment should be rejected because of the cost of the alternative space leased by the corporate management group which moved out of the 10 South Wacker location. If the ongoing expense of this new lease is taken into account, it more than offsets the savings Staff was attempting to capture due to the elimination of the 10 South Wacker lease.

The Staff consultant further proposed to eliminate AIT's test period expenses for the President - Ameritech Bell Group whose position was eliminated during the test period. Part of this cost is an employee termination payment.

The Company has agreed to the elimination of a portion of the employee termination payment. IBT's Mr. Willenborg responded that any remaining adjustment is in error. He contended that there should be no such adjustment because no savings resulted from the elimination of the office of the Bell Group President. Specifically, he pointed out that new positions were created and other executives were added to replace the Bell Group president. Because no savings have been realized, Staff's proposed disallowance of the remaining cost savings for the test year should be rejected.

Issues also arose with respect to various miscellaneous affiliated expense adjustments proposed by Staff. First, Mr. Warinner proposed an adjustment for unsubstantiated expenses in the amount of $7,000. Mr. Willenborg subsequently provided supporting documentation that establishes that the underlying business activity involves IBT regulated activities.

The Commission rejects Staff's adjustments. Illinois Bell has provided adequate evidence to support the $7,000 expense which Staff had recommended be disallowed. The Commission further finds that Staff's proposed adjustment related to the 10 South Wacker lease should not be adopted in light of the ongoing expense related to a new lease. With respect to the elimination of the office of the Bell Group President, the Commission further believes that the adjustment proposed by Staff based on savings attributable to the elimination of that office is not reasonable when in fact the Company realized no actual savings.

T. Revenue Annualization

The annual revenue levels presented by the Company are based on actual test year volumes of business. However, both CUB/Cook and Staff proposed adjustments based on annualization of specific test year figures.

CUB/Cook contended that the Company recorded a reduction to revenue levels improperly based upon rate changes that occurred beyond the test year. CUB witness Brosch testified that, by contrast, his revenue annualization adjustment reflects an annualization of business and residence revenues as of the end of the test year, utilizing four times the revenue levels recorded in the last three months of the test year. He contended that the use of three months of actual data recognizes the potential variation in revenue levels actually experienced from month to month while capturing ongoing sales and revenue volumes at or near the end of the test year.

He further criticized Illinois Bell's revenue requirement presentation and claimed that it fails to match revenue requirement elements by not reflecting the fact that customers added during the test year are available as of the close of the test year to provide additional revenues for assets existing at that date. He further testified that, should the Commission decide to reject CUB's annualization proposal, he then would recommend limitation of the Company's known changes to match average test year sales and revenues more closely with expenses, and in addition would recommend that the Commission exclude all IBT promotional advertising expenses because utilization of such an average has the effect of denying ratepayers the benefits of promotional advertising.

Staff witness Roth proposed the adjustment of Illinois Bell's test year revenues on an end-of-year basis using one month's data. That adjustment is similar to the rate base adjustments made by Staff accounting witnesses.

Mr. Goens testified that the results of CUB/Cook's and Staff's revenue annualization proposals are less appropriate than the actual test year data provided by the Company. He pointed out that both Mr. Brosch's and Ms. Roth's methods of annualizing test year revenues totally fail to capture seasonality factors and remain subject to aberrations inherent in attempting to project smaller samples.

The Commission concludes that the Company's presentation of its revenues through the use of actual test year data, with an adjustment for known changes involving rate levels, is inherently more reasonable and less prone to measurement error than the annualization projection methodologies proposed by CUB/Cook and Staff. Furthermore, the Commission finds that the use of actual test year data for revenues comports with the intent of 83 Ill. Adm. Code 285.150 to develop revenues and expenses for identical periods. The Commission therefore rejects CUB/Cook's and Staff's revenue annualization proposals and relies instead on the actual test period data presented by the Company.

U. <u>Uncollectible Operating Revenues</u>

CUB/Cook and Staff propose uncollectible operating revenues levels of 1.6054% and 1.42% respectively, in contrast to the Company's test year level of 1.798%. CUB witness Brosch adjusted the Company's uncollectible level by excluding ten months of the

Company's test year experience and including ten months of data subsequent to the Company's filing, through July 1993. CUB/Cook contend in their Initial Brief that the Company currently is experiencing a downward uncollectible cost trend, which emphasizes the conservatism and reasonableness of Mr. Brosch's proposed adjustment.

Staff witness Burchyett also sponsored an adjustment to the uncollectible level, but based it on data through June 1993 and using the Company's total operating revenues to calculate the uncollectible level. He testified that his proposed adjustment better would reflect the level of uncollectible revenues reasonably anticipated to prevail while the alternative regulation plan would be in effect.

Company witness Goens disagreed with the proposed adjustments. He asserted that Mr. Burchyett's uncollectibles calculation was incorrect because it improperly included non-regulated revenues and other intrastate operating revenues that generate no uncollectibles. He further criticized both CUB/Cook's and Staff's proposals because they are based on out-of-test period data and therefore are inconsistent with past Commission decisions.

The Commission believes that Illinois Bell's method of calculating its uncollectible operating revenues is reasonable. First, the Company has excluded from its uncollectible revenue calculation unregulated items and items which generate no uncollectibles. Second, the Company's calculation of its uncollectibles is consistent with the Commission's approach in Docket 89-0033, Order on Remand, where the Company was not permitted to update its uncollectible percentage based on data from months following the original filing. Accordingly, the Commission concludes that the Company has calculated its uncollectible operating revenues properly.

V. Vacancy Levels

The Commission has not adopted Staff's proposed adjustment to the Company's Plant-in-Service category, for lease vacancies. In accordance with this conclusion, the Commission will not adopt Staff's associated proposed $1.3 million depreciation expense reduction.

W. Ameritech Flight Operations

Staff witness Warinner proposed an adjustment to the Company's test period expenses related to AIT flight operation costs charged to IBT. Specifically, he recommended a disallowance of $735,588 from the Company's intrastate test year expense.

He contended that Ameritech's flight operation costs are both excessive and are inappropriately allocated to Illinois Bell during the test period. In arriving at his recommended disallowance, he determined that AIT's average cost per passenger trip was $7,909, compared to an average cost of $1,113 using public air transportation. He also reviewed the purpose of each flight and determined that only 56.81% of the flights provided either a direct or indirect benefit to Illinois Bell.

Company witness Willenborg disagreed with the proposed disallowance. He contended that Mr. Warinner had failed to consider the justification of the business use of corporate aircraft as an appropriate and legitimate expense. He pointed out that private air travel reduces travel time and increases executive efficiency since many trips during the test period were to locations where the use of commercial air carriers and land transportation would have been prohibitively time consuming. In addition, he cited the fact that the Ameritech Board of Directors has directed the Ameritech Chairman to make every possible use of corporate aircraft for security reasons.

The Commission accepts Staff's adjustment. IBT has not met its burden of showing that these expenses are reasonable in total. The Commission is not convinced that these flight operation costs produced any benefit to ratepayers.

X. Management Audit Expense

Staff witness Burchyett recommended an adjustment to management audit expense that would reduce AIT operations expense by $318,000, representing the intrastate portion of such expense booked in the test year. He testified that this expense is not a recurring one and that the intrastate portion of this expense should be removed from the test year. In addition, he recommended a $535,000 reduction in IBT's test year management audit expense based on his recommendation that such expense be amortized over a five-year period.

He opined that an amortization period of five years is reasonable in light of Company witness Gebhardt's testimony that five years is the projected life of the alternative regulation plan. Finally, he argued that the unamortized portion should not be included in rate base, thereby developing a form of sharing between ratepayers and shareholders.

On behalf of the Company, Mr. Goens responded that management audit expenses are legitimate test year expenses, explaining that the Commission had ordered the management audit and that Staff had closely tied the results of the audit to its positions in this docket. Therefore, he contended, the Company should be able to include all such expenses. He said that he could accept as a less desirable alternative the amortization of the total management audit expenses over a three-year period. He stressed that this treatment would be consistent with the Commission's Order in Peoples Gas Light and Coke Company, Docket 91-0586. Finally, he contended that Staff's recommendation not to include any unamortized amount in rate base is unsupported, unprecedented, and should not be adopted by the Commission.

The Commission concludes that Staff's proposal is reasonable. We are of the opinion that the non-recurring portion of this expense should not be included for purposes of setting initial plan rates. We believe that a five-year amortization is more reasonable in light of the fact that we are approving a five-year alternative regulation plan.

Y. Workforce Resizing Expense

As noted in the section of this Order dealing with proposed rate base adjustments, IBT witnesses discussed several programs that impact the size of its workforce.

CUB/Cook contend that, while the Company has included as a known adjustment to its revenue requirements the workforce reductions resulting from these programs, these adjustments stop short of recognizing its actual workforce levels. They propose a $17.2 million downward adjustment to the Company's test period expenses.

In arriving at this adjustment, CUB witness Brosch suggested an employee headcount annualization based on actual headcount statistics through July 1993. He contended that his adjustment would account for all transfers of IBT employees to ASI and incorporate an offset for employee reductions that IBT already had included as a known change in its calculations. He also claimed that, in calculating the cost that Illinois Bell incurs as a result of ASI employees, he had included the cost IBT incurs as a result of employee transfers to ASI from Ameritech entities other than Illinois Bell.

Company witness Goens contended that Mr. Brosch's proposal ignores actual expenses for the test year as adjusted for known changes. He characterized Mr. Brosch's calculations as speculative and as based on an annualization of out-of-period figures. He pointed out that Mr. Brosch acknowledged that he failed to consider the most recent data Mr. Goens supplied regarding the Company's

SIPP program and its management resizing program. Finally, he criticized Mr. Brosch for failing to consider Illinois Bell's share of all AOC employees transferred to ASI.

The Commission rejects CUB/Cook's proposed $17.2 million disallowance as itself being speculative and unsupported. The Commission believes that the Company has captured accurately the savings associated with each of its resizing programs and has adjusted test year expenses accordingly.

Z. <u>Bellcore Research and Development Expenses</u>

CUB/Cook propose to exclude from Illinois Bell's operating expenses the costs related to certain Bellcore projects which CUB/Cook argue do not benefit Illinois ratepayers. The total proposed disallowance is $3.7 million.

Mr. Brosch testified that regulators must be careful when it comes to reviewing research and development ("R&D") expenses as regulated telephone companies seek to become less regulated and more competitive. He contended that Bellcore R&D may not produce benefits for current ratepayers. He reviewed various documents included with the 1992 Customized Work Program that IBT purchased from Bellcore. Based upon his review, he recommended disallowance of expenses associated with those projects which represent the most forward-looking network technology endeavors. He asserted that his proposed disallowances are appropriate because nowhere in Illinois Bell's case is it indicated that the Company intends to offer new regulated services based upon the various new technologies resulting from Bellcore's work. Finally, he discussed the opinions of NARUC auditors who concluded after reviewing Bellcore's projects that benefits to monopoly service ratepayers would not necessarily be realized.

In response, IBT witness Jennings described how the Bellcore R&D work benefits Illinois ratepayers. He argued that the R&D efforts discussed by Mr. Brosch lead to enabling technologies which produce real benefits in the provision of regulated services, facilitate the offering of the fullest range of high functionality business and residence services, and at the same time engender cost efficiencies. In addition, Mr. Goens cited to Financial Accounting Standards Report FAS-2, which calls for immediate expense recognition of R&D costs. Mr. Willenborg also discussed the NARUC report on which Mr. Brosch relied, noting that the opinions expressed in that report represent the opinions of only a NARUC accounting taskforce which have not been adopted by the full NARUC or by any individual regulatory jurisdiction.

The Commission accepts CUB's adjustment. The record does not show that the R&D expenses in question offer real benefits in the provision of regulated services to Illinois ratepayers. Accordingly, these expenses will not be used in the calculation of initial rates for this alternative regulation plan.

VI. DEPRECIATION

A. INTRODUCTION

In a prior section of this Order the Commission found that it will no longer set depreciation rates for Illinois Bell under its alternative regulation plan and that it will allow Illinois Bell to set its own depreciation rates pursuant to generally accepted accounting principles. In this section of the Order the Commission again addresses the depreciation issue, but only to determine the reasonableness of the going in rate levels under the plan.

Illinois Bell proposes to increase its test year intrastate depreciation expense by $173 million a year. As part of its proposal, the Company proposes to amortize a $559 million intrastate depreciation reserve deficiency. The Company proposes to amortize the portion of the reserve deficiency attributable to analog switching over four years and the remaining amount over five years. Staff proposes adjustments to the Company's depreciation study which would result in an $84 million increase to intrastate depreciation expense. Staff proposes that the entire depreciation reserve deficiency (which it believes is smaller than the Company's figure) should be amortized over a five-year period. CUB/Cook County propose that the Company's depreciation expense be reduced by $18 million and do not believe there is any depreciation reserve deficiency which requires amortization.

The Company's depreciation proposal was presented by Quentin J. Kossnar, Illinois Bell's Manager of Capital Recovery, Dr. Lawrence K. Vanston, a principal at Technology Futures, Inc. and Scott Jennings, the Company's Director of Integrated Planning. Staff's depreciation proposal was presented by S. Rick Gasparin, an economic analyst in the Telecommunications Department of the Public Utilities Division of the Commission. CUB/Cook County's depreciation testimony was presented by James W. Currin, a consultant with the Washington, D.C. firm of Snavely, King & Associates.

B. Specific Account Analysis

The four accounts to which Staff and/or CUB/Cook made depreciation rate adjustments to: Digital Electronic Switching, Digital Circuits, Exchange Metal Cable, and Analog Circuit Equipment.

1. Digital Electronic Switching

a. Projection Life

This account consists of all digital electronic central office switching and packet switching equipment and associated cross-connecting frames, power plants, test and control equipment. The Company proposes a projection life of 14 years; Staff proposes a projection life of 18 years; CUB/Cook County propose a projection life of 18 years.

The Company contends that its 14-year projection life is reasonable because digital switches are composed of "modular" components which will be continually replaced as new functionalities and technologies are developed, thereby shortening the projection life of the entire switch as the outdated modules are retired. The Company also contends that its forecast is also reasonable because the average life span of the analog switching technology was 15.6 years and no switching technology has ever had a life span greater than its predecessor. Mr. Jennings testified that modularity speeds up switch replacement because new functionality can be added by replacing individual modules rather than changing out the entire switch. Mr. Jennings testified that some modular replacement has already taken place; he cited the replacement of the NT40 in the Northern Telecom DMS 100 switch with the "supernode" processor.

Mr. Jennings emphasized that the Company's 14-year projection life is not dependent on the appearance of any "successor technology"; rather, currently-deployed modules will be retired as they are replaced by improved editions of digital switching technology -- similar to the way that speakers, amplifiers, and CD players are updated in a home entertainment system. Mr. Jennings did note that there are new technologies -- such as asynchronous transfer mode switching and photonic switching -- which could speed this process even further.

Staff asserted that the life of Digital Electronic Switches will extend to the 18-year projected life because the technology required to evolve to the "next generation" switching format is many years away from implementation. Staff also questioned the benefits of next generation switching touted by the Company and claimed that improvements to the basic "plain old telephone service" ("POTS") customer will be negligible. Staff noted the modularity of digital switches and the ability to revise and easily replace software packages gives IBT's digital switches the capability of having a P-Life of 18 years, because the modularity provides digital switches the ability to evolve into the next generation of telecommunications services without the need to retire an entire switch and its appurtenances. Mr. Gasparin testified that upgrades to digital switches can and do occur by simple replacement of modules, and wholesale replacement of digital switches should not occur until there is a need for such change.

In making its proposed adjustments, Staff relied, in part, on the 19 year projection life for Digital Electronic Switches and depreciation rate of 6.9% set for IBT by the FCC in August 1991. Staff also relied, in part, on the June 1993 intrastate projection life and depreciation rate prescribed for GTE North by the Commission, which were 18 years and 6.6 percent, respectively.

CUB/Cook County also oppose the Company's 14-year proposal for several reasons. First, Mr. Currin testified that the modular design of the digital switch allows upgrades without total replacement and that this will greatly extend the life of the basic switch. Next, CUB/Cook County contend that their projection is more reasonable than the Company's because the Company assumes that virtually all of the current investment in digital switches will be retired by the year 2011. Third, CUB/Cook County assert that photonic switching is the replacement technology for digital switches and that it is many years away from implementation. Fourth, CUB/Cook County argue that it is unreasonable to expect that the Company will invest in digital switches in 1997 when they would only have an average remaining life of only 6.5 years at that time. Fifth, CUB/Cook County argue that certain components of a basic switch such as power equipment, distribution frames and right-to-use fees on the basic switch will continue to provide service as long as the basic switch unit is in service and that only the introduction of a completely new technology will have a significant impact on their lives. Finally, CUB/Cook County assert that Dr. Vanston's testimony should be given little weight because his prior work for Regional Bell Operating Companies places his professional independence in doubt.

In response to Staff's position, the Company asserts that reliance on 1991 FCC prescriptions is unreasonable because they are based on 1989 historical data and 1990 forecasts. Mr. Kossnar testified that the rapid pace of technological developments means that forecasts made in 1990 are not adequate today -- and will be even more inadequate when this proceeding is resolved later this year. Mr. Kossnar further testified that modularity of digital switches will shorten rather than extend the projected life of the account. Mr. Kossnar also disagreed with Staff's reliance on the depreciation rate prescribed by the FCC, alleging that the projection was out of date, since it was based upon 1989 historical data and 1990 forecasts. Mr. Kossnar claimed Staff's reliance on GTE's prescribed depreciation rate was irrelevant, since that prescription does not reflect data and forecasts specific to IBT.

With respect to CUB/Cook County's arguments, Dr. Vanston testified that while CUB/Cook County and Staff speculate on whether modularity will increase or decrease the projection life of digital switching, only the Company provided concrete evidence that modularity decreases the projection life of digital switches. Dr. Vanston testified that part of this concrete evidence is an analysis he made of the life characteristics of the individual components which make up a digital switch such as the processor and the switching fabric. With a modular architecture, some components such as the shell will last longer than they would have in an analog switch, while other components such as the processor will not last as long. Dr. Vanston weighted each component to reflect its percent of investment in the entire switch and found that the weighted average life of those components is shorter than the average life of an analog switch.

b. Future Net Salvage

The Company and Staff agree on a future net salvage (FNS) value of -3%. Mr. Kossnar testified that the Company's proposal starts with the actual gross salvage for digital switching and cost of removal for digital switches which the Company has experienced in the recent past. The Company then projected that gross salvage for digital switching will decline over time the same way that gross salvage for analog switching has declined over time. The Company also projected that the cost of removal for digital switching will increase over time as it has in the past for analog switching. Mr. Kossnar testified that Mr. Currin's recommendation of 9% (which Mr. Currin took from his FNS analog switching proposal) is far too high because there are important differences between digital switches and analog switches. Mr. Kossnar explained that one clear difference is that digital switches are smaller and lighter than analog switches and, therefore, have less junk salvage value.

