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March 27, 2002

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *Ex Parte Presentation*
Petition for Forbearance of Iowa Telecommunications Services
CC Docket No. 01-331

Dear Mr. Caton:

On March 19, 2001, Mike Lieberman and I of AT&T met with Aaron Goldschmidt, Jay Atkinson, Noel Uri and Paul Zimmerman of the Common Carrier Bureau concerning the above-captioned petition. This letter memorializes the points we made concerning Iowa Telecommunications Services' ("ITS'") procedurally inadmissible, logically flawed and factually incorrect arguments in support of an increase in its interstate access rates.

We first reiterated the arguments presented in AT&T's Comments on the ITS petition as to why as a matter of legal procedure the Commission should not in the context of a waiver petition repudiate its decisions in the USF, Forward-looking Cost Model, Rural Task Force ("RTF"), CALLS, and numerous section 271 proceedings (several of which are currently under judicial review). In these proceedings, the Commission has declared, variously, that access charges are not to be used in lieu of universal service support and that the default Synthesis Model ("SM") is not an acceptable tool to determine the cost levels of any rural carrier or the absolute cost levels of even nonrural carriers.

In particular, we noted that there are four dimensions associated with potential use of the SM.

Dimension	Alternative 1	Alternative 2
Model version	USF	UNE/access
Desired purpose	USF cost calculation	UNE cost calculation
Type of carrier	Nonrural	Rural
Level of accuracy	Relative levels of cost	Absolute levels of cost

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While the Commission has accepted the USF version of the SM for use in calculatingUSF support for nonrural carriers based on their relative cost levels, and has accepted a UNE version of the SM for use in calculating the relative UNE costs of nonrural carriers, it has explicitly declined to sanction use of the model to calculate either absolute cost levels or the costs of any rural carrier. But not only is ITS proposing the SM be used for a use (calculation of absolute UNE/access cost for a nonrural carrier) that the Commission has never sanctioned, it proposes to use a version of the model that calculates and reports only USF costs for this UNE/access purpose.

But even if these procedural reasons for rejecting ITS' petition to raise its access charges are ignored, there are logical and factual reasons why the USF Synthesis Model results that ITS purports to represent its forward-looking economic costs ("FLEC") are severely wide of the mark. These divide into two categories: (1) the default SM as proposed by ITS does not produce accurate forward-looking costs for rural carriers; and (2) even if the SM was adjusted to produce accurate FLECs for rural carriers, ITS' conversion of these FLECs into its proposed access rates is invalid.

The default SM does not produce accurate rural FLECs:

That the default SM does not produce accurate FLECs for rural carriers has been noted at length by both the rural carriers participating in the Rural Task Force (RTF), as well as by consultants specializing in rural carrier cost analysis. These concerns are reported in RTF White Paper 4, *A Review of the FCC's Non-rural Universal Service Fund Method and Synthesis Model for Rural Telephone Companies.* Among these findings are that: the SM's estimates of line counts differ significantly from actual counts, and generally underestimate actual lines; the SM builds route-miles of plant that differ significantly from and generally overestimate actual route-miles, frequently by over 200 percent; the SM's plant mix differs from actual rural plant mixes; the SM's wire center boundaries are frequently severely in error; along with many other deficiencies.[1] All of these findings led the RTF and concurring parties such as GVNW to conclude:

> The aggregate results of this study suggest that, when viewed on an individual rural wire center or individual Rural Carrier basis, the costs generated by the Synthesis Model are likely to vary widely from reasonable estimates of forward-looking costs. In fact, much of the data analysis suggests that the model results tend to be in the high and low extremes, rather than near the expected results for the area being analyzed. While it may be technically possible to construct a model with added precision and variables to account for the differences among Rural Carriers and between non-Rural Carriers and Rural Carriers, it is the opinion of the Task Force that the current model is not an appropriate tool for determining the forward-looking cost of Rural Carriers.

Furthermore, the difficulties that the RTF and GVNW find are extremely severe. Appendix E to the RTF White Paper notes that the area in which the SM appears to vary most from rural actuality is in transport and signaling. Furthermore, this Appendix

[1] *See*, http://www.gvnw.com/news/filings/2001/reply0312.pdf and http://www.wutc.wa.gov/rtf/rtfpub.nsf/43e458610b70dda8882567d00074c6cd/7e7e6b591c8b6bf3882569 6800730b2b!OpenDocument.

concludes that before the SM would be able to yield accurate estimates of rural carrier costs, it would need extensive (and regular) updating of its input data on line counts and types, wire center service areas and types, traffic patterns, engineering practices, equipment costs, etc. And as is well-known, the Commission's RTF Order generally concurred with these concerns and found that the SM was not yet appropriate for use in developing even the relative costs of the rural carriers.[2]

While AT&T does not necessarily agree with all of the frailties that the rural carriers and their consultants have suggested, AT&T is aware of many additional deficiencies with the SM as it pertains to rural carriers.[3] We list just a few of them here.

1. The customer and network data underlying the SM are old. For the rural carriers, they date from 1996. Thus, the customer location data, line counts, wire center lists, traffic statistics and study area definitions need to be updated for six years of change to represent rural carriers as they exist in 2002. Indeed, the data set used by the SM does not even have any entries for ITS. Rather, it contains only the three Iowa GTE study areas (as they were defined in 1996), that eventually became ITS.

2. The input prices used in the SM are stale and are not always appropriate for rural carriers. For example, the Commission developed its SM data primarily to represent nonrural networks. Such networks average about 14,000 lines per wire center. In contrast, ITS averages about 900 lines per wire center. The switch prices that the Commission developed were primarily from BOC depreciation data. These SM inputs cost a switch at $87 per line plus $486,700 getting started for a host/standalone switch and $161,800 for a remote switch. Because of these huge getting started costs (which are appropriate only for switches with large lines and traffic-handling capabilities), the SM inputs generate a switch investment for a sub-1000 line switch at about $360 per line. But the Rural Utilities Service (RUS) data considered by the Commission (which focuses more on switches that are in ITS' sub-1000 line category) shows investment per line of only $260. Thus, before the SM can yield accurate costs for rural carriers, its input prices that reflect very high capacity pieces of equipment must be replaced with lower input prices charged for the lower-capacity equipment used by rural carriers.

3. While with just one exception, the nonrural companies modeled by the SM have only one study area in a state,[4] rural carriers often have many overlapping study

[2] Other regulatory commissions have come to similar views as to the appropriateness of using current FLEC models for setting USF or access rates for rural carriers. Indeed, the Illinois Commerce Commission expressly found the HAI model to significantly overestimate rural costs. *See*, http://eweb.icc.state.il.us/e-docket/ (copy attached), p. 36.

[3] In this regard, ITS is wrong when it suggests in its Reply Comments that AT&T has endorsed use of the default SM for setting access charges. While AT&T believes that the default SM could provide the basis for a model used to set access charges, it has always observed that the SM has many current faults that would need to be corrected before this would be appropriate.

[4] The one exception is that US West (now, Qwest) has two study areas in Idaho.

areas in a state. In Iowa, ITS operates three study areas. Because the SM models each of these study areas separately, it fails to reflect the efficiencies (particularly in interoffice transport networks) that are gained when the study areas are all part of a single holding company. An example will illustrate this. Because the SM models these three study areas separately, it builds separate interoffice transport and tandem switch networks for each of these ITS subsidiaries – even when they are in the same LATA. In LATA 632, the SM creates separate interoffice networks for the ITS study areas that it calls:

- "Contel of Iowa DBA GTE - Iowa" or NECA ID 351207 in the SM with a tandem switch at CLLI location KNVL (Knoxville, Iowa).
- "Contel of Kansas Inc - Iowa" or NECA ID 351790 in the SM with a tandem switch at CLLI location GNFD (Greenfield, Iowa).
- "GTE and Contel of Iowa" or NECA ID 351186 in the SM with a tandem switch at CLLI location GRNL (Grinnell, Iowa).

The OC-48 interoffice networks connecting the host and standalone switches in each of these study areas are mapped in Exhibits 1, 2, and 3. But all of these study areas in LATA 632 overlap – as shown in Exhibit 4. This exhibit shows that if a single interoffice network was used to link these offices, the route-miles and cost would be far less than building three separate networks.[5] Without detailed information from ITS on its interoffice network structures, its point-to-point traffic demands and time of day patterns for each of its switches, it is impossible for the SM in its current form to cost out a network that is even close to being efficient for a rural carrier such as ITS. Instead, the interoffice network costed and reported by the SM is inefficient, redundant, and grossly exceeds the capacity required to serve ITS' customers.[6]

But not only are the interoffice transport links engineered by the SM redundant, both links and tandem switching capacity engineered by the SM are excessive. The minimum interoffice capacity in the SM is OC-48. Thus, the 27 host/standalone switch rings that the SM engineers in ITS territories in Iowa can easily serve 8.6 million lines, or over thirty times the number of lines actually served by ITS. In addition, minimum common investment per SM tandem is

[5] A huge portion of interoffice transport cost derives from structure and cable costs that are proportional to route length.

[6] The OC-48 interoffice rings engineered by the SM can each serve at least 320,000 customer lines. Because ITS has so many small end offices, the SM engineers *eight* rings – capable of serving over 2.5 million lines – just to serve ITS' 150,000 modeled lines in LATA 632. Note, too, that the overlapping, redundant nature of these eight interoffice rings is in excess of the redundancy already guaranteed by the SM's requirement that even the smallest interoffice routes be served by a route-redundant SONET ring architecture. In addition to the more detailed traffic and network information noted above, before the SM could more accurately and efficiently model an interoffice network for ITS, it would also have to have input prices for transmission equipment with far smaller than OC-48 capacity that would be employed in rural environments.

$400,000 – and the minimum capacities of these tandems exceed by orders of magnitude the demands offered by ITS modeled lines in any LATA.[7] Efficient engineering practices would place only one tandem in each LATA to serve these three study areas' combined demands.[8]

4. In addition to the inefficiency with which the SM engineers or costs end office switching, interoffice transport and tandem switching for rural carriers, it has similar inefficiencies in its engineering and costing of loops, digital loop carrier systems and signaling systems.[9] Indeed, because of these recognized inefficiencies, the Commission generally has decided to use the SM only to establish relative, not absolute, levels of cost. But for the rural carriers, the SM is also likely inadequate to determine accurate relative cost levels. This is because the road-surrogate customer location methodology used by the SM systematically generates a greater overstatement of loop distances and costs in rural areas than it does in urban areas.[10]

Even if the SM were adjusted to produce accurate rural FLECs, ITS' ratemaking does not use them properly

The SM develops the FLEC for an efficient network architecture designed to provide a given basket of outputs (e.g., customer lines, switching minutes, direct transport trunks/minutes, common transport minutes, tandem switching minutes, etc.). But rather than using the FLECs generated by the SM to calculate its proposed access rates, ITS takes *rates* from the SM's output sheets and applies them against its embedded profile of outputs and alleges that the result is ITS' forward-looking economic cost. Nothing could be more inconsistent and, as a matter of economic index theory, be guaranteed to result in an overstatement of ITS' calculated access "costs." An example will best illustrate. A case of 144 apples costs $14.40 or 10¢ an apple. By the dozen, apples cost $1.80 or 15¢ an apple. A case of 144 oranges costs $28.20 or 20¢ an orange. But by the dozen, oranges cost $3.60 or 30¢ an orange. Suppose that for proper nutrition, your model says that you should consume a case of apples and a dozen oranges (which totals $18.00) per day. Now suppose a person comes along who wants to consume a dozen apples and a case of oranges per day. Two problems arise. The first is that this person's consumption is not what your model says constitutes proper nutrition – but even if it was, the correct cost of this bundle is $30.00 (= $1.80 + $28.20). It is certainly not the cost generated by applying the per case price of apples to a dozen, and the per dozen price of oranges to a case, which gives $44.40. But this is

[7] Indeed, the number of *trunks* that each of these tandems can handle rivals the number of customer *lines* subtending them.

[8] Indeed, it is usually inefficient to have any tandems dedicated to a single rural study carrier's use. Rather, it is more efficient (and standard actual practice) to have small rural carriers make use of the larger, more efficient tandems employed by neighboring nonrural carriers.

[9] *See*, *Ex Parte* letter from Richard N. Clarke, AT&T to Magalie Roman Salas, FCC in CC Dkt. Nos. 96-45 and 97-160, dated February 28, 2000.

[10] *See*, *Ex Parte* letter from Michael R. Lieberman, AT&T to Magalie Roman Salas, FCC in CC Dkt. Nos. 96-45 and 97-160, dated September 27, 2000.

exactly what ITS has done – used unit costs from a model predicated on an efficient basket of outputs, and applied these unit costs to its inefficient (or merely different) basket of outputs. Economic index theory shows that the second calculation must, of mathematical logic, exceed the efficient costs of producing this different basket of outputs.

More particularly, ITS' most fundamental ratemaking errors are as follows:

1. The SM, using forward-looking principles and input costs, determines the forward-looking network architecture that is most economic to serve assumed demands. The SM engineers its transport network to carry 80% of all access traffic on direct trunks and only 20% to be routed on common transport via a tandem switch. Thus, because most minutes travel over direct trunks, the SM's calculated unit cost of direct trunked minutes is relatively small. And because only a few minutes are carried over high minimum scale tandem facilities, the SM's calculated unit costs of tandem minutes is large.

   But rather than taking the overall transport network cost from the SM and developing its rates from this figure, ITS extracts the cheap direct trunk rate and the expensive tandem trunk rate from the SM *and applies these rates to its embedded numbers of direct trunk and tandem minutes.* Thus because ITS has, on an embedded basis, only about 40% of its minutes direct trunked and 60% tandem trunked, it applies the SM's cheap direct trunked rate to only half the percentage of minutes that it should, and applies the SM's expensive tandem rate to three times the percentage of minutes that it should. The result of this faulty ratemaking process is, of course, a vast overstatement of ITS' claimed access transport "costs."

2. But ITS' ratemaking errors are even larger. ITS runs the SM assuming the traffic demands that existed six years ago in 1996. Because the maximum traffic capacity of the switches and interoffice facilities engineered by the SM so exceeds either ITS' 1996 demand or its 2002 demand, the total costs calculated by the SM for either demand set will be roughly the same. But instead of developing unit costs from these total costs based on its 2002 demand, ITS uses the unit costs developed from 1996-level demand *but applies these unit costs to its far higher 2002 demand.*

   The effect of this faulty ratemaking process is dramatic. GTE last filed ARMIS reports on these study areas in 1999. *See* Exhibit 5. Between 1996 and 1999, their Iowa DEMs increased at a compound annual rate of 14.2%. Thus, projected to 2002, DEMs should have increased by 122% since 1996. Therefore, even if net switch investments had remained static (and in actuality, they declined), a rate based on 1996 DEMs would overstate the 2002 per DEM rate by 122%. During the 1980s, large controversies ensued between LECs and IXCs over whether there was a couple of percent understatement in forecasted access demand for ratemaking purposes. Here, ITS proposes to make an access rate based on "demand" that appears to be understated by more than *half.*

3. In addition to the above errors in accepted ratemaking practice, ITS also appears to have made substantial errors in its conversion of SM rates into its particular structure of rates per minute or per trunk-mile, and rates for terminations versus usage, etc.