Mr. Currin testified that the Commission should simply adopt the past net salvage for analog switching as the FNS value for digital switching, with a slight downward adjustment to be conservative. Mr. Currin argued that this method is more realistic because historical salvage associated with analog switching is more representative of what can be expected in digital switching. Even though digital switches are smaller and lighter than analog switches, Mr. Currin contended that the net salvage value will be the same because the value of electronic equipment generally has no relationship to the scrap metal involved; because the cost of removing modular units should be less than the cost of removal for analog switching equipment; and because the ability to remove modules while they still have value should yield a greater gross salvage value.

In response, the Company contends that costs of removal may well be greater for digital switches because modules will be removed in working switches and this effort will require a great deal of precision and caution. The Company also points out that CUB/Cook County fails to make any allowance for future increases in the labor costs associated with removal. Moreover, Mr. Kossnar demonstrated that the total expected net salvage for analog switching is 4% using Mr. Currin's proposed FNS, not 9% as Mr. Currin testified, and that this error is symptomatic of the overall flaws in CUB/Cook County's approach.

<u>COMMISSION ANALYSIS AND CONCLUSION</u>

The Commission is of the opinion a projection life of 18 years as proposed by Staff and CUB/Cook is reasonable. In setting depreciation rates, the Commission must consider current information that is based upon fact, not speculation. IBT's statements that digital switches will have a shorter life then the analog swithes they replace is speculative. At this point in time, 18 years is the most reasonable estimate of projection life. The switches are modular and allow for periodic improvement without total replacement. The Commission rejects IBT's contention that modularity decreases the life of this equipment. IBT's statements to this effect are not convincing.

The commission is of the opinion that the Company's FNS value of -3% is reasonable because the Company's analysis begins with the actual salvage experienced for digital switches.

2. <u>Digital Circuit Equipment</u>

a. <u>Projection Life</u>

This account consists of digital central office equipment that provides communication channels for telephone, data, and video circuits. This equipment connects interoffice trunks--special service circuits between central offices and between central offices and subscribers. The Company proposes a projection life of 11 years; Staff and CUB/Cook County propose 13 years.

Mr. Jennings contends that the 13-year proposal is unreasonable because it is no change from the projection life prescribed for the Company in 1989 and it does not take into account the technological changes which have occurred in the intervening five years. Mr. Jennings testified that, for example, major retirements in the digital circuit equipment account are happening now because of analog switch replacement and will accelerate between now and 1997 when all analog switches are replaced. In particular, digital carrier trunk equipment and D-Channel bank equipment, which allow an analog switch to process digital calls by converting the digital signals to analog, will not be needed once analog switches are removed. The Company contends that imminent removal of all analog switches, which was not a factor in 1989, shortens the projection life of this account.

Mr. Jennings also testified that fiber optic terminals, which convert signals from electrical to optical for transmission over fiber cable, are being replaced and upgraded with SONET-compatible equipment as SONET transmission becomes more ubiquitously deployed. Similarly, he explained that digital loop carrier equipment, which performs analog to digital conversions in the loop, is also being replaced with SONET-compatible equipment. The Company contends that its currently-prescribed life simply fails to take these developments into account. The Company also notes that retirements for this account for 1988-1992 exceeded forecasts by 49% and that, therefore, past projections have been overly-conservative.

Staff's proposal relied, in part, on the 1991 FCC interstate depreciation rate for this account of 9.8 percent with a projection life of 12 years. In making his adjustment, Mr. Gasparin also evaluated IBT's proposal against GTE's depreciation rate for the Digital Circuit account. Mr. Gasparin contended his adjustment for this account was appropriate for the same reasons that his adjustment to the Digital Electronic Switch account was appropriate. Mr. Gasparin reasoned that Digital Circuits will be replaced only new generation technology arrives in the marketplace or when the digital technology advances to a stage where replacement of this equipment would be appropriate. Mr. Gasparin stated that he considered all relevant factors affecting the projection life for this account, including the anticipated deployment of SONET systems.

Mr. Currin testified that the Company's proposal is questionable because the Company proposes a 7.8-year remaining life for pair-gain devices which provide transmission over metallic cable, but proposes a 12.2-year average remaining life for metallic cable. Similarly, Mr. Currin testified that Company proposes that fiber cable have a composite remaining life greater than 17 years, but proposes that fiber electronic investment have a remaining life of only 4.2 years.

CUB/Cook County argue that the fact that retirements in this account for 1988-1992 exceeded forecasts by 49% is not persuasive because the Company may have intentionally mis-forecast retirements, retirements may have been impacted by unusual events such as fires or floods, or the Company may have simply performed a bad forecast. CUB/Cook County also contend that the Company's criticism of its use of historical data is misplaced because historical data for this account already reflects the impacts of technological advances.

CUB/Cook County also discount the impact of SONET deployment on the projection life of digital circuit equipment because, in their view, the life of new fiber optic SONET systems should extend beyond what is expected of the older units.

Finally, Mr. Currin testified that his Exhibit 2.19 demonstrates the problem with the Company's forecast. He testified that this Exhibit compares the actual investment deployed in the digital circuit account to the life cycle forecasts used by the Company in support of its proposal. In Mr. Currin's view, the graph shows that, despite the fact that the investment in this account increased sharply in 1992, the Company predicts a precipitous drop in the level of this account's investment in service.

In reply to Staff's reliance on the FCC's 1991 prescription, the Company once again asserts that if the Commission is going to rely on FCC prescriptions at all, it should use the most recent information available, i.e., the average of the 1993 FCC prescriptions which is 12 years. Dr. Vanston testified that even that number is too long and that the Company's 11-year proposal is a more reasonable forecast.

The Company also takes issue with CUB/Cook County's contention that historical mortality data incorporates the impacts of technological advances. In the Company's view, that would be true only if the future is a repeat of the past. The Company contends that, since the pace of technological change for technology-impacted accounts such as this is accelerating, historical data cannot capture the impact of future technological developments.

With respect to CUB/Cook County Exhibit 2.19, Mr. Kossnar explained that the two graphs show two different things: one shows total investment, the other shows retirements from existing vintages. Mr. Kossnar testified that CUB/Cook County is confusing two distinct issues. It is completely proper for actual investment in an account to continue to grow over time (thereby increasing total investment) while there is a decline in the amount of investment in service from a particular vintage.

b. Future Net Salvage

The Company and Staff both propose a future net salvage of -5% for the digital circuit equipment account. The Company's proposal is based on the recent historical salvage and cost of removal trends in this account and the expected increase in labor costs associated with cost of removal.

Mr. Currin testified that a 1% future net salvage value is reasonable. Mr. Currin used the Company's recent actual net salvage data from 1988 through 1992. In response to the Company's criticism that his analysis fails to recognize that labor costs associated with removal will increase in the future, Mr. Currin argued that historical information has inflation built into it. He also contended that labor cost increases will not have as significant an effect if it turns out that the Company is correct that the projection life for this account has declined from 13 to 11 years.

COMMISSION ANALYSIS AND CONCLUSION

The Commission is of the opinion that the projection life of 13 years proposed by Staff and CUB/Cook is reasonable and results in a fair projection life and depreciation rate for this account. The Commission agrees with Staff that the digital circuits will be replaced either when circuits employing new generation technology are available or when the digital technology advances to a stage where replacement of this equipment would be appropriate. At this point in time, the estimates of Staff and CUB/Cook are more reasonable and less speculative.

The Commisssion also agrees with Staff's reliance on the FCC's 1991 IBT specific depreciation prescription and with depreciation rates recently prescribed by the Commission for a large local exchange carrier which does business in Illinois. The Commission rejects IBT's proposal which is based on neither IBT specific nor Illinois specific information.

In addition, the Commission finds that the FNS value of -5% proposed by both the Company and Staff is reasonable because it takes into account the future costs of removing plant.

3. Exchange Metallic Cable Accounts

a. Projection Life

Exchange metallic cable equipment is often referred to as the "local loop." It includes the copper facility which runs from the central office to the customer's premises either through the underground conduit system (underground cable), through cable buried in the ground but not in conduit (buried cable), or through cable placed on overhead poles (aerial cable). For the underground cable account, the Company proposes a projection life of 21 years; Staff and CUB/Cook County recommend 30 years. For the buried cable account, the Company proposes a projection life of 22 years; Staff and CUB/Cook County propose 27 years. Finally, for the aerial cable account, the Company and Staff propose a projection life of 24 years; CUB/Cook County propose 25 years.

The Company contends that the projection lives for all exchange metallic cable accounts should be shortened from current levels because all indications increasingly point to the aggressive deployment of fiber optic cable or coaxial cable as a substitute for metallic cable. Mr. Jennings testified that there has already been extensive deployment of fiber optic cable in the interoffice network and that deployment of fiber optic cable in the feeder portion of the loop is accelerating. While deployment of fiber in the distribution portion of the loop (from the feeder to the premises) has been limited, deployment will accelerate as the cost of fiber continues to fall and the benefits of fiber become more pronounced. According to Mr. Jennings, fiber optic cable is superior to metallic cable because it has reduced maintenance costs, it is immune to electrical interference and water damage, and it can deliver broadband services, i.e., voice, data or video at speeds over 1.54 MB/S.

Mr. Jennings also testified that deployment of broadband capability is increasingly becoming the standard for providing services. He testified that Pennslyvania's new law requires high capacity capability to the home by 2015 and that New Jersey Bell has committed to be 100% fiber optic in the loop by 2010. Subsequent to the announcement of these two initiatives, other companies have also announced plans to extensively deploy broadband capability throughout their networks. The Company contends that the same considerations that have led to the adoption of fiber in these states will also accelerate fiber deployment in Illinois Bell's network.

Dr. Vanston testified that his independent analysis confirms that the projection lives proposed by the Company for the exchange metallic cable accounts are reasonable. Dr. Vanston's conclusion is based on an industry study of fiber feeder facilities which he performed in 1988 and updated in 1992; on his New Services study which examined the demand for high capacity services; and on his extensive analysis of technology in the distribution plant.

Dr. Vanston's testimony that current projection lives must be shortened is supported by the most recent FCC prescriptions for the projection lives of underground and buried cable of 26 years and 22 years, respectively.

Staff witness Gasparin argued that IBT's 21 year projection life is inappropriate because it assumes that the life of this account needs to be shortened so that the Company can replace existing copper cable with fiber optic cable. Mr. Gasparin asserted that deployment of fiber is not necessary for IBT to provide service to the vast majority of its customers who subscribe to basic voice communications service, or plain old telephone service ("POTS"). Mr. Gasparin further asserted that technologies exist, such as HDSL, which can extend the useful life of existing copper cable. In recommending adjustments to the Company's rates, Mr. Gasparin again used the FCC's 1991 prescribed projection life and deprecation rate for IBT and the Commission's prescribed projection life and depreciation rate for GTE.

CUB/Cook County advance several arguments in support of their proposal. First, they contend that the Company's proposal is based on the assumption that there will be customer demand for broadband services. Second, CUB/Cook County question the Company's commitment to broadband technologies since the Company continues to invest substantially in metallic cable while placing limited quantities of fiber cable. For example, CUB/Cook County contend that the Company added $202.7 million in investment in the buried cable account during 1990-1992, but added only $1.2 million in the exchange fiber account. Third, CUB/Cook County assert that HDSL technology will be the only economic choice for installation of high-capacity (1.54 MB/S) services where very high capacity fiber technology is not needed. Mr. Currin explained that HDSL technology can provide 1.54 MB/S service over copper loops that are 6,000 feet or less from the central office. For premises located more than 12,000 feet from the central office, HDSL technology will work in conjunction with fiber feeder cables. Finally, CUB/Cook County note that the Company's projected retirements for the underground cable exchange plant account in 1992 were $8 million, but that actual retirements were only $6.7 million.

The Company makes several responses to these arguments. First, the Company claims that Staff and CUB/Cook County have overlooked the serious limitations of HDSL technology. The Company contends that HDSL is not a viable long-run substitute for fiber because it cannot serve customers above the 1.54 MB/S speed which is necessary for full motion video applications. The Company also explained that HDSL technology is not effective beyond 9,000 to 12,000 feet and that 31% of its customers are located beyond 12,000 feet from their serving central office. In addition, Dr. Vanston testified that HDSL cannot provide National Television Systems Committee quality (today's television standard) and does not come close to providing HDTV quality which will become important within the next 10 years.

Dr. Vanston also explained that the relative levels of recent investment in fiber and metallic cable cannot provide a reliable forecast of useful lives. Dr. Vanston explained that technology substitution patterns do not occur gradually as CUB/Cook County appear to believe. In the early years, substitution of the new technology for the old technology does begin slowly, but when the new technology takes over, old products are displaced suddenly and simultaneously over relatively brief periods of time.

Finally, the Company contends that Staff and CUB/Cook County are wrong to assert that fiber will not be deployed because it is not needed to provide basic voice services. Mr. Jennings testified that fiber provides improved clarity of transmission for voice services today and provides the capacity for the sophisticated data transmission needs which are developing for video conferencing, home entertainment, medical applications and distance learning applications. He also testified that it will facilitate telecommuting and will provide the transmission capacity which special needs groups will use to overcome barriers to communications and access.

b. Future Net Salvage

The Company and Staff propose a future net salvage value for the aerial and underground accounts of -36% and -19%, respectively. CUB/Cook County contend that the figure should be -30% and -8%. With respect to buried cable, the Company proposes a future net salvage of -14%, Staff proposes -12% and CUB/Cook County propose -13%.

The Company's future net salvage proposal for these cable accounts is based strictly on a review of the latest 10-year average of historic gross salvage and cost removal activity. The Company contends that it is appropriate to use a 10-year average rather than a shorter average because no clear trend is seen in the annual or 5-year band data. According to Mr. Kossnar, the Company proposes no change to its current FNS prescription for the underground account and only small changes for the buried and aerial accounts.

Staff objects to any change in FNS for the buried cable account because, in Staff's view, the Company's proposal does not represent the actual occurrences to the account.

CUB/Cook County's proposal is based on the use of 5-year bands of Company data rather than the latest 10-year average. (A 5-year band of data is simply 5 years of information, e.g., 1988-1992; two 5-year bands represent overlapping periods, e.g., 1987-1991 and 1988-1992). Mr. Currin contends that FNS for aerial cable should be analyzed based on the last two 5-year bands of data, that underground cable accounts should be analyzed based on the last single band of 5-year data, and that buried cable accounts should be analyzed based on the last three 5-year bands of data. CUB/Cook County object to the use of a 10-year band of data because, in their view, changes since the early 80's have reduced the cost of removal and increased gross salvage. For example, they contend that during the early 80s much of the Company's retirements involved only "partial systems" which were more expensive to remove than "entire systems." Moreover, CUB/Cook County contend that manual record keeping in the early 80's was more expensive than record keeping later on. They also assert that due to "consolidation" the Company is in a better position now to maximize its salvage than it was 10 years ago.

In response, the Company contends that CUB/Cook County's use of data in its analysis was arbitrary and was apparently selected to produce the desired result. The Company observes that CUB/Cook County used either one band of 5-year data, two bands of 5-year data, or three bands of 5-year data without any consistency among accounts. The Company also contends that CUB/Cook County's argument regarding the alleged decrease in cost of removal and increase in salvage since the early 80's are mere conjecture. The Company argues that there were no changes which decreased overall costs of removal or which increased gross salvage.

COMMISSION ANALYSIS AND CONCLUSION

This issue is one area that is an indicator of the problems that this Commission would face under ROR regulation in the future. The Commission is clearly put in the position of having to choose whether and when a new technology should be implemented. The Commission agrees with Staff and CUB/Cook that for purposes of providing POTS, metallic cable will suffice. If the Commission takes the position that depreciation rates must be based upon the philosophy that IBT provide only POTS, the Commission would be detering progress and all of the people of the State of Illinois would suffer. As stated previously in this order, the time has come for Illinois Bell to make its own investment decisions. The Commission should not be in the position of determining whether new technologies should be implemented.

For purposes of setting the initial rates going into the alternative regulation plan, however, the Commission will set this depreciation rate based upon the proposals of Staff and CUB/Cook. It is Illinois Bell that will enjoy the profits, if any materialize, of providing broad-band services -- it is, therefore, not the ratepayers' obligation to pay for this technology. For the underground cable account, the Commission accepts a projection life of 30 years. For the buried cable account, the Commission accepts a projection life of 27 years. Finally, for the aerial cable account, the Commission acceptsa projection life of 24 years as proposed by Staff and IBT.

In addition, the Commission is of the opinion that the Staff's proposal for future net salvage is the most reasonable.
The Commission accepts a future net salvage value for the aerial and underground accounts of -36% and -19%, respectively. With respect to buried cable, the Commission accepts a future net salvage of -12%.

4. Analog Circuit Equipment

a. Projection Life

The analog circuit account consists of central office equipment that provides analog transmission paths serving telephone, data and video circuits. It interconnects message trunks and carrier equipment for special service circuits between central offices and between central offices and subscribers.

The Company contends that the current projection life of 11.5 years is too long and that its proposal of 8.3 years is reasonable. The Company argues that analog circuit equipment is becoming less and less useful in its network as analog transmission technologies are replaced with digital transmission. To illustrate how far this process has already come, Mr. Jennings testified that at the end of 1991, 17% of the Company's total circuit investment (analog and digital) was in analog circuit equipment. By the end of 1994, this figure will drop to just 10%. Mr. Kossnar testified that the diminishing need for analog circuit equipment is reflected in the fact that the Company's actual retirements in this account have exceeded forecasted retirements by an average of 8.0% over the past five years. Finally, Mr. Kossnar noted that Staff agrees with the Company's projection life of 8.3 years.

CUB/Cook County contend that the projection life should be reduced to 11 years. Mr. Currin testified that $65 million of the $186 million investment in this account was Line Test equipment which does not necessarily have to be replaced in conjunction with analog switches. He also noted that a large portion of the Company's investment in this account was labeled "miscellaneous". Finally, Mr. Currin discounted the fact that actual retirements exceeded forecasts because, in his view, this could have been caused by reasons other than accelerating retirements.

In reply, Mr. Jennings explained that the retirement of Line Test equipment is related to conversion from analog to digital transmission technologies, not necessarily conversion from analog to digital switching, and that most of the Company's transmission facilities are digital. He also identified the categories of equipment which make up the "miscellaneous" category.

b. Future Net Salvage

The Company proposes an FNS of -20%. Mr. Kossnar based this proposal on the fact that historical net salvage in this account has declined rapidly in the past several years. He testified that net salvage realized in this account in 1991 was as low as a -21.6% and that the Company's proposal is less than this amount. Staff agrees with the Company's FNS proposal.

CUB/Cook County propose an FNS of -19% because the net salvage in the analog circuit account has averaged -19% for the last five years. CUB/Cook County do not believe that any adjustment is needed to reflect increases in labor costs. In their view, since net salvage is treated as a percent of the original cost of the investment being retired, and since labor for the cost of removal and the cost of installing have increased, the cost of removal as a percent of original cost may not increase.