If ITS is serious about proposing use of the SM for calculation of its access costs, it must propose that the Commission:

- Open a general rulemaking to consider and adopt the changes needed to the SM to calculate accurately absolute levels of UNE/access costs for rural carriers and to determine the tariff structure changes that are necessary to be consistent with reported SM output data;

- Have all rural LECs provide the Commission and intervenors with comprehensive, up-to-date data on their customer locations, line counts and types, engineering practices, input costs, traffic patterns, operating and overhead expenses and miscellaneous other information.

- Determine how costs and rates developed under this FLEC/SM methodology will be revised and regularly updated to ensure that they stay consistent with forward-looking practices.

If ITS and the Commission wish to follow this path, AT&T will be an active participant in such an investigation and proceeding. But in the meantime, there is no economic, cost analytic or standard ratemaking foundation for the access rates that ITS has proposed in its waiver petition. For these reasons, in addition to the legal procedural reasons outlined earlier, this petition should be denied.

Please contact me if you have any questions.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Richard N. Clarke/ha

Richard N. Clarke

Attachments: Exhibits 1-4 (Powerpoint)
Exhibit 5 (Excel)
Illinois Commerce Commission Order (PDF)

cc: Aaron Goldschmidt
Jay Atkinson
Noel Uri
Paul Zimmerman

Exhibit 1

ITS 1

LATA 632

Exhibit 2

ITS 2

LATA 632

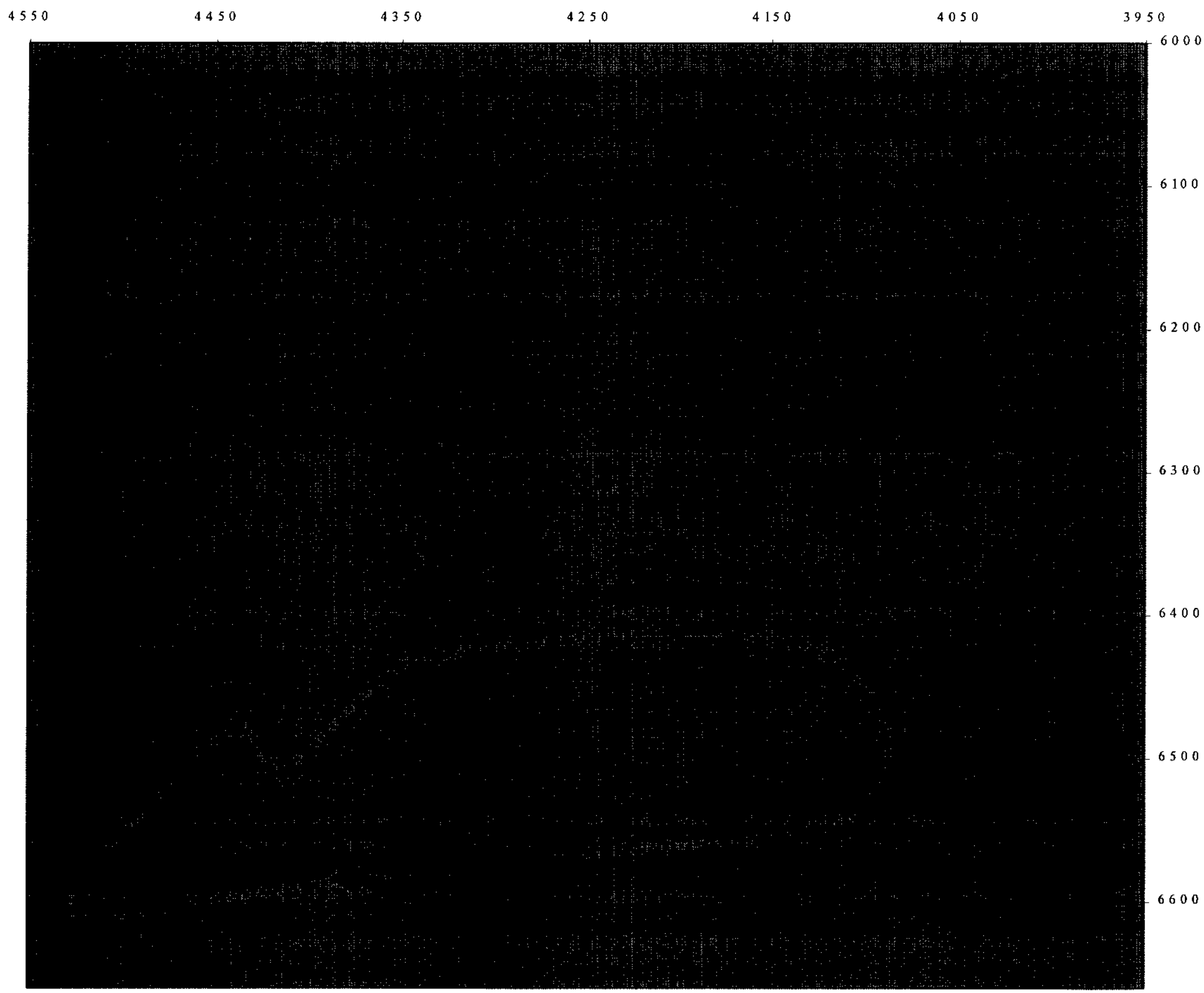

Exhibit 3

ITS 3

LATA 632

Exhibit 4

Total ITS

LATA 632

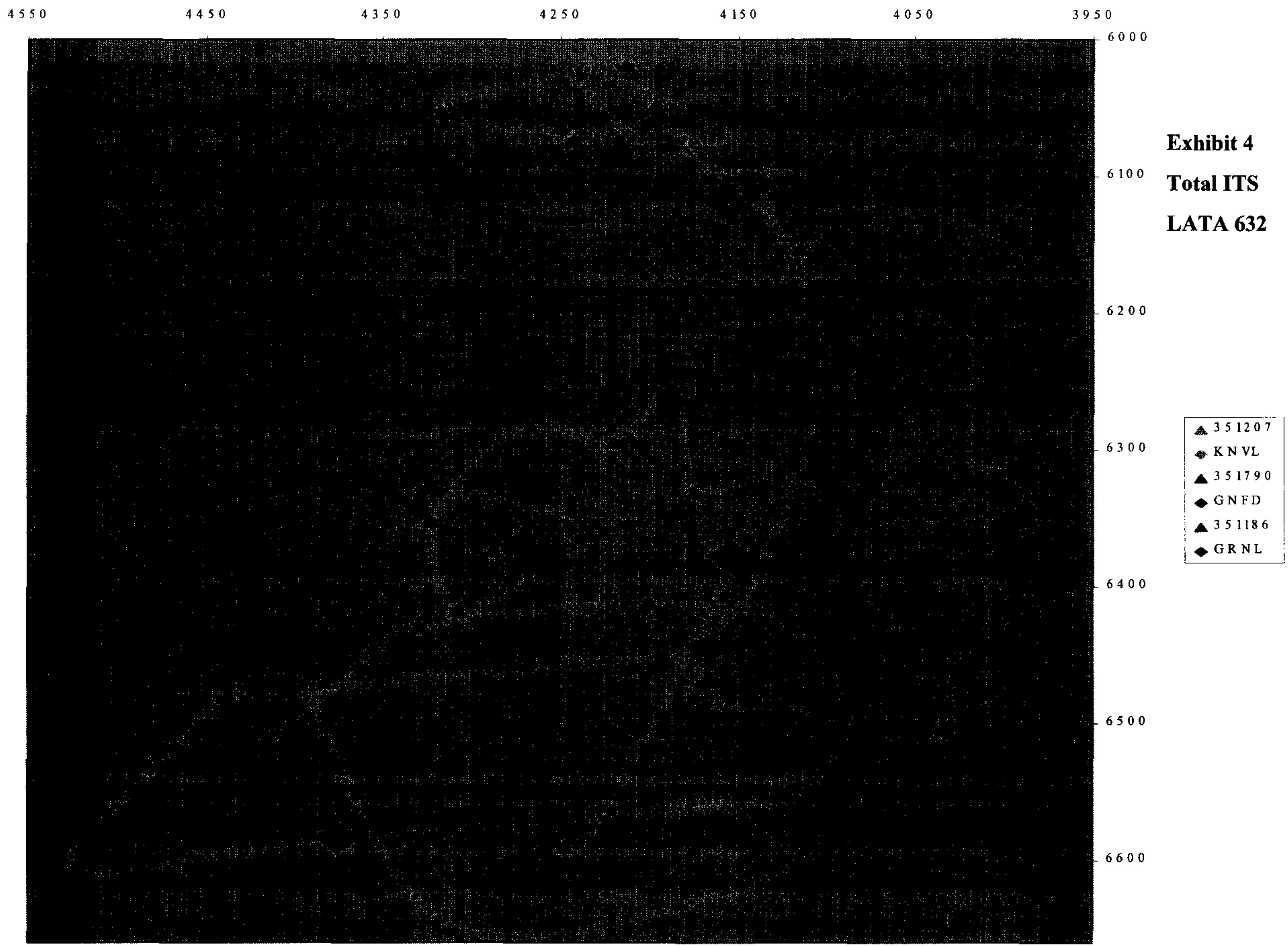

Exhibit 5

Former GTE-Iowa Minutes Growth and Switch Investment Trends

GTE and Contel of Iowa	1996	1997	1998	1999	Compound Annual Growth (1996 to 1999)	Estimated Overall Growth (1996 to 2002)
Total DEM (Millions)	1,475	1,617	1,882	2,136	13.1%	110%
Total CO Switch Gross Plant ($M)	68,883	68,513	70,927	71,868	1.4%	9%
Est Total CO Switch Net Plant ($M)	39,826	37,946	38,398	37,224	-2.2%	-13%
Net Switch Investment per DEM	$0.0270	$0.0235	$0.0204	$0.0174	-13.6%	-58%
Contel of Kansas Inc - Iowa						
Total DEM (Millions)	938	1,122	1,261	1,542	18.0%	170%
Total CO Switch Gross Plant ($M)	24,946	25,872	26,788	27,427	3.2%	21%
Est Total CO Switch Net Plant ($M)	14,423	14,329	14,502	14,206	-0.5%	-3%
Net Switch Investment per DEM	$0.0154	$0.0128	$0.0115	$0.0092	-15.7%	-64%
Contel of Iowa DBA GTE - Iowa						
Total DEM (Millions)	1,060	1,190	1,314	1,496	12.2%	99%
Total CO Switch Gross Plant ($M)	46,846	48,177	47,085	49,479	1.8%	12%
Est Total CO Switch Net Plant ($M)	27,085	26,683	25,490	25,627	-1.8%	-10%
Net Switch Investment per DEM	$0.0256	$0.0224	$0.0194	$0.0171	-12.5%	-55%
All 3 GTE - Iowa Study Areas						
Total DEM (Millions)	3,473	3,929	4,457	5,174	14.2%	122%
Total CO Switch Gross Plant ($M)	140,675	142,562	144,800	148,774	1.9%	12%
Est Total CO Switch Net Plant ($M)	81,334	78,959	78,390	77,057	-1.8%	-10%
Net Switch Investment per DEM	$0.0234	$0.0201	$0.0176	$0.0149	-14.0%	-60%
Total GTE - Nationwide						
Total DEM (Millions)	278,822,000	310,488,000	337,145,000	370,038,000	9.9%	76%
Total CO Switch Gross Plant ($M)	8,719,082	8,966,038	9,046,393	9,117,936	1.5%	9%