COMMISSION ANALYSIS AND CONCLUSION

The Commission is of the opinion that the Company's depreciation proposal for the analog circuit account is reasonable. The projection life of 8.3 years reflects the analog to digital conversion which has been under way in the Company's network for years. In addition, the future net salvage value of -20% is reasonable.

C. Accumulated Depreciation Reserve Deficiency

1. Amortization of the Reserve Deficiency

The issues of whether the reserve deficiency should be amortized and if so, over what period of time were disputed in this proceeding. IBT has proposed that the reserve deficiency be recovered over either a four or five year period, depending on the particular account. Mr. Kossnar testified that the Company has an accumulated depreciation reserve deficiency of $716 million ($559 million intrastate) which represents a shortfall in depreciation due to rapid changes in technology which has not been incorporated into past depreciation rates. The amount of the Company's reserve deficiency is based upon its depreciation study discussed above. The Company gives three reasons to support its proposal that (with the exception of the analog switching reserve deficiency) this reserve deficiency should be amortized over five years. First, the Company contends that a five year period reasonably distributes the financial affect of the amortization and avoids an undue impact on earnings in any one year. Second, the Company contends that a five year period is consistent with prior amortization proposals approved by this Commission. Third, the Company contends that five years matches the initial period during which Illinois Bell's plan is expected to be in effect, and that, since the Public Utilities Act sunsets on July 1, 1999, this will provide a logical opportunity for a formal review of the plan.

Staff also proposes that Illinois Bell be permitted to amortize its reserve deficiency over five years, but argues that the reserve deficiency is actually less than the Company calculates when it is based on Staff's overall depreciation proposal. Staff opposes the Company's proposal for four year amortization of the portion of the reserve deficiency attributable to analog switching.

CUB/Cook County deny that any reserve deficiency exists and, therefore, oppose the proposals of the Company and Staff. In CUB/Cook County's view, the reserve deficiency is "imagined" because it is based upon the Company's overly aggressive product life cycle forecasts and FNS percentages as well as the Company's belief that past represcriptions by regulators were inadequate to fully recover capital costs. In fact, CUB/Cook County allege that if a calculation were made using the lives and FNS levels proposed by Mr. Currin, it would reveal a reserve excess rather than a reserve deficiency.

The Commission agrees with IBT and Staff that an accumulated depreciation reserve deficiency exists. The Commission believes that this deficiency should be recovered over the life of the alternative regulatory plan, which is five years. The Commission rejects IBT's argument that a four year amortization period for the analog switch account would better match the life of the account.

2. <u>Analog Switching Amortization</u>

The Company proposes a four-year amortization of the reserve deficiency in the analog switching account in order to match the recovery of capital with the actual retirement of that equipment. Staff proposes a five-year amortization, but Staff witness Smith acknowledged in his prepared testimony that a four-year amortization may be appropriate as a "exception". The Company contends that an exception is justified because all analog switches will in fact be replaced within four years. Mr. Kossnar calculated that, with a four-year amortization, Staff's proposed change in intrastate depreciation expense would increase by $10.9 million -- from $84.4 million to $95.3 million.

CUB/Cook County object to the Company's depreciation rate for analog switching and propose "dying account" treatment rather than amortization. First, Mr. Currin testified that 1998, rather than the Company proposed date of 1997, is the more reliable end-retirement date for this account. He based this conclusion, in part, on his observation that the Company's analog line replacement forecast for the future is 156% of the actual replacement for 1991-1992. He also asserted that actual retirements in 1992 were 11% less than forecasted in a prior study.

Mr. Currin also contended that the Commission should adopt his FNS proposal of 0% rather than the Company's -3%. He contends that this difference is solely attributable to his view that the cost of removal will decrease from the current 2.3% range to around 2.0%, while the Company believes cost of removal will increase to the 5% range. Mr. Currin argued that his view is more reasonable because less care will be required when removing analog switches than when replacing components (presumably in digital switches).

Mr. Currin also testified that capital recovery in the analog switching account should be reduced by 6.5% to account for reclassifications of analog switching investment to other accounts. Mr. Currin testified that reclassified investment in the analog switching account has been 6.5% of its retirement amount for the years 1990-1992 and that the Commission should assume the same level of reclassifications will occur in the future.

Finally, CUB/Cook County contend that the Company's amortization proposal should be rejected in favor of a "dying account" amortization. Mr. Currin testified that this procedure is accomplished by taking the net book investment, plus or minus future net salvage, and amortizing the balance over the remaining period the plant is in service. To adequately reflect the expected depreciation amount over the amortization period, reclassifications must also be subtracted. Mr. Currin further testified that the FCC has authorized the use of the dying account amortization method for the analog-ESS account in several companies in the past and that use of the dying account amortization fully recovers the investment in plant. Finally, he contended that this procedure is not complex and can be achieved by simple division of the net book investment at the beginning of the month by the number of months remaining.

In response, the Company first contends that "dying account" treatment is inappropriate because it does not meet the applicable FCC criteria. Although Mr. Currin testified the FCC has authorized the use of "dying account" treatment for other LECs, Mr. Kossnar argued that the fact that other LECs may have warranted "dying account" treatment for this account does not establish in any way that this treatment is appropriate for Illinois Bell in this proceeding. Second, Mr. Kossnar testified that FCC procedures are very specific in defining when an account qualifies for "dying account" treatment. He stated that the FCC in Prescription of Revised Percentages of Depreciation, FCC Docket No. 83-587, Order, December 20, 1983, allows "dying account" treatment only when one of the following conditions is met:

1. When plant balance is zero and there is a depreciation reserve balance; or

2. when a plant balance exists and due to a large reserve imbalance there would result an extremely high remaining life depreciation rate (i.e., approaching or in excess of 100%).

Mr. Kossnar testified that the analog switching account meets neither of these criteria because analog switching has a calculated remaining life rate without amortization of 22.3% and a book reserve percent of 51.7% as of the study date. He noted that Mr. Currin does not dispute these facts.

Mr. Kossnar also testified that CUB/Cook County's proposal would result in an estimated shortfall in depreciation accruals of $29 million because Mr. Currin makes a "reclassification" of equipment out of analog switching, but does not adjust his proposal to account for the necessary recovery of that investment in any other account.

Third, Mr. Kossnar testified that CUB/Cook County's proposal to reclassify 6.5% of analog switching investment is non-standard practice and is unsupported. The Company argues that just because a given level of reclassification may have been made in account in the past is absolutely no reason to believe that equivalent levels of reclassification are appropriate in the future.

Finally, Mr. Jennings contradicted Mr. Currin's assertion that the Company would not physically be able to complete the work involved in retiring the remaining analog switches by the end of 1997. Mr. Jennings stated that the Company has replaced an average of 30 switches per year during the 1990-1992 period. Since the Company will have only 18 analog switches remaining at the end of 1994, Mr. Jennings testified that this work can clearly be finished within the schedule. Mr. Jennings also testified that the advent of the "jumperless" switch cut-over has reduced the amount of labor required to install a new switch and will further facilitate the Company's ability to complete its project within the schedule.

Staff does not agree with CUB/Cook County's proposal for "dying account" treatment for analog switching.

The Commission is of the opinion that the Company's proposal to amortize the analog switching reserve deficiency over a four-year period is reasonable. Since we believe that it is appropriate to recover the costs of analog switching while analog switches are still in use in the Company's network, we reject Staff's proposal to amortize the reserve deficiency over five years. Finally, we reject CUB/Cook County's proposal for "dying account" treatment because it is not appropriate in this situation under recognized depreciation procedures and because the proposal, as framed by CUB/Cook County, would result in an under-recovery by the Company.

3. CUB/Cook County's Proposal to Record Cost of Removal and Salvage as a Current Period Expense

CUB/Cook County propose that the Commission should change existing practice and should require the Company to begin recording its cost of removal and salvage as a current period expense for regulatory purposes. Mr. Currin testified that this would provide incentives to the Company to minimize its cost of removal and maximize its gross salvage.

Mr. Kossnar testified that Illinois Bell opposes the proposal. Mr. Kossnar explained that this idea is not new; the FCC evaluated this issue in the past (FCC Docket 84-468) and decided not to modify present methods. The FCC recently considered this issue again in its simplification docket, but again decided not to adopt it.

Mr. Kossnar also testified that CUB/Cook County's proposal would impact all of the major LECs in Illinois and that, therefore, if this Commission chooses to address the issue, it would be best to do so in a separate rulemaking. Such a rulemaking would allow all affected companies to participate and to address the advantages, disadvantages, and possible implementation problems associated with this proposal.

For the reasons contained in Mr. Kossnar's testimony, the Commission finds that it would not be appropriate to adopt CUB/Cook County's proposal to record cost of removal and salvage as a current period expense.

VII. RATE BASE ADJUSTMENTS

The Company proffered an adjusted intrastate original cost rate base of $3,122,223,000, which reflects the adoption of certain adjustments. The accepted adjustments, and their effect on net original cost ("NOC") are set forth below:

The Staff and Intervenors have proposed several additional rate base adjustments with which the Company takes issue.

A. Cash Working Capital

Staff witness Judith Marshall reviewed Illinois Bell's cash working capital analysis and proposed adjustments which would produce a net cash working capital allowance of negative $20.1 million, a level limited to the offsetting of a materials and supplies inventory balance otherwise reflected as a rate base component. CUB witness Brosch also reviewed the Company's analysis and proposed adjustments which would reduce the Company's cash working capital requirement to a negative $9.6 million.

Mr. Goens provided the Company's cash working capital analysis. He testified that the purpose of a cash working capital allowance is to compensate investors for the capital they provide to finance the Company's ongoing operations until customers reimburse the Company for the services rendered. He stated that the Company performed an lead-lag study to determine the amount of cash needed for this purpose.

The lead-lag study systematically measured the timing of cash flows through the Company. For example, Mr. Goens explained that the Company receives revenue from its customers and pays expenses such as wages and taxes. If customer payments are received in advance of the service rendered, there is a revenue "lead" whereas if the service is provided in advance of the payment, there is a revenue "lag". The difference between revenue lead and revenue lag, expressed in terms of days, is the net revenue lag.

He explained that the same concept applies to the measurement of expense and tax payment lead-lag days. His application of the Company's lead-lag study to the test year revenue and expense resulted in a cash working capital requirement of $75.1 million.

The disputed working capital issues are discussed in the following sections.

1. Depreciation Expense

Ms. Marshall objects to the Company's inclusion of depreciation expense in its cash working capital requirement.

She testified that investors long have been aware of the traditional approach she followed regarding depreciation expense and are familiar with the fact that every cash flow must be adjusted for the effect of timing. She argued that, to the extent any lag involving depreciation expense recovery exists, capital markets adjust for the lag. She further testified that the Commission rejected the Company's approach most recently in Illinois Power Company Docket 91-0147 and that there is no reason why the Commission should change its longstanding practice of excluding depreciation expense from lead-lag studies.

Mr. Brosch testified that depreciation expense is a non-cash expense element of cost of service which does not require an outlay of current period cash. Accordingly, CUB/Cook contend that depreciation expense does not influence a Company's need for cash working capital and should not be included in a lead-lag study. He maintained that the elimination of depreciation expense would not result in an understatement of rate base because the ratemaking system is not precise enough to capture the dynamics of ongoing and continually changing accruals of depreciation expense and of the related changes in depreciation reserve used to serve current period customers. In addition, he opined that it is not appropriate to provide for working capital requirements at the end of the plant accounting cycle while totally ignoring the working capital effects of the construction phase. Finally, he noted that the FCC concurs with his position, citing to FCC 89-30, Docket 86-497, paras. 28-32.

Mr. Goens replied that all operating expenses represent cash transactions, even though the cash transactions for items such as depreciation do not occur at the same time that the costs are "recognized". He insisted that the relevant concern for ratemaking purposes is the total amount of investor-supplied capital required to finance the cost of service, rather than just those costs paid contemporaneously in cash.

In his view, depreciation expense reflects the recovery of prior investment from customers receiving service from the plant. The Company's proposal compensates investors for financing this depreciation expense from the time service is rendered to the time the customer pays for that service.

The Company notes that neither Staff nor CUB/Cook deny that a depreciation lag exists. Rather, they argue that the lag should not be included in the cash working capital analysis because investors have no expectation that it will be included and because the ratemaking process is not precise enough to capture changes in depreciation adequately. Mr. Goens testified that their theories about investors' expectations are entirely speculative and that there is no evidence that investors have in fact increased their rate of return requirements to adjust for the non-recovery of depreciation lag.

The Commission accepts the adjustment of Staff and CUB/Cook. The Commission is of the opinion that the exclusion of depreciation expenses in the lead-lag approach used by both the FCC and this Commission has been in place for years and is well known. Investors have long been aware of this approach and are familiar with the fact that every cash flow has to be adjusted for the effect of timing and, to the extent that any lag involving depreciation expense recovery exists, capital markets have knowledge of and adjust accordingly. IBT's meritless argument has been presented to and rejected by this Commission many times, most recently in Illinois Power Company Docket 91-0147.

2. Ameritech Services Payments

Staff contends that the Commission should disregard the actual timing of IBT's payments to ASI for materials and services and should substitute instead a 73-day lag period to reflect payments as they should be made under a 1983 contract between the Company and ASI. Ms. Marshall testified that this contract provides for ASI to bill IBT monthly, on the last day of the month following the month to which any bill pertains, and that the Company will pay such bills within 30 days of receipt. She testified that Illinois Bell is billed on a weekly basis for material and services purchased from ASI and that these bills are paid by wire transfer within a few days of the date on which they are received. She avers that other vendors do not receive such favorable treatment of their charges to Illinois Bell; the Company pays those bills approximately 30 days after billing.

Although Staff recognizes that the Company and ASI modified their 1983 contract in 1990 to provide that ASI will render materials bills weekly and service bills monthly on a net seven days basis, Staff contends that the modification was an affiliated interest transaction which requires Commission approval under Section 7-101. Ms. Marshall testified that, since it was not submitted for approval, she must assume that payments still should be made to ASI in accordance with the 1983 contract.

Ms. Marshall also testified that, although the 1983 contract permits the Company to pay its bills to ASI within 30 days, it is good cash management practice to pay bills as near to the due date as possible. She said that the Company acknowledges this in its Accounting Bulletin No. 271, which provides that it is the duty of each employee to process bills so that payment will reach the supplier as close as possible to the due date. In her view, any IBT payment to ASI sooner than 30 days after billing reflects "poor cash management practice" and should not be subsidized by ratepayers.

Finally, Staff contends that there is no evidence that ASI costs allocated to IBT would increase if IBT complied with the terms of its 1983 contract. In Staff's view, ASI allocates costs using a fully distributed cost method which includes a return on its investment. This return on investment is the weighted average allowed rates of return for the Ameritech operating companies and bears no direct relationship to ASI's actual costs.

In response, Mr. Goens testified that, pursuant to Section 13-601, there is no requirement that the 1990 modification be approved by the Commission and that Staff's entire position therefore should be rejected. First, the Company claims that contracts between affiliates of less than $1 million do not have to be approved by the Commission. Since the 1990 contract modification does not change the prices which IBT is obligated to pay below its 1983 agreement with ASI it falls under the $1 million threshold. Second, the Company contends that Rule 310. 60(b) of the Commission's Rules explicitly allows affiliated companies to enter into contracts without Commission approval if such contracts are "made in the ordinary course of business . . . at . . . standard or prevailing market prices, or at prices or rates fixed pursuant to law. "

The Commission accepts Staff's adjustment. The original contract was approved by the Commission and IBT should have applied for approval of its modification. To argue that the effect of the modification is less then $1 million and, thus, not subject to Commission approval is incorrect. Accepting IBT's logic would allow them to come to the Commission with one contract and then subsequently "cherry-pick" the contract through modifications. The Commission does not accept such convoluted reasoning that would permit a utility to circumvent the Commission's oversight to the detriment of ratepayers.

3. <u>Collection Float</u>

Mr. Goens testified that Staff made an adjustment to the Company's analysis for disbursement float (the interval between check payment and its deduction from the Company's checking account). Mr. Goens testified that Illinois Bell then requested but Staff refused a corresponding adjustment be made to reflect collection float (the interval between a deposit of customer checks and their availability for withdrawal). The Company argues that since it does not have the immediate use of the checks when they are deposited, an adjustment should be made. In its view, Staff's one-sided approach is unreasonable.

Ms. Marshall testified that she sees no justification for changing the revenue lags which the Company originally calculated, i. e., the lags associated with the time from receipt of customer payments until they are deposited in the bank.

She further stated that Illinois Bell indicated in a data request that there were no written agreements with any banks regarding fund availability and that therefore no adjustment is appropriate.

In response, Mr. Goens submitted a collection float analysis from the Harris Bank which shows that the Company must wait between zero and four days for check deposit balances to become available. He said that, based on similar reports from its other banks, the Company determined that it must wait an average of 1.1 to 1.5 business days before it can use the funds it deposits. He went on to explain that, while there are no formal "contracts" between Illinois Bell and its banks on this subject, each bank has its own policy regarding fund availability which delays the Company's ability to access its funds immediately.

The Commission finds that the Company's request for recognition of a collection float is symmetrical with its agreement to recognize a disbursement float and therefore is reasonable. We also find that the Company has proved the existence of the collection float adequately by means of the Harris Bank analysis and Mr. Goens' testimony.

4. <u>VEBA Payments</u>

Mr. Goens explained that Voluntary Employee Benefit Association ("VEBA") payments are made by the Company to fund medical and dental benefits of past and current employees. Contributions which are earmarked for active employees are paid into a separate trust fund and also are used to reimburse insurance carriers for the claims of retirees. In his rebuttal testimony, he related that the Company inadvertently omitted $20.6 million of VEBA expenses from its study which developed the benefit expense lead-lag factors and therefore was submitting a revised cash working capital analysis.

Ms. Marshall testified that the VEBA payments were considered in the lead-lag study submitted with IBT's direct case. Payments to the VEBA trust during the study period were recorded in Account 6728.2, Other General and Administrative - Benefit Plan Payments.

Staff states that the "Ameritech Guidelines for Preparing Cash Working Capital Lag Studies" specify a treatment for items recorded in that account. These guidelines state that, "Benefits charged to account 6728.2 will not be studied separately, but will utilize the lag days developed for benefits charged to account number 8701.1, (Benefits and Payroll Taxes)". Staff contends that IBT followed these guidelines for calculating the benefits lag days in preparing the lead-lag study submitted with its direct case. Staff argues that this approach to calculating benefits lag days was accepted in Staff's direct testimony and previously has been adopted by the Commission in Illinois Bell Telephone Company Docket No. 89-0033. The Commission's order in Docket 89-0033 states at page 51, "...the record herein indicates that the Company's lead/lag study was properly conducted...".

Accordingly, she contends that the treatment of VEBA payments proposed in Mr. Goens' rebuttal testimony is not in accordance with the guidelines as quoted above and as previously adopted by the Commission. She further contends that he offered no rationale for changing the way VEBA payments are considered in calculating IBT's cash working capital requirement other than through the statement that these payments were "inadvertently omitted" from its original study.

In response, the Company contends that Staff overlooks a crucial distinction between two separate components of its lead-lag study. Mr. Goens testified that the first component is a "factors" study which developed lead-lag factors by analyzing the size and timing of payments and receipts during a three-month period during 1991. The lead days and lag days produced by this "factors study" were then applied to the test year expenses to develop the cash working capital requirement. He explained that when the Company performed its "factors study" it inadvertently omitted $20.6 million in VEBA expenses and that this mistake significantly overstated the total lag day factor and had a large impact on total cash working capital requirements.

Finally, he emphasized that the Company was aware of, and correctly followed, the Company's guidelines which Staff cited in its testimony. According to Mr. Goens, the Company and Staff agree that VEBA expenses charged to Account 6728.2 are not studied separately and that they are assigned the composite benefit lag day which results from a separate study of Account 8701.1. In his opinion, there is no disagreement on the operation of the guidelines and Staff's objection should be rejected.

The Commission rejects IBT's request that the Company's cash working capital analysis be adjusted to include the VEBA expenses which it inadvertently omitted from its original study. The

Company has not presented persuasive evidence that an error took place.

5. Credit for Non-Cash Benefits

Mr. Goens testified that a Staff mathematical error improperly understates the amount of the Company's cash working capital requirement and should be corrected. He stated that this situation originated when the Company agreed to Staff's request that non-funded employee benefits be removed from the study and to apply the revenue lag appropriately to that amount. In Staff's revised calculations it subtracted this amount. However, Mr. Goens maintained that since the Company's pension is over-funded, the non-funded employee benefit obligation actually is a non-cash credit to the Company, and that to remove the effect of this credit mathematically it must be added to the benefit expense.

For the reasons set forth by the Company, the Commission finds that the appropriate method to remove a non-cash credit to the Company is to add this amount to the benefit expense and to apply the revenue lag to that amount. The final cash working capital analysis should be adjusted to reflect this correction.

6. Wire Transfer Adjustments

Finally, Mr. Goens stated that corrections were necessary to reflect properly the items which the Company paid by wire transfer but which Staff believes were paid by check.

He testified that all of the Company's postage expenses were paid by wire transfer and should be assigned negative 13.5 lag days. Similarly, he maintained that all Federal income taxes were paid by wire transfer and should be assigned 62.5 lag days. Finally, he stated that other taxes were paid by check and by wire transfer and that the composite lag days for all other taxes was 137.7 days.

The Commission finds that the Company's proposed corrections to reflect wire transfer adjustments properly are reasonable, appropriate, and should be adopted.

B. Other Post-Retirement Benefits ("OPEBs")

Staff and CUB have proposed the removal of the test year capitalized portion of the OPEB amortization which was included by the Company in its rate base. IBT witness Goens submits that the Staff and CUB OPEB rate base adjustments should be rejected.

The Company included, as an addition to rate base, the unamortized balance of the deferred transition benefit obligation ("TBO") relating to SFAS 106. Since Staff removed the entire amortization of the deferral, Mr. Griffy concluded that the associated unamortized balance also must be removed from rate base.

During the rebuttal phase of the proceeding, Mr. Goens noted that the Company had included a liability for unfunded OPEB costs in the amount of $99,489,000. He asserted that this liability was associated with the unamortized deferred OPEB asset and that the unfunded liability should be removed if the associated asset were removed.

Mr. Griffy testified that the unfunded OPEB liability was not directly related to the deferred OPEB TBO asset but instead refers to the amount of OPEB costs accrued but not paid to an external fund. He reasoned that since the Company was funding only its current OPEB accruals, no amortization of the TBO had been funded. He concluded that the asset, however, represent the unamortized portion of the deferred OPEB TBO and that the unfunded liability would exist regardless of whether the Company received deferred accounting treatment for the TBO.

Mr. Griffy agreed with Mr. Goens that the cumulative unfunded liability incurred by IBT through the end of 1993 is $99,489,000, and recommended that this entire cumulative amount be included in rate base as a known and measurable change in the test year.

The Commission is of the opinion that the Company's treatment of OPEB-related rate base amounts is reasonable and should be adopted.

C. Vacancy Levels

Staff witness Slattery proposed an adjustment to reduce Plant-in-Service by $47,494,000. Staff's adjustment removes from rate base the cost of vacant office space and is based upon an average vacancy level of the buildings which IBT included in rate base at the end of the test year, August 31, 1992. This adjustment would reduce depreciation expense by $1.3 million on a grossed-up basis, using Staff's revenue conversion factor. In support of the proposed adjustment, Ms. Slattery reasoned that IBT failed to demonstrate how assets representing vacant office space were productive in serving the Company's ratepayers.

IBT witness Goens advanced four basic reasons why IBT should be allowed to include costs of vacant building space in its test year rate base. He claimed that: (1) some of the vacant areas are due to the implementation of new technologies which require less physical space; (2) the Company continually evaluates the relocation and consolidation of employees in leased quarters into Company-owned space as the leases expire; (3) due to the future demand for interconnection, some level of vacant space should be reserved when planning to remodel an existing location or to build a new location; and (4) Staff's adjustment penalizes the Company for taking advantage of new technology and resizing its workforce.

Staff countered that the reason the Company retains vacant space is irrelevant. Rather, it is the Company's business needs that should dictate whether the rate base should be increased or decreased. Moreover, the Company's claim that it is "considering" the relocation of employees is <u>not a</u> known and measurable factor which could alter Staff's adjustment; and that even if the Company were to shift employees from leased quarters into Company-owned space, there would be a corresponding decrease in rent expense which is not presently reflected in the filing.

The Commission accepts Staff's adjustment. The Company failed to present any known and measurable data as evidence in this proceeding to support its claim that there is a foreseeable future need for this excess space.

VIII. <u>CAPITAL STRUCTURE AND RATE OF RETURN</u>

A. <u>Capital Structure</u>

In order to determine the fair rate of return on total capital that should be applied to the Company's approved rate base, the Company and Staff recommended the use of the Company's actual capital structure. The Company submitted evidence of its capital structure as of July 31, 1993, adjusted to reflect the retirement on September 1, 1993, of $125 million of Series I First Mortgage Bonds, which were replaced with short-term debt. Staff presented evidence of the Company's capital structure as of August 31, 1993, adjusted to reflect a 12-month average balance of short-term debt.

Staff witness Jon Summerville recommended the adoption of IBT's actual capital structure which consisted of 59.50% common equity at August 31, 1993. He concluded that the use such a capital structure would be appropriate because it reflects the Company's target capital structure, the capital structure during the period during which rates established by this proceeding will be in effect, and it results in a reasonable overall cost of capital.

Company witness Goens testified that IBT's embedded cost of long-term debt was 7.85% based on a schedule of the embedded cost of long-term debt as of September 1, 1993. This schedule reflects the retirement of the Series I First Mortgage Bonds and includes $6,367,000 of capital leases.

Mr. Summerville testified that the appropriate embedded cost of long-term debt for Illinois Bell was 7.69%. His schedule of the embedded cost of long-term debt is identical to the schedule provided by Mr. Goens except that it does not reflect the retirement of Series I First Mortgage Bonds or include $6,367,000 of capital leases.

Mr. Summerville utilized the end-of-test year schedule of long-term debt because on September 1, 1993, the Company replaced the $125 million Series I First Mortgage Bonds with short-term debt. He opined that the use of a 12-month average balance of short-term debt has the advantage of smoothing out monthly fluctuations in the balance of short-term debt.

Staff notes that Mr. Goens included $6,367,000 of capital leases in his schedule of the embedded cost of long-term debt. Staff states that it is not clear from the Company's testimony or responses to data requests that the $615,000 cost associated with these capital leases is reasonable. Staff takes the position that because the Company has failed to demonstrate the reasonableness of these costs, Staff recommends that the Commission not permit the Company to recover than from ratepayers.

Mr. Goens testified that the Company's cost of short-term debt was 3.43% and the balance of short-term debt on September 1, 1993, was $366,332,000.

Mr. Summerville recommended using a 3.13% short-term debt rate because this was the rate at which 30-day high-grade unsecured commercial paper was sold through dealers by major corporations as reported in the September 1, 1993 edition of The Wall Street Journal. Staff contends that all short-term borrowing at Illinois Bell is done through Ameritech and that Ameritech's short-term debt consists of over 85% commercial paper. Staff contends that this 3.13% short-term debt rate better reflects prevailing market conditions.

Mr. Summerville testified that the average balance of short-term debt for the Company for the twelve months ending August 31, 1993, was $211,538,000. He also testified a 12-month average balance was appropriate because the Company's actual month-end balance of short-term debt tends to fluctuate significantly over short periods of time. This was also the same method the Commission adopted in the last IBT rate case, Docket 89-0033.

Furthermore, Staff points to the fact that Mr. Goens agreed during cross examination that the Company's monthly balance of short-term debt tends to fluctuate significantly from month to month.

Mr. Goens testified that IBT's capital structure is consistent with the Company's long-term objective, as stated to this Commission since 1983, of targeting a debt ratio below 40%. He stated that a 40% debt ratio provides the best balance for customers and investors because it allows the Company to maintain a top quality bond rating and enjoy access to capital markets under almost any conditions. He also opined that the Company's business risk is increasing due to the rapid technological and competitive changes that are occurring in the industry, and that it is appropriate to offset higher business risk by reducing financial risk with a lower debt ratio.

Dr. Phillips testified that the Company's actual capital structure is reasonable for three reasons. First, it is consistent with the capital structures of comparable telecommunications companies. Second, it is required for an "A" bond rating under Standard & Poors' ("S&P") revised telecommunications LEC guidelines. Third, the Commission previously has approved the Company's almost identical equity ratio, and it would be unsettling to investors for the Commission now to reject that ratio at a time when the Company is faced with increasing business risk.

Mr. Summerville recommended the acceptance of the Company's actual capital structure because the structure is consistent with actual and prospective capital structures in the telecommunications industry and is reflective of the Company's capital structure that actually will exist during the term that the Commission's order will be in effect. He also noted that the S&P Credit Review requires less than 42% debt in capital structure in order to qualify for an "AA" bond rating. His analysis of 40 market-traded telecommunications companies included in the Telecommunications Compustat II database demonstrated that at the end of the third quarter 1992, the weighted average common equity ratio was 56.19% with a standard deviation of 8.55%. The Company's equity ratio fell within this range. Similarly, the Value Line Investment Survey projected equity ratios for the telecommunications service industry of 53% in 1992, 54% in 1993, 54.55% in 1994 and 58.5% in the 1996-1998 time period.

Based on his analyses, Mr. Summerville concluded that use of the Company's actual capital structure would facilitate determination of a reasonable overall cost of capital.

AG witness Stephen G. Hill recommended the use of a hypothetical capital structure due, in part, to Ameritech's capital structure. He recommended a capital structure consisting of 51.05% common equity, 44.50% long-term debt, and 4.45% short-term debt, based on Ameritech's actual capitalization at year-end 1992. He reasoned that Ameritech as a whole faced greater business risk than Illinois Bell; therefore, it would be expected that Ameritech would have the higher equity ratio. He concluded that IBT's higher equity ratio was evidence of financial cross-subsidization of Ameritech's unregulated activities by IBT's regulated services. This would occur because equity is more expensive than debt; thus, by transfering more equity to IBT's balance sheet, Ameritech could finance its unregulated activities with a higher percentage of lower-cost debt. He also performed an analysis of the independent telephone industry and IBT for an 18-year period from 1973 to 1991 to show that both the industry and IBT had enjoyed relatively stable Earnings before Interest and Taxes ("EBIT") that well exceeded their actual interest expense. He concluded from this that Illinois Bell could be capitalized safely with a much higher level of debt.

CUB witness Rothschild also recommended the use of an imputed capital structure for IBT because of Ameritech's capital structure. He agreed with Mr. Hill's contentions that IBT could be capitalized safely and more cost effectively with less common equity and that the level of common-equity in a capital structure should be expected to decrease as the operating risk decreases. Mr. Rothschild recommended using a hypothetical capital structure containing 42.5% common equity, which would be consistent with a "triple-B" bond rating. He performed an analysis to demonstrate that this equity ratio would provide Illinois Bell with the lowest overall cost of capital. He also demonstrated that IBT's equity ratio was higher than the end-of-1992 average equity ratios of the seven regional Bell holding companies ("RBHCs") and seven independent telephone companies.

Mr. Rothschild also contended that Illinois Bell's high equity ratio was being used to support Ameritech's unregulated activities. He backed out of Ameritech's balance sheet the combined balance sheets of the five AOCs and concluded that Ameritech's unregulated activities were being financed with only 28.68% common equity.

Mr. Rothschild indicated that it would be "totally unnecessary" for IBT actually to sell debt in order to reduce its equity ratio; it was sufficient that the Commission simply impute a higher debt level to IBT for ratemaking purposes.

COMMISSION ANALYSIS AND CONCLUSION

The Commission is of the opinion that Staff's proposed capital structure is reasonable and should be adopted. The Commission concurs that the use of a 12-month average balance of short-term debt is more sound because it smooths out monthly fluctuations in the balance of short-term debt. In addition, the Commission accepts Staff's $615,000 adjustment of the costs associated with certain leases. The Commission agrees that the Company has failed to demonstrate the reasonableness of these costs.

The Commission also accepts Mr. Summerville's use of a short-term debt rate of 3.13%. The Commission agrees with Staff's use of the prevailing rate, as of September 1, 1994, at which 30-day high-grade unsecured commercial paper was sold through dealers by major corporations. The Commission believes that a short-term debt rate of 3.13% better reflects current market conditions.

The Commission rejects the proposals of Mr. Hill and Mr. Rothschild to use a hypothetical capital structure. It is impossible to determine the overall cost of capital for IBT accurately by using a hypothetical rather than an actual capital structure, because with a hypothetical capital structure the cost of common equity and cost of debt cannot be determined accurately. For example, if the Company had been capitalized with higher percentages of debt, the costs of individual debt issues and the cost of equity would have been higher. It is impossible to calculate those costs accurately. Conversely, utilizing the actual capital structure, the embedded cost of debt can be calculated precisely and the estimation of the cost of equity is facilitated because the actual capital structure is what is reflected in current market prices and investor expectations. No persuasive evidence has been adduced to warrant deviating from our customary practice of using an actual capital structure wherever possible.

The Commission rejects the contention of Mr. Hill and Mr. Rothschild that financial cross-subsidigation exists between IBT and Ameritech. The Company does not guarantee the debt of Ameritech or of its unregulated subsidiaries. Absent such a guarantee, investors in Ameritech could obtain little solace from IBT's lower debt ratio.

The Commission also is concerned with Mr. Hill's failure to compare IBT's capital structure with those of other telecommunications firms, even though this information was readily available. Mr. Hill concluded that financial cross-subsidization exists between IBT and Ameritech based on the capitalization of companies in the gas, electric and industrial industries, not of companies in the telecommunications industry.

Another drawback associated with the analyses of Mr. Rothschild and Mr. Hill is that they are incomplete since they ignored the future of the telecommunications industry when conducting their respective capital structure analyses. The Commission agrees with Staff and IBT that for ratemaking purposes, a utility's capital structure should reflect the best available estimates for the period during which prospective rates will be in effect. The Commission is of the opinion that it is important to consider forecasted data when evaluating the reasonableness of a utility's capital structure.

In summary, we find IBT's actual capital structure, as adjusted by Staff, to be reasonable. It is consistent with the present and prospective capital structures of firms in the telecommunications industry. It appropriately reflects the business risks the Company faces and it allows the Company to maintain a high quality bond rating that will afford ready access to the capital markets whenever necessary to meet service requirements. Finally, it results in lower costs for both debt and equity than would exist with a higher debt level.

B. Return On Equity

IBT claims a return on common equity ("ROE") of 15.50% based upon the testimony of Dr. Charles F. Phillips, Jr., who recommended this rate of return on book equity based on his comparable earnings analysis. IBT also offered the testimony of Dr. Roger Ibbotson, who performed a market return analysis. Three other witnesses, Ms. Antonia Joy Nicdao for Staff, Mr. Stephen Hill for the AG, and Mr. James A. Rothschild for CUB, presented evidence on the required return on Respondent's common equity.

Dr. Phillips recommended an equity return of 15.50% based on his comparable earnings analysis of a group of proxy telecommunications firms and unregulated entities having similar investment risk to that of Illinois Bell. He is the Robert G. Brown Professor of Economics at Washington and Lee University and has testified on rate of return matters in many regulatory proceedings in Illinois and around the country.

He used four publicly-traded independent telephone companies and the seven RBHCs as a proxy for Illinois Bell. He also identified twelve unregulated companies that he believed have investment risk comparable to that of the proxy telecommunications companies, using three measures of investment risk: Value Line beta coefficient, Value Line safety rating and S&P bond rating. By this method, he identified twelve companies: Anheuser-Bush, Bristol Myers Squibb, Clorox, Coca-Cola, Heinz, IBM, Kellogg, McDonalds, McKesson, Quaker Oats, Sara Lee and Vulcan Materials. He analyzed the earned returns on book equity of the proxy firms as well of as the unregulated firms and looked at both historic and expectational data. His analysis determined the following average annual earned returns of the unregulated firms and the proxy telecommunications firms:

	Unregulated Firms	Proxy Telecommunications Firms
1987 -- 1991	20.52 - 24.27%	11.93 - 15.13%
1992	20.82%	13.98%
1993	24.08%	14.63%
1995 -- 1997	23.87	16.37%
1996 -- 1998	25.28%	16.61%

After Ms. Nicdao criticized his method of selection of his proxy telecommunications firms, Dr. Phillips presented a comparable earnings analysis of the proxy telecommunications firms that Ms. Nicdao selected for her analyses. These firms earned average book returns on equity of 13.83% for the 1988-92 period and are expected to earn average returns of 16.46% for the 1996-98 period.

Based on his entire analysis, Dr. Phillips concluded that an ROE above 20% would not be unreasonable for the Company and will be required by investors as the Company's business becomes fully competitive. However, for the present, he concluded that an ROE equal to the average of the future expected returns of the proxy telecommunications firms, i.e., 15.50%, would be reasonable.

The Company contends that the Commission should give Dr. Phillips' recommendation significant weight in reaching its final determination, noting that since the ROE that the Commission determines is applied to a book value rate base (as a component of the total return on capital), the comparable earnings method has the advantage of comparing apples to apples.

Both CUB and the AG cite Docket 89-0033 and Illinois Bell v. F.C.C., 988 F.2d 1255 (D.C Cir. 1993) as support for rejecting Dr. Phillips' comparable earnings analysis. With respect to Docket 89-0033, CUB and AG cite the following:

> The Commission concludes a decision on an appropriate rate of return for Illinois Bell cannot be based on Dr. Phillips' comparable earnings analysis. This Commission has used market based approaches to determining the cost of equity for Illinois Bell for some time. The Company's own evidence as

> to its financial condition speaks to the adequacy of this approach.

(Order on Remand, Docket 89-0033, p. 15.)

With respect to *Illinois Bell v. F.C.C.*, 988 F.2d 1255 (D.C Cir. 1993), CUB and AG argue that his comparable earnings analysis was rejected when IBT presented it before the FCC.