CO Switch Depreciation Reserve	3,677,977	4,000,125	4,148,972	4,395,348	6.1%	43%
CO Switch Reserve Ratio	42%	45%	46%	48%	4.5%	31%
Est Total CO Switch Net Plant ($M)	5,041,105	4,965,913	4,897,421	4,722,588	-2.2%	-12%
Net Switch Investment per DEM	$0.0181	$0.0160	$0.0145	$0.0128	-29.4%	-88%

Source: Study area-specific data from ARMIS 43-03 and 43-08, total GTE-nationwide data from ARMIS 43-02 and 43-08

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Independent Telephone Association	:	
	:	
Petition for initiation of an investigation of the necessity of and the establishment of a Universal Service Support Fund in accordance with Section 13-301(d) of the Public Utilities Act.	:	00-0233
		(Consolidated)
	:	
Illinois Commerce Commission On Its Own Motion	:	00-0335
	:	
Investigation into the necessity of and, if appropriate, the establishment of a Universal Support Fund pursuant to Section 13-301(d) of the Public Utilities Act.	:	

<u>SECOND INTERIM ORDER</u>

DATED: September 18, 2001

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STATE OF ILLINOIS

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SECOND INTERIM ORDER

By the Commission:

I. INTRODUCTION

On March 16, 2000, Docket No. 00-0233 was initiated with the filing by the Illinois Independent Telephone Association ("IITA") of a Petition seeking the initiation of an investigation of the necessity of and the establishment of a Universal Service Support Fund in accordance with § 13-301(d) of the Illinois Public Utilities Act ("IPUA"). Subsequently, the Illinois Commerce Commission ("Commission") entered an order on March 29, 2000 in Phase 2 of Docket Nos. 97-0601/97-0602/97-0516 (Consolidated) that, among other things, deferred all universal service issues that had been raised in that case to a new proceeding through which the Commission contemplated that it would conduct a comprehensive investigation pursuant to Section 13-301(d) of the IPUA. That investigation was initiated in Docket No. 00-0335 pursuant to a Commission Order entered on May 10, 2000. The Commission's May 10, 2000 Order directed that Docket Nos. 00-0335 and 00-0233 be consolidated. Pursuant to the request of certain parties and with the concurrence of the Hearing Examiner, it was determined that the proceedings in consolidated dockets 00-0233/00-0335 would be addressed in separate phases.

In Phase 1 of these proceedings, the IITA and various parties agreed that an "interim universal service fund" should be established for the small local exchange carriers that had received funding from the temporary Dial Equipment Minute Weighting Fund ("DEM Weighting Fund") and the existing state High Cost Fund ("HCF"). The IITA and various parties agreed that the level of the interim fund would be equal to the combined level of the DEM Weighting Fund and the HCF, which was $13,385,264. The IITA contended the interim fund should remain in place pending an in-depth analysis of the need for a 13-301(d) fund in Phase 2 of these proceedings. The Commission on November 21, 2000 rejected the stipulation between the IITA and the parties concerning the interim fund that was the subject of Phase 1 of these proceedings, and reduced the fund amount to $12,669,196, which was consistent with the prior stipulation for the DEM Weighting fund.