The Company's second rate of return witness, Dr. Roger Ibbotson, performed a risk premium (i.e. Capital Asset Pricing Model or "CAPM") analysis and a non-constant growth Discounted Cash Flow ("DCF") analysis on Ameritech and used the results to derive IBT's cost of equity mathematically.

A DCF model implies that the market value of a firm's common stock equals the aggregate value of its expected stream of future dividends, discounted at the investor-required rate of return. That is, the expected rate of return equals the dividend yield (dividend divided by price) plus the expected rate of growth in dividend yield. The expected rate of growth in earnings can be substituted for dividend growth in the model.

The quarterly DCF model recognizes that dividends are paid quarterly and can be reinvested immediately to earn a return. The constant growth DCF model assumes that the firm's dividends (or earnings) will grow at a constant rate; whereas, the non-constant growth model assumes that they will grow at different rates during different future periods.

For his DCF analysis, Dr. Ibbotson used the quarterly compounding DCF method and relied on published analysts' estimates (from IBES) for his first-stage growth rate. For his second stage growth rate, he used the historical, long-term, real growth rate in the economy, plus an estimate of long-term inflation. He stated this was reasonable because Illinois Bell's customer base represents a broad cross-section of the economy and, thus, the Company can be expected to grow in the long-run at least at the rate of growth of the economy as a whole. Otherwise, the Company would go into decline, which is not anyone's current anticipation. His DCF analysis produced an expected market return of 13.6% for Ameritech.

The CAPM or risk premium model is based on the premise that investors are risk averse. It assumes that the return an investor expects is equal to a risk-free rate plus a premium to compensate for the perceived risk of owning the security. For his risk premium analysis, Dr. Ibbottson estimated IBT's beta (a measure of risk or volatility) by removing the beta of Ameritech's unregulated business from Ameritech's total company beta. He then selected a sample of nineteen companies, which he considered to be comparable to any one of four unregulated businesses of Ameritech, in order to estimate the beta of Ameritech's unregulated businesses. His risk premium analysis indicated a CAPM cost of equity estimate of 13.00% for IBT, before flotation costs.

Dr. Ibbotson's non-constant growth DCF result for Ameritech was applied to a CAPM formula in order to derive his 13.10% cost of equity estimate for IBT, before flotation costs.

He determined his flotation cost adjustment using an Arzac-Marcus flotation cost formula based on his assumption that IBT's flotation costs are 4.0% and external equity financing rate is 65.0%. Accordingly, he added 40 basis points on top of his DCF and CAPM ROE estimates for IBT, although he did not provide evidence sufficient to support an adjustment of this magnitude. The average of his DCF and CAPM results, adjusted for flotation costs, reflects his recommended 13.50% ROE for IBT.

Ms. Nicdao used the constant growth quarterly DCF, non-constant growth quarterly DCF, and risk premium (i.e., CAPM) models in order to estimate the market cost of common equity for Illinois Bell. Since IBT's common equity is not market-traded, she performed her analyses on nine market-traded telecommuncations companies which she determined to be comparable in investment risk to Illinois Bell based on a quantitative analysis of a set of seven ratios which measure operating and financial risk.

In determining an appropriate dividend yield, Ms. Nicdao used the current price of her proxy firms at the time of her analysis. In order to estimate growth in her constant growth model, she considered four separate estimates of the growth rate from the investment community as published by IBES, Zacks Investment Research ("Zacks"), Prudential Securities Universe and the Value Line Investment Survey. For her non-constant growth model, she used her constant growth estimates for the first five-year period and growth estimates from Merrill Lynch's Quantitative Analysis and Prudential Securities for her third stage (beyond ten years). Her second-stage growth estimate (for the second five years) was a transitional blend of her first-stage and third-stage estimates. She updated her analyses in her rebuttal testimony. Her constant growth DCF analysis, as updated, produced estimated returns for her proxy firms ranging from 9.08% to 11.76%. Her updated non-constant growth DCF analysis produced returns ranging from 10.41% to 11.17%.

For her risk premium analysis, Ms. Nicdao used two measures of the risk-free rate, the rates implied by the prices of futures contracts for short-term Treasury bills ("T-bills") and for long-term Treasury bonds ("T-bonds"). To measure the risk premium, she first determined the risk premium of the stock market as a whole. In order to do this, she performed an individual, bottoms-up DCF analysis on the 431 firms in the S&P Composite Index that pay dividends and for which published growth rates were available. Each firm's rate of return was weighted by the proportion of its equity to the total equity of the firms studied. From this DCF return on the market, she subtracted her risk-free rates to determine the risk premium of the market as a whole.

In order to determine IBT's specific risk premium, she multiplied the market risk premium by the betas of her proxy firms. A firm whose stock price rises faster than the prices of the market as a whole in periods of rising prices and falls faster than the market as a whole in periods of falling prices has a beta greater than one, indicating that it is more risky than the market as a whole. Correspondingly, a stock with a beta less than one is less risky than the market, and its price rises and falls more slowly than overall price movements in the market. To determine beta, Ms. Nicdao used the average of published Value Line betas, and betas she calculated using the Merrill Lynch beta calculation method on data contained in S&P Compustat II data tapes.

After determining Illinois Bell's risk premium by multiplying the risk premium on the market by the betas of her proxy firms, Ms. Nicdao determined Illinois Bell's market-required return by adding its idiosyncratic risk premium to the risk-free rates. Her methodology, updated in her rebuttal testimony, produced a CAPM market cost of equity capital for Illinois Bell of 13.06% to 13.49%.

On rebuttal, comparing her DCF and CAPM results and applying her sound judgment as an analyst, Ms. Nicdao concluded that IBT's market cost of equity capital ranged from 11.90% to 12.90%, with a mid-point of 12.40%. She recommended that the mid-point be used in order to determine the equity component of the overall weighted cost of capital.

Mr. Hill presented market cost of equity analyses on behalf of the AG. He performed a constant growth annual DCF analysis on a sample consisting of the seven Bell RHCs and on another sample consisting of nine natural gas distribution companies. He calculated his growth rates utilizing the formula "br + vs". This method determines internal growth by multiplying published estimates of expected future earned returns on book equity times the earnings retention rate, the "br" factor. It also adds a "vs" factor for growth due to external financing. He performed a similar analysis of nine natural gas distribution companies as a check, based on his opinion that gas distribution companies are comparable in risk to telecommunications companies. The results of this analysis for the RHC sample and gas sample are 10.81% and 10.29%, respectively.

Mr. Hill also performed an Earnings-Price Ratio Analysis, Market-to-Book Ratio Analysis and a CAPM analysis in order to corroborate the results of his DCF analysis. On the basis of these four analyses, Mr. Hill derived a 10.75% to 11.25% ROE estimate for his RHC sample and a 10.25% to 10.50% estimate for his gas distribution sample. He then determined that IBT's true cost of equity falls within a range of 10.50% to 10.75%.

CUB witness Rothschild performed a constant growth annual DCF analysis which he referred to as the "Simple DCF" and his own version of the DCF, i.e., the "Complex DCF", wherein he used his forecasts of earnings, dividends, and stock prices for 40 years. The Simple DCF model used a growth rate developed by Mr. Rothschild. The Complex DCF model used a growth rate which, in Mr. Rothschild's opinion, produced realistic market-to-book ratios, payout ratios or earned returns on book equity.

He applied these models to a sample that consisted of the seven Bell RHCs including Ameritech, and to Ameritech only. His Simple DCF results for the RHCs range from 9.21% to 10.81% and for Ameritech, 8.58% to 9.81%. His Complex DCF results for the RHCs range from 9.82% to 10.57% and for Ameritech, 8.58% to 9.52%. Based on his analyses and on a capital structure consisting of 42.50% equity, Mr. Rothschild recommended a 10.85% cost of equity for IBT.

COMMISSION ANALYSIS AND CONCLUSION

In setting a return on equity for a particular utility, the Commission must balance the interests of ratepayers and shareholders. The Commission must authorize a rate of return that is equal to its cost of equity. A rate of return that is higher will unduly burden ratepayers with excessive costs. Meanwhile, a rate of return that is set too low will impair the utility's ability to raise capital and, ultimately, affect the utility's ability to provide quality service.

In determining what the cost of equity is for a utility, the Commission must base its decision on sound financial principles that are used by professional investors. When determining whether or not to invest in the stock of a particular utility, the professional investor is, in effect, setting the real cost of capital for that utility. The Commission, in autorizing a rate of return, makes an estimate what the investor is demanding. It is the Commission that reacts to the investor and not vice versa.

The Commission believes that Staff's analysis is the most reasonable analysis presented in this docket. The Commission is of the opinion that Ms. Nicdao's analysis best reflects the thoughts of the professional investor.

The Commission rejects Dr. Phillips comparable earnings analysis as differing from the conventional thinking of the professional investor. Dr. Phillips' comparable analysis is flawed because it attempts to establish rates based on book equity instead of using a market-based approach. The Commission has previously rejected Dr. Phillips' use of the comparable earnings analysis for this reason and IBT has not establised a basis for the Commission to find differently in this case.

With respect to Mr. Hill's analysis, the Commission does not agree with the growth rates that he utilize in his DCF analysis. Mr. Hill's methodology for determining growth rates is unothodox and clearly inferior to Ms. Nicdao's approach of using published estimates. The Commission is also not convinced of the usefulness of Mr. Hill's Earnings-Price Ratio Analysis and Market-to-Book Ratio Analysis. Neither of these methods reflect an investor's future expectations which is what the Commission's decision should be based upon.

The Commission also rejects Mr. Rothschild's analysis. The growth rates that Mr. Rothschild utilizes for his DCF analysis are highly subjective and, accordingly, unrealistically low. Mr. Rothschild's estimates of future growth do not reflect investors' expectations.

The analysis of Ms. Nicdao and Dr. Ibbotson are fundamentally sound. While neither is completely free of subjective input -- it is impossible for such an analysis to be so -- their is a miniaml amount of subjective content in their analyses. The Commission, however, is of the opinion that Ms. Nicdao's DCF analysis is more reasonable, in part due to her use of a more objective growth rate estimate.

As stated repeatedly in this Order, this docket differs significantly from a rate case. While under normal rate case circumstances this Commission would be inclined to accept the 12.4% midpoint of Ms. Nicdao's range of 11.90% to 12.90%, for purposes of setting the initial rates for an alternative regulation plan, the Commission will adopt the low end of the range of 11.90% as the cost of equity for IBT. There are two reasons for the Commission's choice: first, it must be noted that any point in that range is reasonable and, thus, the Commission's choice of 11.90% is reasonable; second, although the Commission rejected using a hypothetical capital structure as proposed by CUB and AG, some of the concerns espoused by these parties are also of concern to the Commission.

The following computation reflects the Commission's decision on overall cost of capital:

	Amount (000's)	Weighted Ratio	Cost Rate	Component
Common Equity	$2,469,118	59.50%	11.90%	7.08%
Short-Term Debt	211,538	5.10%	3.13%	.16%
Long-Term Debt	1,468,965	35.40%	7.69%	2.72%
Total	$4,149,621	100.00%		9.96%

IX. STARTUP REVENUE ADJUSTMENT

Staff argues that the Commission should reduce revenues an added $20 million in 1994 below the 1994 revenue requirement assessment in order to provide an upfront and ongoing benefit to customers to help ensure that they are not harmed by the move to price regulation. DOD/FEA also support Staff's recommendation to make a startup adjustment to bring 1994 rates to a reasonable level.

IBT contends that Staff's proposal for an additional $20 million up front rate reduction is unnecessary and would impose an excessive financial penalty on Illinois Bell. IBT states that its own proposal causes a substantial revenue requirements shortfall and a further reduction in rates is not warranted. IBT contends that it should be afforded a realistic opportunity to earn a reasonable return and that adoption of price regulation should not be used as the occasion for imposing financially onerous conditions on the Company. IBT also states that the benefits expected from its plan will not materialize if it is subjected to excessive rate reductions. IBT argues that its plan produces ample benefits for customers and additional rate reductions are simply not warranted.

In balancing the interests of ratepayers and IBT, the Commission is of the opinion that an additional $18 million revenue reduction is necessary to ensure that the plan is in the best interest of the public and provides ratepayers with an immediate benefit from the change to price regulation. This reduction, in addition to the reductions resulting from the Commission's rate evaluation, totals approximately $38 million. The total reduction should be implemented through the immediate detariffing of charges for touch-tone services.

Although this adjustment is subjective, the nature of these proceedings is such that subjective decisions are necessary in balancing the interests of IBT and the ratepayers. As technical as the process of evaluating an alternative regulation plan is; in the end such a correction is still necessary. The Commission views this adjustment as a fine-tuning of the plan.

X. RATE DESIGN

Staff witness Ms. Jing Roth described Illinois Bell's current rate design:

> IBT's current local service rate structure includes separate rates for Network Access Lines (NALs) and usage. Those rates are grouped into three geographic areas, by customer class, and mileage bands. Time-of-day discounts also apply to usage rates. The three geographic areas are often referred to as Access Area A, encompassing most of the downtown portion of Chicago; Access Area B, encompassing the remainder of Chicago plus certain suburbs; and Access Area C that includes the remainder of the state served by IBT.
>
> IBT's customers for local service are generally grouped as Business customers or Residential customers.
>
> Mileage bands include Bands A, B, C and D. The original introduction of a four band structure recognized the cost of service concept of pricing. Mileage bands reflect actual mileage between serving offices: Band A - for calls that travel up to to eight miles; Band B - for calls that travel between eight and fifteen miles; Band C - for calls between fifteen and forty miles; and Band D - for calls over forty miles.

> Time-of-day discounts include shoulder-peak and off-peak periods. Shoulder-peak charges reflect 90% of peak period charges. Off-peak charges reflect 60% of peak period charges.

Ms. Roth proposed various rate design alternatives for the Commission to consider in the event that the Commission orders a reduction in revenues for the Company. Staff generally has four major pricing objectives:

i) To ensure that rates are above Long-Run Service Incremental Costs ("LRSICs") and reflect underlying costs;

ii) To eliminate rate differentials, to the extent possible, for the same type of service with identical costs;

iii) To simplify the existing rate structure where appropriate; and

iv) To satisfy the revenue changes as proposed by Staff.

In order of priority, Ms. Roth recommended: (1) elimination of touch-tone service ($38.3 million); (2) reduction of PBX trunk rates so that the differential between the PBX trunk rate and the single line business rate would be eliminated ($5.8 million); (3) elimination of Usage Band D by reducing Band D rates to Band C rate levels ($6.0 million); (4) reduction of local usage rates across the board, except for local untimed calling areas ($50.0 million); (5) reduction of custom calling rates; (6) further reduction of local usage rates; (7) and, finally, reduction of business access lines to the level of residence access lines. In making these recommendations, Ms. Roth recognized that any usage price decreases would have to be considered in tandem with carrier access price reductions due to imputation requirements.

IBT witness Gebhardt agreed with most of Staff's rate design proposal, assuming that any revenue reduction is required by the Commission. However, he asserted that any reduction in usage rates should be accomplished solely by eliminating Band D calls (without a reduction in Bands A-C usage rates) because the elimination of Band D comports with the fact that usage costs are becoming less distance-sensitive. In addition, Mr. Gebhardt opposed any reduction in business network access lines, since the evidence presented by Company witness Palmer demonstrated that network access lines as a whole already fail to cover their total assigned costs. Mr. Gebhardt testified that it makes no sense to reduce the price even more. The Company also pointed out that the Commission will have to consider the outcome of the payphone complaint case (Docket 88-0412) in the event that the Commission decides to order a reduction in revenues for the Company in the instant case.

No intervenor introduced testimony concerning rate design. In their Initial Brief, CUB/Cook take the position that the Company's noncompetitive rates should be reduced by $209.8 million, to be implemented through an across-the-board uniform percentage rate decrease. CUB/Cook also criticize Ms. Roth's rate design proposal, contending that under Ms. Roth's proposal the users of the Company's most monopolistic services, i.e., residence access lines and local calls in the local calling area, would get no benefit from any rate reduction. CUB/Cook maintain Band D should not be eliminated since this rate element reflects additional costs incurred for calls of 40 miles or more. CUB/Cook also criticize Mr. Palmer's development of revenues for network access lines, and assert that if common carrier line charge revenues had been included, a completely different revenue cost relationship would have been shown.

The Commission concludes that Staff's rate design proposal reflects long-standing and widely-accepted rate design principles, including eliminating rate cost disparities. By utilizing established rate design principles for implementation of any revenue adjustment required at the start of the alternative regulatory plan, the Commission has additional assurance that the price regulation mechanism is based on just and reasonable rates.

Application of a uniform percentage rate reduction, as urged by CUB/Cook, is not supported by the evidence. It is undisputed that there is no identifiable cost associated with providing touch-tone service. The elimination of that charge is highly appropriate, and Ms. Roth properly identified it as Staff's highest priority. With respect to the Band D issue, we are persuaded by Staff's argument that the cost differential between Band C and Band D is less than the cost differential between the other mileage bands. Therefore, Staff's proposed elimination of Band D rates would continue to be cost based as long as Band C rates also cover Band D costs. We also conclude that Staff's treatment of costs to be recovered through access line charges is appropriate. Since the LRSIC of an access line is non-traffic sensitive and are developed regardless of jurisdictional considerations, Staff's methodology correctly includes these costs in access line services on a customer specific basis. In view of the size of the rate reduction ordered in this proceeding and our decision with respect to the residential rate freeze, CUB's other contentions are largely academic.

The rate adjustments ordered herein should be implemented in accordance with the rate design priorities set forth by Staff. In addition, future rate changes implemented by the Company under the alternative regulatory plan will be evaluated for consistency with these identified objectives.

XI. <u>CUB's Constitutional Contentions</u>

In its Reply Brief the CUB asserts that if Section 13-506.1 is interpreted as authorizing the Commission to adopt alternative forms of regulation which require ratepayers of noncompetitive telecommunications services to pay excessive rates, then that section of the law is unconstitutional. CUB maintains that Illinois Bell's opposition to earnings sharings indicates its intent to have the Commission authorize a price cap plan under which the Company will be able to realize and retain excess profits. CUB also contends that the authority granted the Commission by Section 13-506.1 is so vague that the section is void. CUB notes that, for a legislative delegation of authority to be legal, the delegation must contain standards that adequately describe the authority to be exercised. Since the provisions of Section 13-506.1 are silent as to how the various requirements of the Act are to be reconciled with Section 13-506.1, CUB argues that the Commission does not have adequate standards to guide its discretion.

The Commission concludes that both of CUB's contentions are without merit. Section 13-506.1(b)(2) specifically states that the Commission must find that the alternative regulation plan will produce fair, just, and reasonable rates. This is the standard which has governed public utility regulation in Illinois for decades, is unquestionably constitutional, and does not change with the implementation of alternate forms of regulation. The constitutional standard identified by CUB never has been interpreted to require the implementation of any specific regulatory approach. In <u>Duquesne Light Co. v. Barasch</u>, 488 U.S. 299, 109 S.Ct. 609, 102 L.Ed. 2d 646 (1989), the Supreme Court of the United States emphasized that no one ratemaking methodology is required constitutionally. The <u>Duquesne</u> Court stated:

> The adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since <u>Federal Power Commission v. Hope Natural Gas Co.</u>, 320

> U.S. 591 (1943). As demonstrated in Wisconsin v. FPC, circumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which might benefit both consumers and investors. The Constitution within broad limits leaves the states free to decide what rate-setting methodology best meets their needs in balancing the interests of the utility and the public.

CUB's argument that Section 13-506.1 is impermissibly vague and a standardless delegation of legislative authority is very puzzling. It would be difficult to find a statutory provision which provides more guidance to an agency in the exercise of its discretion than is found in Section 13-506.1. The law identifies no less than seven very specific findings which the Commission must make before it can approve an alternate regulation plan. It not only focuses the Commission's attention on the overall policy goals of the Universal Telephone Service Protection Law, but also identifies six other considerations. The law also specifies several specific minimum features of an approvable plan.

XII. STATUTORY POLICIES AND CRITERIA FOR ALTERNATIVE REGULATION

Section 13-506.1(b) lists seven findings the Commission must make in order to adopt any alternate regulation plan. The Commission must find, at a minimum, that the plan or modified plan:

> (1) is in the public interest;
>
> (2) will produce fair, just, and reasonable rates for telecommunications services;
>
> (3) responds to changes in technology and the structure of the telecommunications industry that are, in fact, occurring;
>
> (4) constitutes a more appropriate form of regulation based on the Commission's overall consideration of the policy goals set forth in Section 13-103 and this Section;
>
> (5) specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and

> improvements in productivity due to technological change;
>
> (6) will maintain the quality and availability of telecommunications services; and
>
> (7) will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers.

Section 13-506.1(a) states that the Commission "shall consider" the six factors which are set forth in subsection (a) "in determining the appropriateness of any alternative form of regulation." Some parties have interpreted Section 13-506.1(b), finding (4), as requiring the Commission to find that every one of the policy goals set forth in Section 13-103 will, in fact, be promoted by or will occur if an alternate regulatory plan is adopted. In addition, several of the parties have interpreted Section 13-506.1(a) as requiring a finding that every one of the considerations will, in fact, be promoted or will occur.

The Commission disagrees with these positions. These parties have misinterpreted Section 13-506.1. The Act requires seven minimum findings in order to approve the plan. Finding (4) requires a determination that the plan constitutes a more appropriate form of regulation based on the Commission's <u>overall consideration</u> of the policy goals set forth in Sections 13-103 and 13-506.1(a). Section 13-506.1(a) states: "In addition to the public policy goals declared in Section 13-103, the Commission shall consider" the six additional policy goals in subsection (a). In other words, the Commission must consider the policy goals set forth in Sections 13-103 and 13-506.1(a), and, "based on the Commission's overall consideration", determine if the plan "constitutes a more appropriate form of regulation". If the Commission makes this determination, it has made the finding required by item (4).

Many of the statutory standards have been addressed explicitly or implicitly in other sections of this Order. The following discussion is a brief summary of our conclusions regarding the alternative regulatory plan we are adopting with respect to its compliance with the statutory goals, considerations and required findings as established by the General Assembly.

A. **Section 13-506.1(a)(1)**

The Alternative Form of Regulation Reduces Regulatory Delay And Costs Over Time

No party to this proceeding presented actual data estimating the current cost of regulation or the estimated regulatory costs associated with an alternative regulation plan. However, the Commission knows by experience that traditional rate base/ROR regulation imposes significant costs on all parties involved - the Commission, the Company and the Intervenors. Rate changes are implemented only after exhaustive proceedings which typically require the full eleven months permitted by statute. The plan adopted herein will avoid protracted rate case proceedings because under the plan, reasonable rate increases or decreases will be accomplished via a streamlined proceeding using a formula known in advance and readily calculated. The plan eliminates regulatory consideration of the prudence of incurred costs, equipment replacement, and cost of capital. Overall, it can be expected that the alternative regulation plan will significantly reduce regulatory delay and costs.

B. **Section 13-506.1(a)(2)**

The Alternative Form of Regulation Encourages Innovation In Services

The Alternative form of regulation encourages innovation by creating an opportunity for the Company to retain earnings achieved through the introduction of new services and the implementation of cost saving efforts. The prospect of higher earnings will encourage the Company to aggressively develop and offer new services. In addition, since the Company will be permitted to set its own depreciation rates to reflect economic costs and market conditions, it will have an enhanced ability to recover existing investments and finance new investment. This will encourage the Company to be more innovative and take more risks. Finally, price regulation will permit the Company to change its prices without extensive regulatory proceedings. This will maximize incentives to innovate because it will permit the Company to adjust its prices to reflect actual market experience. For all these reasons, the Commission finds that the alternative regulation plan will encourage innovation in services.

C. **Section 13-506.1(a)(3)**

The Alternative Form of Regulation Promotes Efficiency

The alternative form of regulation we are adopting will promote efficiency. Under traditional regulation, which utilizes primarily a cost-plus approach to rate-setting, any efficiencies implemented by the company would be reflected as a reduction in the cost of service and rates in the next rate case. Since the company can achieve only a short-term benefit through efficiencies, there is a very limited incentive to implement them.

Alternative regulation will encourage Illinois Bell to operate efficiently because it puts Illinois Bell at risk for how well, or how poorly, it operates and contains costs. It creates the possibility of higher earnings, but only if the Company increases its efficiency and lowers its costs. It will also accelerate network modernization, which, in turn, will increase efficiency.

Increased pricing flexibility with LRSIC floors will allow prices to move to a more economically rational structure and to respond to competitive conditions, thus promoting more efficient consumption of telecommunications services.

D. **Section 13-506.1(a)(4)**

The Alternative Form of Regulation Facilitates The Broad Dissemination Of Technical Improvements To All Classes Of Ratepayers

Price regulation provides the appropriate framework and incentives to encourage market-based investment in infrastructure because Illinois Bell will be able to retain the benefits of successful ventures and to use them to offset losses from unsuccessful ventures. Since the Company will bear the burden of management error, price regulation will encourage the Company to make better decisions on where to deploy its investment funds.

Illinois Bell also has made an explicit commitment to spend at least $3 billion to grow and modernize its network. At least some of this investment represents an increase over a "business as usual" baseline. Since most of Illinois Bell's plant in service is used to provide service jointly to all customer classes, all classes of ratepayers will benefit from network modernization.

Finally, the Commission is requiring Illinois Bell to report on an extensive series of service quality measures, many of them on a geographic basis. To the extent that technical improvements are reflected in improved service quality measures, the Commission will be better able to ensure that all ratepayers benefit from them, regardless of where the customer is located.

Therefore, the Commission concludes that the alternative regulation plan facilitates the broad dissemination of technical improvements to all classes of ratepayers.

E. **Section 13-506.1 (a)(5) and Section 13-103(f)**

The Alternative Regulation Plan Enhances The Economic Development of the State.
The Development Of And Prudent Investment In Advanced Telecommunications Networks That Foster Economic Development Of The State Should Be Encouraged

The record establishes that investment in telecommunications infrastructure improves the quality and number of services, reduces the cost of those services and, therefore, contributes to overall economic development. The Commission is of the opinion that Illinois is uniquely situated to benefit from telecommunications infrastructure development for a number of reasons, including the concentration of leading financial, educational and health care institutions in Illinois Bell's service territory.

The alternative regulation plan provides substantial incentives to Illinois Bell to invest in the telecommunications infrastructure in Illinois. For example, permitting the Company to establish its own depreciation policies and removal of earnings constraints on services should induce the Company to invest in advanced technologies and provide new services to meet its customers needs. The rejection of an earnings sharing provision will make investments in Illinois at least as attractive, if not more attractive, than equivalent investments elsewhere. Accordingly, the Commission concludes that the alternative regulation plan will enhance the economic development of the state.

F. **Section 13-103(b)**

The Alternative Regulation Plan Permits Competition To Function As A Substitute For Aspects Of Regulation When Consistent With Protection Of Consumers.

Section 13-103 (b) establishes the goal of permitting competition to function as a substitute for certain aspects of regulation in determining the variety, quality and price of telecommunications services, when consistent with the protection of consumers and the furtherance of other public interest goals.

The Alternative Regulation Plan better reflects the incentives and risks which competitive firms face because Illinois Bell will be at more risk for its operations and investments. Deployment of technology and introduction of new services will be primarily based on marketplace developments, thereby substituting customer choice for regulatory control.

The pricing flexibility which the plan permits also will enable the Company to respond more rapidly to competitive conditions as they develop. The alternative regulation plan also removes earnings constraints from competitive services, which is more consistent with a competitive marketplace. The Company's competitors in those markets do not face earnings constraints. The plan reduces the economic burdens of regulation by eliminating cumbersome and costly rate case proceedings, by eliminating depreciation represcription proceedings, and by giving the Company the ability to change its prices without undue regulatory delay. The Commission concludes that the alternative regulation plan is consistent with its pro-competitive policies and will reduce the economic burdens of regulation.

G. **Section 13-103(c)**

The Alternative Regulation Plan Will Not Disrupt The Telecommunications System or Consumers Of Telecommunications Services.

Nothing in the alternative regulation plan would change the way the Company delivers service to its customers. Many of the provisions of the plan are designed specifically to enhance the Commission's ability to protect consumers and avoid system disruptions. The basic residential service rate freeze and extensive service quality reporting requirements are but two of these features. Accordingly, the Commission concludes that the alternative regulation plan will not disrupt the telecommunications system or consumers of telecommunications services.

H. **Section 13-103(d)**

Rates Under The Alternative Regulatory Plan Will Not Be Discriminatory And Will Not Include Cross-Subsidies

To the extent determined in this proceeding, the Company's current rates are nondiscriminatory, as required by Section 13-505.2. However, the Commission has identified certain deficiencies in the Company's imputation tests and aggregate revenue studies which need to be corrected. Therefore, the Commission is requiring the Company to demonstrate compliance with the requirements of Section 13-505.1 and Section 13-507 when filing initial rates implementing the alternative regulation plan.

The Commission is of the opinion that the identified deficiencies require only minor technical corrections to the Company's studies, and do not raise any substantial possibility that rates under the alternative regulatory plan will be discriminatory or include cross-subsidies. As the Company adjusts its rates in the future, it will continue to be required to demonstrate compliance with Sections 13-505.1, 13-505.2 and 13-507. Since nothing in the alternative regulation plan would change these statutory requirements, the Commission finds that rates under the plan will be non-discriminatory and will not produce cross-subsidies.

I. Section 13-103(e)

The Regulatory Policies And Procedures Provided In Article 13 Of The Public Utilities Act Remain Subject To Systematic Legislative Review

This section reflects a legislative judgment that the telecommunications industry is subject to rapid change and evolution, and that the telecommunications policies and procedures set forth in Article 13 should remain subject to systematic legislative review to ensure that the public benefits intended to result from such policies are fully realized. The alternative regulatory plan in no way limits the ability of the legislature systematically to review the telecommunications policies and procedures set forth in the Act. In addition, by extending the term of the basic residential service rate freeze, the Commission believes that it has ensured the full realization of one the public benefits intended by the General Assembly when promulgating Section 13-506.1. The Commission concludes that the alternative regulation plan is consistent with this section.

J. Section 13-103(a) and Section 13-506.1 (b)(6)

Section 13-103 (a) declares as a legislative policy that telecommunications services should be available to all Illinois citizens at just, reasonable and affordable rates and that such services should be provided as widely and economically as possible in sufficient variety, quality, quantity and reliability to satisfy the public interest. Section 13-506.1(a)(6) requires the Commission to consider, in determining the appropriateness of any alternative form of regulation, whether it will provide for fair, just, and reasonable rates.

These requirements are reflected in the required findings in Section 13-506.1 (b)(2) and 13-506.1 (b)(6), and are discussed below.

Specific Findings

K. **Section 13-506.1(b)(2)**

The Alternative Regulatory Plan Produces Fair, Just And Reasonable Rates For Telecommunications Services

The Company has provided all of the information typically submitted in a general rate proceeding. This comprehensive filing has shown that from a traditional rate of return standpoint, its current rates are generally reasonable in light of its current costs of capital, its capital structure, its operating revenues and expenses in the test year and its rate base. The evidence establishes that with the start-up revenue adjustment and depreciation determinations adopted by the Commission, start-up rates under price regulation are very likely to be lower than rates which would result if the Commission retained traditional ROR regulation.

After rates are initialized, the price index mechanism will continue to produce reasonable rates. Price increases will be limited by the rate of inflation in the overall economy (as measured by the GDPPI), less an offset to reflect Illinois Bell's differential rates of growth of input prices and productivity compared to the economy as a whole. This index reasonably will reflect the impact of cost changes over which Illinois Bell has no control and which properly should be reflected in customer rates. By linking price increases to general cost changes in the economy, rather than to the Company's own internal costs, the plan will protect ratepayers from the impact of competition and management error. This also means that the real price, if not the actual price, of telecommunications services overall will fall over the duration of the alternative regulation plan. Indeed, as a result of the inclusion of the consumer productivity dividend factor in the price regulation formula, which the Commission deems necessary to satisfy Section 13-506.1 (b)(5); based on current GDPPI projections, the actual price of noncompetitive services is likely to decline.

The price index also will ensure that individual price changes are reasonable. Establishment of the four service baskets will prevent any shifting of Illinois Bell's overall revenue requirement among customer groups from what exists today. In addition, the absolute cap on price increases for any single service within a basket of 5% plus the amount of the change in the price index will allow the Company to make any gradual changes in its overall rate structure that may be needed to remove interservice cross-subsidies and to respond to the marketplace without customer disruption or undue rate impact. Moreover, because any 5% increase in a service within a basket must be offset by a 5% decrease on a service within the same basket in order to maintain compliance with the price index, the Company's overall rate levels applicable to that class of customers will remain reasonable. Finally, the price for any given service can be increased only once a year.

The overall impact on residential service rates of the Company's proposed plan is further constrained by operation of law. Section 13-506.1(c) prohibits any increases in basic residential rates for the first three years that the plan is in effect. In addition, the Commission has extended the basic residential service rate freeze to the full five year initial period contemplated by the alternative regulation plan. This restriction will ensure that residential ratepayers cannot be harmed by the adoption of price regulation, and a base level of universal telecommunications services will be available to all of the citizens of Illinois at a just and reasonable rate.

Statutory protections designed to ensure just and reasonable rates also will apply to tariffs for new noncompetitive services which will be filed in accordance with the notice and filing requirements of Article 9 of the Act. Finally, reporting requirements will permit the Commission to monitor the reasonableness of Illinois Bell's rates closely, and the Commission's complaint and investigation processes will remain open to both customers and the Commission.

For all of these reasons, the Commission finds that the alternative regulation plan produces fair, just and reasonable rates for telecommunication services.

L. **Section 13-506.1(b)(3)**

The Alternative Form of Regulation Responds To Changes In Technology And In The Structure Of The Telecommunications Industry

Traditional ROR regulation was developed in order to address monopoly supply of essential telecommunications services. This approach was sustainable as long as the industry structure remained stable, there was limited competition, and economic trends were favorable. As this Commission previously has concluded, the market environment which Illinois Bell will be facing in the future will be an increasingly competitive one. Price regulation responds to these changes in the structure of the telecommunications industry.

Price regulation directly ensures that noncompetitive rates will remain just and reasonable, while market forces will control competitive service prices and earnings. Price regulation will protect captive users of noncompetitive services from the risks of competition for other services, because revenue losses due to increased competition or increased costs due to management errors in responding to that competition will not result in increased noncompetitive services rates.

Price regulation also will allow Illinois Bell to assume responsibility for its capital recovery policies, at no risk to ratepayers, because increases in depreciation rates no longer will impact noncompetitive customer rate levels. Price regulation also will encourage network investment, without increasing the risks borne by noncompetitive ratepayers, because the benefits of successful ventures will be retained by the Company and its shareholders, thus offsetting failed ventures. Price regulation should eliminate the debate over "who pays" for network modernization because any price increases should be responsive to inflationary pressures in the economy, rather than to increased network investment, and those increases must be spread equitably across customer classes.

Price regulation also will provide better inducements for Illinois Bell to operate efficiently, to introduce new services, and to be responsive to its customers. For all these reasons, the Company's proposal responds to changes in technology and in the structure of the telecommunications industry.

M. **Section 13-506.1(b)(4).**

Based On An Overall Consideration Of The Policy Goals Set Forth Above, The Alternative Form Of Regulation Is A More Appropriate Form Of Regulation

This section requires an overall consideration of the policy goals set forth in Sections 13-103 and 13-506.1(a). Each of these policy considerations is discussed separately above. The Commission has found that the alternative regulation plan will reduce regulatory delay and costs over time; will encourage innovation in new services; will promote efficiency; will facilitate the broad dissemination of technical improvements to all classes of ratepayers; will enhance the economic development of the State; will provide for fair, just and reasonable rates; and will reduce the economic burdens of regulation.

The alternative regulation plan also will not make any changes which disrupt the telecommunications system; will not result in discriminatory rates or cross-subsidies; and will not prevent systematic legislative review of regulatory policies and procedures.

Some of these policy goals strongly favor adoption of the alternative regulation plan; other policy goals are less affected by the plan. On an overall basis, the Commission finds that, in consideration of these policy goals, the alternative regulation plan is a more appropriate form of regulation.

N. **Section 13-506.1(b)(5)**

The Alternative Form of Regulation Specifically Identifies How Ratepayers Will Benefit From Any Efficiency Gains, From Cost Savings Arising Out Of The Regulatory Change, And From Improvements In Productivity Due To Technological Change

Ratepayers will benefit from the Company's efficiency gains, cost savings, and productivity improvement in several ways. The alternative regulation plan provides incentives to the Company to implement cost-saving efficiencies. These efficiencies should be reflected in an improvement in the Company's productivity measures. The price regulation formula includes a 0.5% consumer productivity dividend factor. This ensures that consumers will be the first to benefit from any gains Illinois Bell achieves over and above its historical productivity experience. Moreover, ratepayers will benefit even if the Company's total factor productivity lags because of declining output due to competition or otherwise; that is because the total offset will apply regardless of the Company's actual productivity performance. Ratepayers are thereby assured that the price of telecommunications services will decline in real terms.

The alternative regulation plan also provides considerable incentives to the Company to invest in new technologies and develop new services at a pace determined by market forces. Consumers themselves, not the Commission, will largely determine how and when they benefit from technological change.

The Commission also anticipates that the regulatory change will result in considerable savings in the costs of regulation. Under traditional ROR regulation, virtually all of the costs incurred by the Company related to regulation are recovered from ratepayers through rates. Price regulation eliminates the automatic pass-through to ratepayers of these costs.

Accordingly, the Commission finds that the alternative regulation plan specifically identifies, and provides for, ratepayer benefit from any efficiency gains and cost savings arising out of the regulatory change, and from improvements in productivity due to technological change.