The November 2000 USF Order also reopened Docket 98-0679 and required the parties to that Docket to enter into a stipulation that would extend the DEM weighting fund pending the outcome of the full 13-301(d) universal service inquiry in Phase 2 of this proceeding. The Commission decreed that the extension of the temporary DEM Weighting fund will be effective until September 30, 2001 or upon the completion of the full-blown 13-301(d) investigation, whichever occurs first. In response to motions to amend and clarify its November 2000 USF Order, the Commission on December 19, 2000, rejected requests by Verizon and Ameritech to modify the November 2000 USF to determine the "permanent funding methodology" for purposes of truing-up payments made by carriers into the temporary DEM Weighting Funds. The Commission declined to do so leaving the issues of the determination of a permanent funding methodology and true-ups of past payments into DEM Weighting Funds to be resolved in Phase 2 of this proceeding.

Hearings in Phase 2 of these proceedings were convened on June 19 through June 21, 2001. Parties participating in the hearings included: Staff of the Illinois Commerce Commission ("Staff"); the Illinois Independent Telephone Association ("IITA"); Illinois Bell Telephone Company ("IBT); AT&T; MCI WorldCom ("MCI"); Verizon Communications ("Verizon"); the Frontier Companies ("Frontier"); Moultrie Independent Telephone Company ("Moultrie"); and a number of individual small Telcos that became disenchanted with some positions taken by the IITA ("Interveners").

II. SECTION 13-301(D)

Section 13-301(d) states, in relevant part:

> Section 13-301. Consistent with the findings and policy established in paragraph (a) of Section 13-102 and paragraph (a) of Section 13-103,

and in order to ensure the attainment of such policies, the Commission shall:

> (d) investigate the necessity of and, if appropriate, establish a universal service support fund from which local exchange telecommunications carriers who pursuant to the Twenty-Seventh Interim Order of the Commission in Docket No. 83-0142 or the orders of the Commission in Docket No. 97-0621 and Docket No. 98-0679 received funding and whose economic costs of providing services for which universal service support may be made available exceed the affordable rate established by the Commission for such services may be eligible to receive support, less any federal universal service support received for the same or similar costs of providing the supported services; provided, however, that if a universal service support fund is established, the Commission shall require that all costs of the fund be recovered from all local exchange and interexchange telecommunications carriers certificated in Illinois on a competitively neutral and nondiscriminatory basis. In establishing any such universal service support fund, the Commission shall, in addition to the determination of costs for supported services, consider and make findings pursuant to paragraphs (1), (2), and (4) of item (e) of this Section. Proxy cost, as determined by the Commission, may be used for this purpose. In determining cost recovery for any universal service support fund, the Commission shall not permit recovery of such costs from another certificated carrier for any service purchased and used solely as an input to a service provided to such certificated carrier's retail customers . . . .

Pursuant to the legislative prerogative, the Commission must first determine the necessity of establishing a universal service fund ("USF"). If such a fund is deemed necessary, the Commission must also determine the size of the fund, which carriers will be eligible to draw from the fund, and a competitively neutral funding method to sustain the fund. In addition, once it has determined the appropriate competitively neutral funding mechanism for the 13-301(d) fund, the Commission must decide whether that same permanent funding mechanism should be used for the purpose of "truing-up" past payments made into DEM Weighting Funds between and among certain carriers who supported those funds.

The parties to this proceeding were able to reach agreement on a number of issues. First, there appears to be consensus that some amount of universal service funding is appropriate under 13-301(d). There also appears to be consensus that the permanent funding methodology by which carriers' contributions to the universal service fund, whatever the size of that fund may be, should be based on each local exchange carriers' and each interexchange carriers' total intrastate retail revenues.

The majority of the debate within this proceeding has focused on what the size of the fund should be, how to set the "affordable rate," and how to determine carrier eligibility to draw from the fund. In addition, there is disagreement over the obligations of carriers to "true-up" payments made into the DEM Weighting Fund based on the competitively neutral permanent funding methodology the Commission adopts in this proceeding.

III. CONTESTED ISSUES

As noted above, the parties were unable to reach consensus on all issues. The contested issues include: (1) what services constitute those eligible for support; (2) whether Section 13-301(d) contemplates the use of forward-looking costs or embedded costs in establishing the "economic costs of providing services for which universal support may be made available;" (3) whether, in the event a forward-looking cost model is used, any adjustment to the inputs of the model are necessary; (4) whether and how company specific rate of return results should be used in judging the necessity of providing universal service funding to requesting companies; (5) the affordable rate to be used in determining the size or eligibility for USF funds; and (6) whether any USF fund established should be considered the final funding methodology for purposes of triggering the "true up" requirements of previous stipulations and agreements reached by the parties to this docket. In addition, there are a minor number of miscellaneous and company-specific accounting issues that must be decided.

A. Services Eligible for Support

The parties reached general agreement that the services eligible for support should be those previously identified by the FCC including:

1. Voice grade access to the public switched network
2. Local usage
3. Dual tone multi-frequency signaling or its equivalent
4. Single-party service or its functional equivalent
5. Access to emergency services
6. Access to operator services
7. Access to interexchange service
8. Access to directory assistance
9. Toll control services for qualifying low-income consumers

AT&T, Ameritech, Verizon and MCI WorldCom suggest that support only be provided to certain access lines, such as the primary residence line and single line businesses. MCI/WorldCom's position is that the Commission should specifically find "that any state universal service fund should support service only over primary access lines, including some amount of local usage provided over those lines." MCI Brief at 5. AT&T takes the position that it would not object to the inclusion of all access lines so long as the changes recommended by its witness, Dr. Clarke, are made to the inputs to the HAI cost model.

Ameritech Illinois recommends that support be limited to a primary residence and a single business line. It believes that any high cost subsidization should be limited to ensuring that all customers have access to basic services. (Ameritech Illinois Reply Brief at 9.) Further, it contends, if high cost funding is permitted for discretionary services (e.g. second residential lines), other carrier's customers and customers in other areas of the state would subsidize these discretionary services. An inner city customer who can barely afford basic service should not be required to subsidize second lines and other discretionary services for customers in rural areas who are much better off financially. (*Id.* at 9.)

Staff and the IITA recommend support for all access lines. In addition, at one point Verizon recommended that the Commission consider the *de minimus* cost of white pages insertion as a supported service, while IITA suggested in testimony that the Commission consider the provisioning of advanced services, in light of recently enacted legislation. Neither party argues these issues on brief, from which the Commission concludes that the positions have been abandoned.

1. Commission Conclusion

The Commission concludes that the list of Illinois-supported services should be the same as the list of FCC-supported services. Section 13-301(e)(1) (which is made applicable to any inquiry under Section 13-301(d)) provides that the FCC list shall be the minimum list, and no party has adduced any convincing evidence that any services should be added. With respect to the element of the "voice grade access to the network," the Commission finds that it shall be limited to a primary residence line and a single business line. The basis for this conclusion is that discretionary services should not be supported by the Section 13-301(d) fund. As Ameritech Illinois appropriately argues, to do otherwise might create the unintended result of low-income end user customers in one area of the state subsidizing discretionary services of high-income end user customers in another area of the state whose service is supported by the fund.