O. **Section 13-506.1(b)(6)**

The Alternative Form of Regulation Will Maintain The
<u>Quality And Availability Of Telecommunications Services</u>

The record in this proceeding indicates that the current quality of service provided by Illinois Bell is fully satisfactory. Nevertheless, as part of the alternative regulation plan, the Commission is requiring the Company to report, on a monthly basis, its compliance with a series of service quality benchmarks. In addition, the Staff has been directed to actively monitor developments potentially affecting the Company's service quality, including areas not specifically identified by the statewide minimum service quality standards we have established, and to report to the Commission on a regular basis the results of its analysis.

As discussed previously, the alternative regulation plan enhances quality and availability of telecommunications services by creating the proper incentives for more aggressive deployment of an advanced telecommunications infrastructure. The basic residential services rate freeze will help ensure the availability of telecommunications services to all citizens of Illinois. Nothing in the alternative regulation plan reduces, restricts or diminishes the availability of Illinois Bell's services in any way. Accordingly, the Commission finds that the Company's proposal will maintain the quality and availability of telecommunications services.

P. <u>Section 13-506.1(b)(7)</u>

The Alternative Form of Regulation Will Not Unduly Or
Reasonably Prejudice Or Disadvantage Any Particular
<u>Customer Class, Including Telecommunication Carriers</u>

The alternative form of regulation will ensure equitable treatment of all customer classes by establishing four customer categories and applying the price index separately to each category (residence, business, carrier, and "other"). This mechanism will prevent the Company from raising prices disproportionately in one customer category. The plan also will prevent the Company from raising prices disproportionately for any single service, because increases would be limited to the amount of the price index plus 5% in any one year. In addition, the Company has committed to increase no intrastate carrier access rate to a level that exceeds the interstate rate for that service, and access rate changes will be further limited by any future Commission Orders regarding access charges.

Particular customer classes are safeguarded further by the Commission's reporting requirements and monitoring, as well as by the complaint process. The Company will be required to file annual reports regarding the actual price index for each customer category, as well as more detailed documentation on the impact of any proposed rate increase. The Company's compliance with the applicable price indexes will be monitored by the Commission, and the Company will remain subject to rate-related complaints under Section 13-506.1(e).

Finally, all of the existing mechanisms to ensure equitable treatment of customers would remain in place. These include statutory requirements regarding cost allocation, imputation, and the use of a long run service incremental cost standard, as well as the nondiscrimination provisions of the Act.

The Commission has identified certain technical deficiencies in the Company's imputation studies and aggregate revenue test and is directing that appropriate corrections be made. The Company will be required to demonstrate through modified imputation and aggregate revenue tests, that the start-up tariffs under the alternative regulation plan comply with the requirements of Section 13-505.1 and 13-507. For these reasons, the Commission finds that the alternative regulation plan will not unduly or unreasonably prejudice or disadvantage any particular customer class, including other telecommunications carriers.

Q. **Section 13-506.1(b)(1)**

<u>The Alternative Regulatory Plan Is In The Public Interest</u>

A finding that the alternative regulatory plan would serve the public interest takes into consideration all of the policies and criteria set forth in response to Sections 13-506.1 (a)(1)-(6), 13-103, and 13-506.1(2)-(7). Since the alternative regulation plan as modified by the Commission satisfies all of these policies and criteria, the Commission finds that the alternative regulation plan is in the public interest.

XIII. <u>FINDINGS AND ORDERING PARAGRAPH</u>

The Commission, having considered the entire record herein, and being fully advised in the premises thereof, is of the opinion and finds that:

(1) Illinois Bell Telephone Company is an Illinois corporation engaged in the business of providing telecommunications services to the public in the State of Illinois and, as such, is a telecommunications carrier within the meaning of Section 13-202 of the Illinois Public Utilities Act;

(2) the Commission has jurisdiction over Illinois Bell Telephone Company and the subject matter of this proceeding;

(3) the recital of facts and conclusions reached in the prefatory portion of this Order are supported by evidence of record, and are hereby adopted as findings of fact and conclusions of law for the purposes of this Order;

(4) on December 1, 1992, Illinois Bell Telephone Company filed a Petition with this Commission, pursuant to Section 13-506.1 of the Illinois Public Utilities Act, to regulate the rates and charges of its noncompetitive services under an alternative form of regulation in lieu of traditional rate of return regulation;

(5) on July 13, 1993, the Citizens Utility Board filed a complaint seeking an investigation and reduction of Illinois Bell Telephone Company's rates under Article IX of the Public Utilities Act; the complaint was docketed as 93-0239 and subsequently consolidated with the Illinois Bell petition;

(6) for purposes of determining whether Illinois Bell Telephone Company's rates are just and reasonable and an appropriate starting point for rates under a price regulation plan, a test year ending August 31, 1992, based upon twelve months actual data, is the appropriate test year for this proceeding;

(7) the Company's projected capital structure as of September 1, 1993, reflecting Staff adjustments adopted herein, should be used for determining the Company's overall cost of capital; the rates to be applied to the Company's long-term debt and short-term debt are those provided by the Staff; a fair return on the Company's equity capital is 11.90%, resulting in a weighted cost of capital of 9.96%, this weighted cost of capital constitutes an acceptable target return for purposes of

determining whether the Company's current rates are reasonable and an appropriate starting point for alternative regulation;

(8) giving effect to the adjustments approved hereinabove, Illinois Bell Telephone Company's intrastate net original cost rate base of its telephone plant in service used or useful in providing telephone service to its customers in Illinois is $2,904,920,000;

(9) Illinois Bell Telephone Company's pro forma Operating Income, as of August 31, 1992, after giving effect to the adjustments to revenue and expenses approved hereinabove, is $289,330,000; this level of Operating income produces a rate of return of 9.996% on the Original Cost Rate Base of $2,904,920,000;

(10) the depreciation rates as established herein are reasonable and are supported by the record;

(11) Illinois Bell Telephone Company's balance available for return as of August 31, 1992 is $301,558,000; this income balance produces a rate of return of 10.38% on the original cost rate base of $2,904,920,000;

(12) a reduction in operating income of $12,228,000 is necessary to provide for fair and reasonable rates;

(13) based on the foregoing findings with respect to capital structure, fair return, rate base, depreciation and balance available for return, the Citizens Utility Board's Complaint for an investigation and reduction in rates is granted to the extent consistent with the findings herein and denied in all other respects;

(14) to ensure that implementation of the alternative regulation plan is in the public interest and will produce fair, just and reasonable rates for telecommunications services, an additional start-up revenue reduction of $18,000,000 is required; the total revenue reduction should be implemented through a detariffing of charges for touch-tone service;

(15) to ensure that the conditions set forth in Section 13- 506.1 (b) are satisfied, for the first 5 years the alternative regulation plan is in effect, basic residence service rates should be no higher than those currently in effect;

(16) Illinois Bell's long-run service incremental cost studies are a reasonable basis on which to base rates and meet the statutory standards set out in Section 13-502 of the Public Utilities Act;

(17) the Company provides multiple services, both competitive and noncompetitive services, using joint facilities and common expenses; Article XIII of the Act directs this Commission to prevent cross-subsidies between competitive and noncompetitive services;

(18) the record establishes that the Company must modify certain *of* its imputation tests, *in a manner* identified hereinabove, to demonstrate that each of its switched interexchange and competitive services subject to imputation pass an imputation test in accordance with Section 13-505.1 of the Act;

(19) the record establishes that the Company must modify its calculation of the Aggregate Revenue Test, in a manner identified hereinabove, to demonstrate that it passes the Aggregate Revenue Test required by Section 13-507 of the Act;

(20) the Commission will initiate a proceeding to investigate whether imputation should be required for *local calling area offerings* as stand-alone services or as part of more aggregated service offerings;

(21) as modified herein, and reflected in Attachment A to this Order, the plan for an alternative form of regulation of noncompetitive services filed by Illinois Bell:

a) is in the public interest;

b) will produce fair, just, and reasonable rates for telecommunications services;

c) responds to changes in technology and the structure of the telecommunications industry that are, in fact, occurring;

d) constitutes a more appropriate form of regulation based on the Commission's overall consideration of the policy goals set forth in Sections 13-103 and 13-506.1;

e) specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change;

f) will maintain the quality and availability of telecommunications services; and

g) will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers;

(22) the requirements of Section 13-506.1 of the Act have been satisfied;

(23) Illinois Bell Telephone Company should be allowed to set its own depreciation rates in accordance with Generally Accepted Accounting Principles;

(24) in filing the annual updates of its Aggregate Revenue Tests, the non-economic costs to be allocated by the Company as part of such tests are defined as the difference between the revenues and the long run service incremental costs of the Company;

(25) the Company should use the cost of equity determined in this proceeding for use in its service cost studies. The Commission will review the appropriate cost of equity if the 30 year Treasury bond yield rises 250 basis points above its yield at the time the Commission enters its order in this proceeding and stays at that level for at least three consecutive months;

(26) in updating the depreciation rates used in its service cost studies, the Company should develop remaining life depreciation rates using the projected life of plant at age zero;

(27) the Chief Clerk of the Commission should be directed to maintain all such information identified as proprietary and data so designated in this proceeding in a manner which will not permit disclosure, dissemination, revelation or reproduction thereof without further Order of the Commission; provided that the proprietary information and data shall be certified on any appeal in a manner which informs the Clerk of any Court of the action of this Commission with regard thereto in order to enable any such Court to enter such order or orders as such Court shall deem necessary and proper; and

(28) any objections, motions or petitions filed in this proceeding which remain undisposed of should be disposed of in a manner consistent with the ultimate conclusions herein contained.

IT IS THEREFORE ORDERED that Illinois Bell Telephone Company's petition for an alternative form of regulation for noncompetitive services, as modified herein and reflected in Attachment A to this Order, be, and is hereby, granted.

IT IS FURTHER ORDERED that as soon as practicable after entry of this Order, Illinois Bell Telephone Company shall file revised tariffs reflecting the revenue requirement and rate design determinations herein, and shall demonstrate that the tariffs comply with Section 13-505.1 and 13-507.

IT IS FURTHER ORDERED that Illinois Bell Telephone Company's Motion For a Protective Order be, and is hereby, granted.

IT IS FURTHER ORDERED that all motions not previously disposed of are hereby disposed of consistent with the findings of this Order.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code

200.880, this Order is final; it is not subject to the Administrative Review Law.

DATE:	May 3, 1994
BRIEFS ON EXCEPTIONS DUE:	May 24, 1994
REPLIES ON EXCEPTIONS DUE:	June 7, 1994

Michael Guerra,
Paul J. Rebey,
Hearings Examiners

APPENDIX A

PLAN FOR ALTERNATIVE FORM OF REGULATION

Summary

Pursuant to Section 13-506.1 of the Illinois Public Utilities Act ("Act"), Illinois Bell Telephone Company ("Illinois Bell") proposes to replace traditional rate of return regulation with a price regulation plan for those Illinois Bell services that are classified as noncompetitive under the Act. On the first of the month following the filing of initial implementing rates demonstrating compliance with statutory imputation and aggregate revenue requirements, Illinois Bell may adjust its rates within a price index which reflects the impact of inflation and productivity. There will be no direct regulatory oversight of Illinois Bell's earnings or its depreciation rates.

Section I contains rate stability provisions and other terms and conditions of the plan. Section II describes the procedures for price changes pursuant to the price index.

I. Rates and Conditions of Price Index Plan

A. Rate Adjustments

1. Rate Stability for Basic Residential Service

(a) Increases in the tariffed rates for basic residence services shall not be permitted for the first five years that the plan is in effect. Basic residence services include the monthly recurring charges for Illinois Bell's lowest priced primary residence network access line and any associated untimed or flat local usage charges. For purposes of this paragraph, basic residence services are defined as Illinois Bell's residence network access line rates for Access Areas A, B and C; Band A residence usage service; and flat rate residence usage service in those exchanges where usage sensitive service is not yet available. (Ill. C.C. No. 5, Part 2, Section 19, par. 2.5; par. 4.4, A(2); par. 5.4, A(2); par. 3.2, C; par. 3/2, E, note). Decreases in the tariffed rates for basic residence service shall be permitted, consistent with other provisions of the Act.

(b) After expiration of the initial five-year period of the plan, increases in basic residence services may be made subject to the provisions of paragraphs 2 and 3, unless otherwise modified by the Commission.

2. <u>Price Index-Based Rate Adjustments</u>

(a) On the first of the month following the filing of initial rates implementing the alternative regulation plan and demonstrating compliance with Section 13-505.1 and 13-507 of the Act, Illinois Bell shall be permitted to change the rates for services then classified as noncompetitive in its tariffs in an amount which, when taken together with all price changes in the customer categories described in paragraph 2(c), produce revenues which will be limited to the percent change in the Gross Domestic Producer Price Index ("GDPPI"), as determined and published by the United States Department of Commerce, and an offsetting adjustment reflecting Illinois Bell's *differential growth in input price* and productivity, plus a consumer productivity dividend. The total offsetting adjustment will be 3.8%. The price index is as follows:

> Price Index (PI) *for the current* year = PI of Prior Year times [1 plus the Quantity % Change in the GDPPI Over Prior Year - 3.8%].

The initial price index under the plan will be 100.00. Such index is effective on the first of the month following filing of the initial rate changes implementing the plan and demonstrating compliance with statutory imputation and cross-subsidy tests in accordance with the findings of the Commission's Order approving the plan, and will remain in effect until January 1, 1995.

(b) The price index set forth in paragraph 2(a), together with the Actual Price Index ("API") set forth in paragraph 2(d), provide the basis for the reasonableness of price changes within the four customer categories. The four customer categories and the principal services within each category at the outset of the plan are as follows: (1) residence (residence network access lines; Band A through Band D usage, including volume discounts; touch-tone; Starline; Multi-ring; custom calling; advanced custom calling; and non-recurring charges); (2) business (business network access lines; Band A through Band D usage, including volume discounts; touch-tone; ISDN; custom calling, advanced custom calling; ACBS; remote call forwarding; WATS; and non-recurring charges); (3) carrier (switched access, special access, cellular access and LIDB); and (4) other (directory services, Chicago name and address, payphone, directory assistance, private line and operator services). E-911 service is excluded from the plan. Intrastate toll service is excluded from the plan but may be added at a later time, pursuant to the procedures for new services in Section I, D. (Ill. C.C. No. 5, Part 4).

(c) The reasonableness of price changes under the plan are determined by a comparison of the price index applicable to a given year to the API for each of the four customer categories described in Section 3(c). If the proposed price changes are such that the API for each category is less than or equal to the PI for that year, the price changes will have a presumption of reasonableness, and absent special circumstances, will be allowed to go into effect without suspension. As with the PI, the initial API will be 100.00 for each customer category. While the PI may change only once each year, the API may change at any time during the year when price changes are made. The API for each customer category is as follows:

$$API^{(t)} = API^{(t-1)} * V^{i} \frac{P^{i}(t)}{P^{i}(t-1)}$$

where:

$P^{i}(t)$ = the proposed price for rate element i

$P^{i}(t-1)$ = the existing price for rate element i

V^{i} = the revenue weight for rate element i, which is calculated as the revenue from rate element i using demand from the most recent July through June period and the current rate divided by the revenue from all rate elements in each customer category individually using demand from the most recent July through June period and current rates.

(d) Individual service price increases within each customer category are subject to two additional limitations. The price for any individual service element may not be increased more than once in any calendar year. The price for any individual service element may not be increased by more than the change in the price index for that year over the previous year plus 5%. In addition, no intrastate carrier access rate may be increased to a level that exceeds the interstate rate for that service. Access price changes also remain subject to any limitations imposed by future Commission access orders.

(e) Illinois Bell may choose to forego any price index-based revenue increases to which it might be entitled under the plan.

(f) Revenue increases foregone in the current year pursuant to paragraph (e) may be made cumulatively in a following year as long as the Price Index is not exceeded. Any individual service price increases would remain subject to the limitations in paragraph (d).

(g) Illinois Bell may decrease prices for any of its noncompetitive services. Such price decreases will be included in the calculation of allowable revenue increases in Section II. No price will be decreased below the long run service incremental cost for that service.

3. <u>Other Rate Adjustments</u>

Individual service price changes that exceed the limits set forth in paragraph 2(d) may be made subject to the notice and filing requirements of Article 9 of the Act and not as part of the plan's rate adjustment mechanisms. The overall revenue effect of rate changes made pursuant to this paragraph must comply with the restrictions placed on the service category to which the individual service is assigned in accordance with paragraphs 2(a), (c), and (d).

4. <u>Exogenous Events</u>

The price index will be adjusted to reflect exogenous events only to the extent deemed necessary by the Commission to ensure that the conditions set forth in Section 13-506.1(b) of the Act continue to be satisfied.

B. <u>Depreciation</u>

Upon the filing of initial rates implementing the plan, Illinois Bell will adopt the depreciation rates and amortization schedules consistent with the determinations made by the Commission in its Order approving the alternative regulatory plan. Beginning on January 1, 1995, Illinois Bell shall have the flexibility to adjust its depreciation rates as it deems necessary to reflect the consumption of capital accurately, in accordance with generally accepted accounting principles, without prior Commission approval.

C. <u>Reclassification Of Services As Competitive</u>

Illinois Bell may reclassify existing noncompetitive services as competitive in accordance with Section 13-502 of the Act. Upon reclassification, all impacted rate elements will be removed from the API and the index recalculated for the affected customer categories. If rate increases are required at the time that a service is reclassified as competitive to satisfy Section 13-507, then the price index will be reduced to reflect the increase in the competitive service rates. No change in noncompetitive service rates will be required if the adjusted API is equal to or less than the adjusted PI.

D. New Services

Illinois Bell may file tariffs for new competitive services in accordance with the notice and filing requirements of Article 9 of the Act. The API for the affected customer categories will be adjusted and recalculated only after the service has been offered for one year. The demand weighting in the API calculation will be for the most recent one year period or for the most recent July to June period as described in paragraph 2(c).

E. Infrastructure Development

Upon approval of the plan by the Illinois Commerce Commission, Illinois Bell will commit to at least $3 billion in expenditures in Illinois for growth and modernization of the telecommunications network over the first five-year period of the plan.

F. Term

The term of the plan shall run from the date of its approval by the Illinois Commerce Commission. The Commission retains the authority under Section 13-506.1(e) to rescind the plan upon petition by Illinois Bell, any other person or upon its own motion if, after notice and hearing, the Commission finds that the conditions set forth in Section 13-506.1(b) no longer can be satisfied.

II. Rate Adjustment Proceedings

A. This section describes the procedures for rate adjustments described in Section I, A, 2 during the period of the plan. By October 1 of each year of the plan, Illinois Bell will file with the Commission:

1. The price index for the following calendar year, calculated in accordance with Section I, A, 2. Supporting documentation will provide:

(a) Then current data showing the GDPPI for the previous 12-month period (July to June) and the GDPPI % change for that 12-month period;

2. The API for each customer category, including the effects of proposed rate changes determined in accordance with Section I, A, 3(c). The API shall be less than or equal to the PI for the

upcoming year for each customer category. Adjustments will be made for:

(a) New services added, existing services withdrawn and services reclassified as competitive or noncompetitive; and

(b) Residence basic services for all customer categories.