In response to the IITA and Staff arguments of limiting the fund to primary residence line and single business line, no party has adequately demonstrated that it would be administratively burdensome to limit the supported services to the primary residence line and single business line. Merely because it is possible that end user customers would falsely identify additional lines as being "primary residence" lines is not reason enough to justify subsidization of discretionary services by other customers.

B. Costing Methodologies

Section 13-301(d) contemplates the establishment of a Universal Service Fund for the small companies if their economic costs of providing services for which universal service funds may be made available exceed the affordable rate established by the Commission for such services less any federal universal service support received for the costs of providing such services. The statute specifically authorizes the use of cost proxies found by the Commission to be appropriate.

While the Act does not define "economic costs" as used in § 13-301(d), the IITA assumed, based on the discussion of cost issues before the Commission in a variety of dockets over the past several years, that most parties would assert that "economic costs" should be interpreted as "forward-looking costs." As discussed in greater detail subsequently, the IITA developed and submitted into evidence an estimate of the forward-looking costs of the 50 small companies using the HAI Model 5.0a. The estimated forward-looking costs submitted were for the FCC's defined set of services constituting universal service, the minimum set of services allowed by the Illinois Act. All parties but the Interveners agreed to the use of forward-looking costs.

1. Intervener's Position

Interveners note that the Commission is a creature of the legislature deriving its power and authority solely from the statute and any of its acts or orders that are beyond the purview of the statute are void. *E.g*, Illinois *Power Co. v. ILCC*, 111 Ill.2d 505, 490 N.E.2d 1255 (1986). The term "economic costs" is not defined in the Public Utilities Act ("Act") and the term "costs" is used in a later sentence in the same context. "Economic costs" and "costs" are used interchangeably. No Illinois court case has defined "economic costs" under the Act but it undoubtedly, according to Interveners, along with "costs," means historical costs. The Staff and some parties labor under the misguided interpretation that the term "economic costs" or "costs" in 13-301(d) compels the use of future-looking costs such as the HAI 5.0a model (hereafter "HAI"). (Staff Ex.1 at4; T.798-802 [Hoagg]; T.705 [Koch]; IITA Ex. 2 at12-13, 16 [Schoonmaker]; Ameritech Ex. 2 at4-5 [O'Brien]). Although well meaning, these parties have misconstrued the statute and have read into it terms and conditions that are plainly not there. This interpretation is contrary to the fundamental principles of statutory construction.

The primary rule of statutory construction is to follow the legislative intent. *E.g.*, *Denton v. Civil Service Commission*, 176 Ill.2d 144, 148, 697 N.E.2d 1234 (1997). There is nothing in the context of the use of "costs" or "economic costs" in 13-301(d) to indicate a legislative intent to require the Commission to use some future-looking cost model. Instead, the legislature intended for the Commission to use only historical costs.

13-301(a) specifically embraces the legislative findings in 13-102 (a) and expression of policy in 13-103(a). 13-102(a) makes the following findings:

With respect to telecommunications services, as herein defined, the General Assembly finds that:

(a) Universally available and widely affordable telecommunications services are essential to the health, welfare and prosperity of all Illinois citizens.

13-103(a) sets forth the State policy as follows:

Consistent with the findings, the General Assembly declares that it is the policy of the State of Illinois that:

(a) 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. (Emphasis added.)

In interpreting 13-301(d), the Commission should keep in mind the legislative policy and consider the reason and necessity for the law, the evil to be remedied, and the object to be obtained by the statute. *Collins v. Board of Trustees,* 155 Ill.2d 103, 610 N.E.2d 1250 (1993). The main purpose of universal service is to provide support to rural telecommunications carriers so that they can provide service to rural customers that would otherwise be cost prohibitive. Providing services economically under 13-103(a) does not indicate forward looking. Nothing in the policy of the legislature in 13-103(a) suggests that "economic costs" or "costs" means hypothetical future or "forward-looking" costs.

The legislature has used the term "economic costs" in an undefined manner on 2 other occasions, *i.e.*, 410 ILCS 325/2 ([i]ncidents of sexually transmittable diseases is rising at an alarming rate and that these diseases result in significant social, health and economic costs . . .); 415 ILCS 5/22.32 (the hospital shall consider the quantity of waste, the hazardous properties of the waste, the safety of its patients and employees, economic costs and savings . . .). Neither instance indicates forward-looking costs.

Forward-looking cost models like HAI 5.0a incorporate the principles of long-run service incremental costs or LRSIC (T.194-195 Clarke) IITA Ex. 1, Attach 2, model description manual, Intro 1.1 states, "The HAI Model Release 5.0a has been developed by HAI Consulting, Inc. . . . for the purpose of estimating the forward-looking economic costs of: (a) basic local telephone service . . . . All three sets of costs are calculated based on Total Service Long Run Incremental Costs ("TSLRIC") principles . . . ."

If the legislature meant for the term, "costs" or "economic costs" to mean forward-looking long run service incremental costs, as some parties suggest, the legislature certainly knew how to clearly express that meaning because the legislature has unequivocally stated that in 4 other sections of the Act. (See 220 ILCS 5/13-502 (c); 5/13-505.1(a); 5/13-505.7; and 5/13-507) The only reasonable interpretation, then, of "costs" and "economic costs" is historical costs or 13-301(d) would have specifically stated, "long-run service incremental costs" as the legislature has on other occasions in the Act.

A statute has to be construed as a whole. *E.g., Harris v. Manor Health Care Corp.*, 111 Ill.2d 350, 489 N.E.2d 1374 (1986). "Economic costs" is also used in 13-301(e)(3), which states: "Identify the incumbent local exchange carrier's economic costs of providing the supported telecommunications services." (Emphasis added.) The present tense "providing" in both 13-301(d) and (e) is indicative of historical costs; otherwise, to express a future intent the legislature would have stated, "economic costs to provide the supported telecommunications services."

A portion of 13-301 that is not applicable here, subpart (e), states:

> No funds shall be created pursuant to this item until existing implicit subsidies, including, but not limited to, those subsidies contained in interexchange access charges, have been identified and eliminated through revisions to rates or charges. (Emphasis added.)

Although subpart (e) is not the pending subject matter before the Commission, the word "existing," when viewed, in conjunction with the interchangeable use of the term "costs," the ability to clearly express, but the absence of, the term "long-run incremental costs," indicates a firm and consistent intent of the legislature to measure the telecommunications carrier's existing, *i.e.,* historical costs, not future long-run costs. In addition, all rural carriers (except cooperatives) are subject to ROR regulation under the Act (220 ILCS 5/13-504) and ROR is based on historical costs. It is only logical, then, that the legislature intended to provide universal service support to rural telephone companies in a way consistent with other portions of the Act applicable to rural telephone companies, *i.e.* historical costs.

When a statutory term like "economic costs" or "costs" is undefined, that term must be given its ordinary and properly understood meaning. *E.g.,* Union *Electric Co. v. Dept. of Revenue*, 136 Ill.2d 385, 397, 556, N.E.2d 236 (1990). *Armour Pharmaceutical Co. v. Dept. of Revenue*, 321 Ill.App.3d 662, 748 N.E.2d 265 (2001). While the term "economic costs" is not defined in the dictionary, the use given to the term by several witnesses in this proceeding illustrates that "economic costs" does not mean forward-looking costs because they often use "forward-looking" to modify "economic costs." In other words, if "economic costs" meant forward-looking costs, common usage would not require a redundant explanation. Yet, several witnesses when referring to "economic costs" interject "forward-looking" before or after the term "economic costs." For example, Hoagg, Staff Ex. 1 at 4, L.82, at 6, L.123, at 7, L.140, at 628, L.18, at 690, L.20, at 705, L.1, at 718, L.21-22, at 799, L.4; Clarke, AT&T Ex. 4, L.7 at 6, L.16 at 7, L.10 at 7, L.15, AT&T Ex. 6 at 2, L. 15-16, at 10, L.10; O'Brien, Ameritech Ex. 2 at 4, L.23; Sands, MCI Ex. 1 at 5 and at12.

Webster's defines "economic" as, "relating to or concerned with economics; financially sound, reasonably profitable; useful in the production of wealth or promotion of commercial prosperity. . . . " "Cost" is defined as, "The price paid or to be paid for something." Nothing in these definitions indicates a future or forward-looking cost model. The ordinary meaning, then of "economic costs" or "costs" is clearly historic costs rather than forward-looking costs.

A recent decision, *Commonwealth Edison v. Ill.Comm.Comm.*, 2-00-0375, June 6, 2001 lends support to the historic or embedded cost approach. Under the single billing option of 5/16-118(b), Commonwealth Edison filed a tariff proposing a credit of 20¢ per month for each customer through the use of an "avoided cost" methodology, which was arrived at using an average cost per customer. This Commission rejected that approach and instead adopted an "embedded cost" methodology. The "embedded cost" methodology gave the customer a 55¢ credit.

Commonwealth Edison argued on appeal that the "embedded cost" methodology violated 5/16-108(c) of the Act, which required that the single billing option to be "cost based." The Act does not define, "cost based." The court reasoned that its meaning was not plain on its face so the court upheld the Commission's interpretation. In the present case, the Commission should also interpret "economic cost" or "costs," as "embedded costs" just as it did in interpreting "cost based" in *Commonwealth*. Any other interpretation of "cost" or "economic cost" would be incompatible with the *Commonwealth* decision.

It is not reasonable to interpret "costs" or "economic costs" as forward-looking costs, but a statute capable of two interpretations should be given that which is reasonable and which will not produce absurd, unjust, unreasonable or inconvenient results that the legislature could not have intended. *Collins v. Board of Trustees Firemen's Annuity*, 155 Ill.^{2d} 103, 610 N.E.^{2d} 1250 (1993). The FCC has determined that it is impossible for forward-looking cost models to determine rural carriers' costs at this time (See Argument IB), so surely the legislature did not intend an impossible meaning of "costs" or "economic costs." Interpreting "economic costs" as forward-looking costs would lead to absurd results. Forward-looking cost models such as the HAI grossly misstate carriers' costs under 13-301(d) and are, therefore, contrary to the explicit legislative policy in 13-103(a). An interpretation of "costs" or "economic costs" as forward-looking costs would unduly restrict the Commission in fashioning a universal service fund in Illinois because it would preclude the use of real world considerations. (Staff Ex. 2 at 19); (IITA Ex. 2 at 31) (See Argument IV).

13-301(d) allows the use of proxy cost. A proxy is an agent or substitute. The rate of return (hereafter "ROR") is a reasonable proxy of costs in lieu of individual carrier cost studies. While ROR may not identify costs like a cost study, it comes very close. Ameritech recommends ROR for support (Ameritech Ex. 2.1 at 2-3) and so does IITA (IITA Ex. 2.0 at 47-50). Staff originally relied upon ROR for support purposes with the exception of the use of HAI for carriers whose HAI results were less than ROR (Staff Exs. 1 & 2). On the last day of the hearings, Staff modified its recommendation to propose that all carriers should receive 100% of their first year ROR revenue requirement, and at the end of that year, if HAI results were less than ROR, the carrier's support could be reduced by one-fifth each year over five years if all other circumstances remained the same (T.837-841, 857-858 Hoagg). AT&T clings to the HAI approach (AT&T Ex. 4) but curiously, AT&T does not recommend using HAI for its intended purpose, *i.e.*, establishing carriers' future costs and the amount of support needed.

The only reasonable construction, then, of 13-301(d) is that "costs" or "economic costs" means historic costs. Historic costs can be based on either ROR results or a carrier's FCC cost study results. Any other construction of 13-301(d) is patently unreasonable and contrary to the manifest intent of the legislature. 13-301(d) does not authorize the Commission to use HAI for universal service (See, *GTE MTO v. Ill.Comm.Comm.*, 166 Ill.App.3d 916, 521 N.E.2d 584 (1988)) but even if it did, the FCC has preempted the use of forward-looking cost models for universal service for the time being.

On May 23, 2001, the Federal Communications Commission ("FCC") entered an order in C.C. No. 96-45, 21st order on rehearing in docket No. 00-256 (hereinafter "FCC Decision") and found that forward-looking cost models simply are not reliable or useful for rural telephone companies. The FCC rejected the use of forward-looking cost models at the present time and proclaimed that historical or embedded costs will be used over the next five years for federal universal support purposes for rural carriers. The FCC stated at paragraph 177 as follows:

> Although we conclude that the Rural Task Force's analysis has not demonstrated that a forward-looking mechanism could never appropriately be used to estimate rural costs, we do not have sufficient information to do so at this time. Even those commentators who urge the Commission to move to forward-looking cost for rural carriers recognize that the Commission would need additional time to develop suitable rural input values. Because the Commission has not developed rural inputs and it is not possible to determine forward-looking costs for rural carriers at this time, we find that rural carriers should continue to receive support based upon their embedded costs while the five-year plan adopted in this Order is in place. (Emphasis added.)

While the FCC has worked on the Synthesis forward-looking cost model, AT&T witness Clarke described the FCC's Synthesis model as closely comparable and incorporating the same data as HAI (AT&T Ex. 4 at 5-6, 8, 10; Staff Ex. 2 at 18) and IITA agrees (IITA Ex. 2 at 22). The FCC was very much aware of the HAI by Dr. Clarke's active participation in the federal universal service docket (AT&T Ex. 4 at 3). Dr. Clarke stated that in collaboration with the FCC, the Synthesis model incorporated HAI's switching and interoffice module (Ex. 4 at 5-7) and he also emphasized that the validity of HAI has generally been affirmed by the collection of expense factors that has been adopted by the FCC for the Synthesis model (AT&T Ex. 4 at 10-11).

47 USC §254(f) restricts state authority on universal service as follows:

> A State may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service. * * * A state may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific, predictable, and sufficient mechanisms to support such definitions or standards that do not rely on or burden Federal universal service support mechanisms. (Emphasis added.)

In other words, Congress has preempted the field and Illinois cannot adopt a procedure for IUSF that is inconsistent with the FCC's rules, but Illinois may adopt rules that expand universal service but not restrict it. The preemption doctrine provides that federal law overrides state laws on the same subject. Absent explicit preemptive language, the courts may infer Congress's intent to preempt the field where a federal regulation is so pervasive that it is reasonable to infer that Congress left no room for the states to supplement it or where a federal statute touches on a subject that no federal system will be assumed to preclude the enforcement of state laws on the same subject. *Funeral Financial Systems v. Metropolitan Life Ins, 2001 WL 747595 (June 29 2001).* Even when Congress has not completely displaced state regulation of a specific subject or object, state law is nullified to the extent that it actually conflicts with federal law. Actual conflict arises when state law or state regulations interfere with the accomplishment and execution of the purposes and objectives of Congress. (*Funeral Financial*).