3. Tariff pages to reflect revised rates, if rate increases or decreases are proposed to be effective on January 1 of the following calendar year.

4. Supporting documentation demonstrating that any proposed rate increases are consistent with the limitations set forth in Section I, A, 2, including:

(a) the actual price index ("API") for each service basket, including the effects of proposed rate changes and adjustments for new services added, existing services withdrawn, and services reclassified as competitive or noncompetitive;

(b) a description of any rate increases or decreases being proposed;

(c) the maximum percent price change allowed for any individual service;

(d) the percent price change resulting from any rate increase or decrease proposed for any individual service.

5. A demonstration that Illinois Bell would be in compliance with Section 13-507 of the Act, assuming the proposed rate changes went into effect.

6. A demonstration that Illinois Bell would be in compliance with Section 13-505.1, if rate changes are proposed for services subject to Section 13-505.1 and assuming that the proposed rate changes went into effect.

7. A sources and uses of funds statement for the immediately preceding year, the current year and the following calendar year.

8. An identification of any modifications in the past year to the GDPPI weights, what effect the new

weights have on the GDPPI and whether the PCI should be adjusted accordingly.

B. The Commission Staff and all interested parties shall have an opportunity to file written comments regarding Illinois Bell's annual filing and Illinois Bell shall have an opportunity to file reply comments. Following completion of the comment period and prior to January 1 of the following year, the Commission shall approve a price index that will be applicable during that year.

C. Illinois Bell may file tariff pages to increase or decrease individual service rates under the price index plan at any time during the calendar year to which the index applies.

1. In connection with such filings, Illinois Bell shall file the supporting documentation described in Section II, A, 4.

2. All such tariff filings shall be made at least 45 days in advance of their effective date.

D. Tariffs filed pursuant to Sections II, A, 3 or II, C that are found to be consistent with the price index and individual rate limitations of this plan shall enjoy a presumption that they are just and reasonable and, absent special circumstances, shall become effective without suspension or investigation under Article 9 of the Act.

E. By March 31 of each year of the plan, Illinois Bell will file with the Commission an annual report which includes the following information:

1. Total Company and Illinois jurisdictional rate base;

2. Total Company and Illinois jurisdictional operating revenue and expenses;

3. Other income and deductions, interest charges, and extraordinary items (with explanation);

4. Current capital structure;

5. Calculated total Company and Illinois jurisdictional return on net utility rate base and total Company return on common equity;

6. Statement of Sources and Applications of Funds;

7. A description of the projects and amounts invested in new technology pursuant to Section I, D, during the preceding calendar year;

8. A calculation of the then current price index and actual price index, including the formula used, the inflation factor and its source, and the productivity factor.

9. A description of new services including the price of each and its effect on the calculation of the API during the preceding calendar year;

10. Demand growth by revenue basket;

11. Summary of price changes initiated under the plan during the preceding calendar year;

12. A demonstration that Section 13-507 of the Act has been complied with.

G. The annual filings set forth in Section II, A, Section II, E and the tariff documentation set forth in Section II will document that the requirements of the plan are being implemented properly, as required by Section 13-506.1(e). A formal assessment of the plan will be conducted beginning July 1, 1998, for submission to the Legislature in 1999.

ILLINOIS BELL TELEPHONE COMPANY
Revenue Effect of Adjustments
For the Test Year Ended August 31, 1992
(In Thousands)

Company Indicated Increase			$276,807 (1)
HEPO Rate of Return	9.96% (2)	($98,016)	
Return on Equity	11.90% (2)		
HEPO Rate Base Adjustments		(40,013)	
HEPO Operating Statement Adjustments		(159,618)	
Rounding		(3)	

Total Effect of HEPO Proposals			(297,650)

HEPO Proposed Change to Revenues			($20,843) (3)
			=======

(1) Source: Illinois Bell Ex. 9.12, Page 10
(2) Source: ICC Staff Ex. 10.01, Schedule 4
(3) Source: Schedule 2

ILLINOIS BELL TELEPHONE COMPANY
Revenue Effect of Adjustments
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description (A)	Schedule (B)	Amount (C)	Description (D)	Schedule (E)	Amount (F)
1	HEPO Rate Base Adjustments			HEPO Operating Statement Adjustments		
2						
3	Vacancy Factor	Ex 5.01, Sch 2	($5,399)	Interest Synchronization	Schedule 7	(2,207)
4	Capitalized OPEB Amortization	Ex 6.01, Sch 3	(15,042)	Advertising	Ex 5.01, Sch 1	($378)
5	Capitalized SFAS 112 Amortization	Ex 6.01, Sch 7	(201)	Vacancy Factor	Ex 5.01, Sch 2	(1,270)
6	Working Capital	Ex 8.01, Sch 1	(17,534)	Expensed OPEB Amortization	Ex 6.01, Sch 1	(17,317)
7	Work Force Resizing	CUB Sch B-4	(1,837)	Expensed SFAS 112 Amortization	Ex 6.01, Sch 5	(8,074)
8			------	Depreciation Expense	Ex 7.01, Sch 6	(91,253)
9				Vouchers Processed Management Audit	Ex 9.01, Sch 3	(327)
10	Total		($40,013)	Management Audit Expense	Ex 9.01, Sch 4	(550)
11			======	Link-Up Expense	Ex 9.01, Sch 5	(954)
12				Lobbying Expense	Ex 9.01, Sch 8	(70)
13				ASI Depreciation	Ex 18.01 Sch 1	(2,163)
14				Work Force Resizing	CUB C-5, C-13	(22,823)
15				Bellcore R&D	CUB Sch C-12	(3,821)
16				AIT PAC Costs		(506)
17				AIT Excess Corporate Wages		(308)
18				AIT Advertising and Promotion		(2,788)
19				AIT Project Code 01		(3,994)
20				AIT Excess Flight		(757)
21				AIS Accruals		(58)
22						-------
23						
24				Total		($159,618)
25						=======
26						
27						
28						
29						
30						
31						
32						
33						
34						
35						
36						
37						
38						

ILLINOIS BELL TELEPHONE COMPANY
Statement of Operating Income with Adjustments
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description	Company Pro Forma Present (Illinois Bell Ex. 9.12)	HEPO Adjustments (Sch. 3)	HEPO Pro Forma Present (Col B+C)	Company Indicated Increase	Adjustment to Indicated Increase	HEPO Pro Forma Proposed (Col D+E+F)	Revenue Change (Col G-D)	% Revenue Change (Col H/D)
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
1	Operating Revenues	$2,089,403	$0	$2,089,403	$276,807	($297,650)	$2,068,560	($20,843)	-1.00%
2									
3	Operating Expenses:								
4	Depreciation & Amortization	541,380	(93,419)	447,961			447,961		
5	Plant Specific Operations	475,207	(7,613)	467,594			467,594		
6	Plant Non-Specific Operations	160,339	(3,450)	156,889			156,889		
7	Customer Operations Marketing	67,129	(561)	66,568			66,568		
8	Customer Operations Services	252,350	(5,527)	246,823			246,823		
9	Corporate Operations	211,692	(45,895)	165,797			165,797		
10	Interest on Customer Deposits	339	0	339			339		
11	Uncollectibles	33,939	0	33,939	4,976	(5,352)	33,563		
12	Other Operating Taxes	83,215	0	83,215	2,602	(2,799)	83,018		
13	Other Expenses	4,194	(68)	4,126			4,126		
14									
15	Total Operating Expense								
16	Before Income Taxes	1,829,784	(156,533)	1,673,251	7,578	(8,151)	1,672,678		
17									
18	State Income Tax	13,763	11,452	25,215	19,330	(20,786)	23,759		
19	Federal Income Tax	35,499	51,811	87,310	87,463	(94,050)	80,723		
20	Deferred Taxes and ITCs Net	0	2,069	2,069			2,069		
21									
22	Total Operating Expenses	1,879,046	(91,201)	1,787,845	114,371	(122,987)	1,779,229		
23									
24									
25	NET OPERATING INCOME	$210,357	$91,201	$301,558	$162,436	($174,664)	$289,330		
26	Rate Base						$2,904,920 (1)		
27	Overall Rate of Return						9.96% (2)		

(1) Source: Schedule 4, Column D
(2) Source: ICC Staff Ex. 10.01, Schedule 4

ILLINOIS BELL TELEPHONE COMPANY
Adjustments to Operating Income
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description	Interest Synchron-ization (Sch. 7)	Advertising Expense (Ex. 5.01, Sch. 1)	Vacancy Factor (Ex. 5.01, Sch. 2)	Expensed OPEB Amortization (Ex. 6.01, Sch. 1)	Expensed SFAS 112 Amortization (Ex. 6.01, Sch. 5)	Depreciation Expense (Ex. 7.01, Sch. 6)	Vouchers Processed Management Audit (Ex. 9.01, Sch. 3)	Management Audit Expense (Ex. 9.01, Sch. 4)	Link-Up Expense (Ex. 9.01, Sch. 5)	Subtotal
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1	Operating Revenues										$0
2		-----	---	-----	------	-----	------	---	---	---	-------
3	Operating Expenses:										
4	Depreciation & Amortization			(1,235)			(92,184)				(93,419)
5	Plant Specific Operations				(6,757)						(6,757)
6	Plant Non-Specific Operations				(3,161)						(3,161)
7	Customer Operations Marketing				(384)						(384)
8	Customer Operations Services				(5,072)						(5,072)
9	Corporate Operations		(368)		(1,469)	(7,853)		(318)	(535)	(928)	(11,471)
10	Interest on Customer Deposits										0
11	Uncollectibles										0
12	Other Operating Taxes										0
13	Other Expenses										0
14		-----	---	-----	------	-----	------	---	---	---	-------
15	Total Operating Expense										
16	Before Income Taxes	0	(368)	(1,235)	(16,843)	(7,853)	(92,184)	(318)	(535)	(928)	(120,264)
17											
18	State Income Tax	212	26	89	1,209	564	6,619	23	38	67	8,847
19	Federal Income Tax	958	120	401	5,472	2,551	29,948	103	174	301	40,028
20	Deferred Taxes and ITCs Net						2,069				2,069
21		-----	---	-----	------	-----	------	---	---	---	-------
22	Total Operating Expenses	1,170	(222)	(745)	(10,162)	(4,738)	(53,548)	(192)	(323)	(560)	(69,320)
23		-----	---	-----	------	-----	------	---	---	---	-------
24											
25	NET OPERATING INCOME	($1,170)	$222	$745	$10,162	$4,738	$53,548	$192	$323	$560	$69,320
		=====	===	=====	======	=====	======	===	===	===	=======

ILLINOIS BELL TELEPHONE COMPANY
Adjustments to Operating Income
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description	Subtotal	Lobbying Expense (Ex. 9.01, Sch. 8)	ASI Depreciation (Ex. 18.01, Sch. 1)	Work Force Resizing (CUB Schedules C-5, C-13)	Bellcore R&D (CUB Schedule C-12)	AIT Transactions PAC Costs	AIT Transactions Excess Corporate Wages	AIT Transactions Advertising and Promotion	AIT Transactions Project Code 01	Subtotal
	(A)	(K)	(L)	(M)	(N)	(O)	(P)	(Q)	(R)	(S)	(T)
1	Operating Revenues	$0									$0
2		-------	---	-----	------	-----	---	---	-----	-----	-------
3	Operating Expenses:										
4	Depreciation & Amortization	(93,419)									(93,419)
5	Plant Specific Operations	(6,757)		(856)							(7,613)
6	Plant Non-Specific Operations	(3,161)		(289)							(3,450)
7	Customer Operations Marketing	(384)		(121)							(505)
8	Customer Operations Services	(5,072)		(455)							(5,527)
9	Corporate Operations	(11,471)		(382)	(22,199)	(3,717)	(492)	(301)	(2,712)	(3,885)	(45,159)
10	*Interest on Customer Deposits*	0									0
11	Uncollectibles	0									0
12	Other Operating Taxes	0									0
13	Other Expenses	0	(68)								(68)
14		-------	---	-----	------	-----	---	---	-----	-----	-------
15	Total Operating Expense										
16	Before Income Taxes	(120,264)	(68)	(2,103)	(22,199)	(3,717)	(492)	(301)	(2,712)	(3,885)	(155,741)
17											
18	*State Income Tax*	8,847	5	151	1,594	267	35	22	195	279	11,395
19	Federal Income Tax	40,028	22	683	7,212	1,208	160	98	881	1,262	51,554
20	Deferred Taxes and ITCs Net	2,069									2,069
21		-------	---	-----	------	-----	---	---	-----	-----	-------
22	Total Operating Expenses	(69,320)	(41)	(1,269)	(13,393)	(2,242)	(297)	(181)	(1,636)	(2,344)	(90,723)
23		-------	---	-----	------	-----	---	---	-----	-----	-------
24											
25	NET OPERATING INCOME	$69,320	$41	$1,269	$13,393	$2,242	$297	$181	$1,636	$2,344	$90,723
		=======	===	=====	======	=====	===	===	=====	=====	=======

Docket No. 92-0448
Appendix A
Schedule 3
Page 3 of 3

ILLINOIS BELL TELEPHONE COMPANY
Adjustments to Operating Income
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description	Subtotal	AIT Transactions Excess Flight	AIS Transactions (AIS Accruals)							Total
	(A)	(T)	(U)	(V)	(W)	(X)	(Y)	(Z)	(AA)	(AB)	(AC)
1	Operating Revenues	$0									$0
2		-------	---	---	---	---	---	---	---	---	-------
3	Operating Expenses:										
4	Depreciation & Amortization	(93,419)									(93,419)
5	Plant Specific Operations	(7,613)									(7,613)
6	Plant Non-Specific Operations	(3,450)									(3,450)
7	Customer Operations Marketing	(505)		(56)							(561)
8	Customer Operations Services	(5,527)									(5,527)
9	Corporate Operations	(45,159)	(736)								(45,895)
10	Interest on Customer Deposits	0									0
11	Uncollectibles	0									0
12	Other Operating Taxes	0									0
13	Other Expenses	(68)									(68)
14		-------	---	---	---	---	---	---	---	---	-------
15	Total Operating Expense										
16	Before Income Taxes	(155,741)	(736)	(56)	0	0	0	0	0	0	(156,533)
17											
18	State Income Tax	11,395	53	4	0	0	0	0	0	0	11,452
19	Federal Income Tax	51,554	239	18	0	0	0	0	0	0	51,811
20	Deferred Taxes and ITCs Net	2,069									2,069
21		-------	---	---	---	---	---	---	---	---	-------
22	Total Operating Expenses	(90,723)	(444)	(34)	0	0	0	0	0	0	(91,201)
23		-------	---	---	---	---	---	---	---	---	-------
24											
25	NET OPERATING INCOME	$90,723	$444	$34	$0	$0	$0	$0	$0	$0	$91,201
		=======	===	===	===	===	===	===	===	===	=======

ILLINOIS BELL TELEPHONE COMPANY
Rate Base
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description	Company Pro Forma (Illinois Bell Ex. 9.12)	HEPO Adjustments (Sch. 5)	HEPO Pro Forma (Col B+C)
	(A)	(B)	(C)	(D)
1	Plant in Service	$5,941,524	($50,970)	$5,890,554
2	Depreciation Reserve	(2,291,806)	13,251	(2,278,555)
3		---------	-------	---------
4	Net Plant	3,649,718	(37,719)	3,611,999
5				
6	Additions to Rate Base:			
7	Working Capital	75,103	(95,224)	(20,121)
8	Telephone Plant Under			
9	Construction	43,369	0	43,369
10	Property Held for Future Use	684	0	684
11	Materials and Supplies	20,121	0	20,121
12	Unamortized Equal Access	0	0	0
13	Separation Changes	0	0	0
14	Unamortized OPEB	79,527	(79,527)	0
15	Unamort. Force Reduction	9,976	(9,976)	0
16				
17	Deductions from Rate Base:			
18	Customer Deposits	(8,372)	0	(8,372)
19	Pre-1971 ITC	(145)	5,143	4,998
20	Deferred Income Taxes	(710,994)	0	(710,994)
21	Net Change due to Rates			
22	Represcription	0	0	0
23	Net Unfunded Liability	(36,764)	0	(36,764)
24				
25				
26		---------	-------	---------
27				
28	Rate Base	$3,122,223	($217,303)	$2,904,920
		=========	=======	=========

ILLINOIS BELL TELEPHONE COMPANY
Adjustments to Rate Base
For the Test Year Ended August 31, 1992
(In Thousands)

Line No	Description	Vacancy Factor (Ex. 5.01, Sch. 2)	Capitalized OPEB Amortization (Ex. 6.01, Sch. 3)	Capitalized SFAS 112 Amortization (Ex. 6.01, Sch. 7)	Working Capital (Ex. 8.01, Sch. 1)	Workforce Resizing (CUB Schedule B-4)					Total
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1	Plant in Service	($47,494)	($2,386)	($1,090)							($50,970)
2	Depreciation Reserve	13,028	223								13,251
3		------	------	-----	------	-----	---	---	---	---	-------
4	Net Plant	(34,466)	(2,163)	(1,090)	0	0	0	0	0	0	(37,719)
5											
6	Additions to Rate Base:										
7	Working Capital				(95,224)						(95,224)
8	Telephone Plant Under										0
9	Construction										0
10	Property Held for Future Use										0
11	Materials and Supplies										0
12	Unamortized Equal Access										0
13	Separation Changes										0
14	Unamortized OPEB		(79,527)								(79,527)
15	Unamort. Force Reduction					(9,976)					(9,976)
16											0
17	Deductions from Rate Base:										0
18	Customer Deposits										0
19	Pre-1971 ITC	5,143									5,143
20	Deferred Income Taxes										0
21	Net Change due to Rates										0
22	Represcription										0
23	Net Unfunded Liability										0
24											0
25											0
26		------	------	-----	------	-----	---	---	---	---	-------
27											
28	Rate Base	($29,323)	($81,690)	($1,090)	($95,224)	($9,976)	$0	$0	$0	$0	($217,303)
		======	======	=====	======	=====	===	===	===	===	=======

ILLINOIS BELL TELEPHONE COMPANY
Gross Revenue Conversion Factor
For the Test Year Ended August 31, 1992

Line No	Description	Rate	With Bad Debts	Without Bad Debts	With Franchise Fees
	(A)	(B)	(C)	(D)	(E)
1	Revenues		1.000000		1.000000
2	Uncollectibles	1.798%	0.017980		0.017980
3	Chicago Franchise Fees	0.94%	0.009402		0.009402
4	State Taxable Income		0.982020	1.000000	0.972618
5	State Income Tax	7.18%	0.070509	0.071800	0.069834
6	Federal Taxable Income		0.911511	0.928200	0.902784
7	Federal Income Tax	35.00%	0.319029	0.324870	0.315974
8	Operating Income		0.592482	0.603330	0.586810
9	Gross Revenue Conversion Factor		1.687815	1.657468	1.704129