It would be inconsistent with §254(f) and the FCC's rules for the Illinois Commerce Commission to utilize a forward-looking cost model. The FCC's rules for universal service require using historical costs so Illinois is preempted for using forward-looking cost mechanisms.

2. Parties Replies

The parties supporting the use of forward-looking costs responded to the Interveners' arguments. In terms of preemption, they note that, as an initial matter, there is nothing in the FCC's Fourteenth Order that disavows the use of forward-looking cost models to determine interstate universal service needs. The FCC made clear that the use of a modified embedded cost mechanism for interstate universal service funding purposes is temporary and designed to allow transition of rural carriers to a forward-looking high-cost support mechanism. Before the FCC can implement such a transition, it needs time to fully analyze and consider long-term solutions. In the meantime, the FCC has adopted as a temporary fix the Rural Task Force plan consisting of a modified embedded cost mechanism. (FCC's Fourteenth Order, para. 25). Thus, Interveners read much more into the FCC's Fourteenth Order than what it actually provides. Simply put, the FCC has not abandoned forward-looking cost models. (FCC's Fourteenth Order, para. 174).

Moreover, arguments that the ICC is preempted from utilizing a forward-looking mechanism for purposes of establishing a state universal service fund are wholly without merit. In the 1996 Act, Congress recognized that the implicit subsidies that previously supported universal service are not compatible with competition. *See, e.g.*, S. Rep. No. 104-230, at 25 (1995) ("S. Rep."). Implicit subsidies deter potential competitors from entering rural markets where rates are below cost, defeating Congress's intent to bring the benefits of competition to all Americans. Conversely, above-cost rates for business and urban customers create incentives for competitors to enter those markets and under price incumbents, eventually eroding the excess profits that subsidize other services.

Congress therefore adopted Section 254 of the 1996 Act, which creates express statutory authority for the FCC to advance universal service through procompetitive means. Section 254 does not oust the states from their primary role in supporting universal service. The 1996 Act envisions that "Federal and State mechanisms" shall together be "sufficient . . . to preserve and advance universal service." 47 U.S.C. §254(b)(5); *see* Conf. Rep. No. 104-458, at 128 (1996) ("Conf. Rep."). Accordingly, the 1996 Act preserves state authority to promote universal service. 47 U.S.C. §254(f). The 1996 Act also leaves intact the states' authority to regulate the retail rates that local telephone carriers charge to consumers for intrastate services. *See* 47 U.S.C. §152(b); *see also IUB*, 525 U.S. at 381 n.8.

In Section 254(b), Congress endorsed the traditional universal service policies of ensuring that quality services be "available at just, reasonable, and affordable rates," and that these rates be "reasonably comparable" in all areas of the country. 47 U.S.C. §254(b)(1), (3). Section 254 departs from traditional approaches to universal service, however, by requiring federal subsidy mechanisms to be compatible with a competitive marketplace. *See* S. Rep. at 25; *See Federal-State Joint Board on Universal Service*, Ninth Report and Order, 14 F.C.C.R. 20432, ¶17 (1999) ("Ninth Order"). Section 254 accordingly provides that any such subsidies must be "explicit." 47 U.S.C. §254(e). *See also* Conf. Rep. at 131. Further, all telecommunications carriers must share the funding burden by "mak[ing] equitable and nondiscriminatory contribution[s] to the preservation and advancement of universal service." 47 U.S.C. §254(b)(4); *see also id.* §254(d), (f).

Finally, Congress made clear that the "total of any contributions required [for universal service] shall be no more than that reasonably necessary to preserve and advance universal service." S. Rep. at 28. The consumers that pay for subsidies through their telephone bills should not pay more than what is strictly necessary to preserve universal service. Excessive exactions on subscribers would violate the principle that rates be "just, reasonable, and affordable." 47 U.S.C. §254(b)(1).

In short, nothing in the 1996 Act or the FCC's rules prohibits states from making determinations concerning intrastate universal service needs, including using forward-looking costs. The 1996 Act expressly preserves states' authority to make such determinations concerning state universal service matters. Contrary to the arguments of Interveners, the Commission is not preempted by the 1996 Act or the FCC from utilizing forward-looking costs. Indeed, if the Commission utilizes such costs it should do so consistent with the 1996 Act to ensure that the total of any contributions required for state universal service shall be no more than that reasonably necessary to preserve and advance universal service.

Finally, it would appear as though this is not the appropriate forum in which to assert that state law or the Commission is preempted. In particular, Section 253 of the 1996 Act states in pertinent part:

> If after notice and an opportunity for public comment, the [Federal Communications Commission] Commission determines that a State or local government has permitted or imposed any statute, regulation, or legal requirement that violates subsection (a) or (b), the Commission shall preempt the enforcement of such statute, regulation, or legal requirement to the extent necessary to correct such violation or inconsistency.

47 U.S.C. Section 253(d).

Because the 1996 Act requires the FCC to make the determination as to whether a given state statute or regulation should be preempted, the FCC is the appropriate entity for Interveners to request preemption. Absent a finding from the FCC that the ICC's use of forward-looking costs for state universal service purposes and Section 13-301(d) of the IPUA is preempted, the Commission is free to implement the Illinois universal service law in the manner it sees fit. In essence, Interveners have lodged their complaint in the wrong forum.

In terms of the Interveners' arguments concerning the proper interpretation of Section 13-301(d), the parties supporting the use of forward-looking costs note first that, Interveners did not oppose the use of forward-looking costs in phase one of these dockets, and did so only when the use of forward-looking costs impacted their bottom lines. From this the parties rely upon principals of estoppel to argue that this position should be rejected now. In addition, the parties argue that, because the term "economic costs" is undefined in the statute, the Commission is free to interpret the term in any reasonable manner and that past practice and policy at the Commission has recognized the advisability of costing telephone services on a forward-looking basis for a long period of time.

3. Commission Conclusion

The Commission has reviewed the statute and the arguments of the parties and concludes that the use of a forward-looking cost model is appropriate in setting the legislatively permitted proxy cost for services eligible for USF support. The term "economic cost" is undefined in the statute but its use is pervasive in Commission proceedings dealing with telephony where it has generally been recognized as involving forward-looking costs, as opposed to embedded costs. In terms of Federal Preemption, the Commission concludes that the FCC action, in rejecting the HAI model as part of its Synthesis Model, in no way precludes the use of the HAI model as a factor in determining costs in Illinois.

C. Adjustments to the HAI

The Commission's conclusion concerning the acceptability of forward-looking costs raises an ancillary issue concerning proposed adjustments to the cost study presented. The cost study, as presented, contains a number of default settings. Adjustments to the default settings were proposed by a number of parties.

1. IITA Adjustments

Robert C. Schoonmaker, a Vice President of GVNW Consulting, Inc., testified on behalf of the IITA and presented evidence concerning each of the §13-301(d) statutory criteria, including the HAI produced forward-looking cost estimates for the 50 small companies. Mr. Schoonmaker and his firm specialize in working with small telephone companies, and he is familiar with telephone networks deployed by small telephone companies in Illinois and elsewhere as well as the cost structures and operations of small rural companies. Mr. Schoonmaker was appointed by the FCC to, and served on, the Rural Task Force, which made recommendations to the FCC-State Joint Board on universal service issues for rural companies.

As Mr. Schoonmaker testified, he considered several forward-looking cost models prior to recommending the use of the HAI Model 5.0a (IITA Exhibit #2, pages 16-19). Using the default inputs the HAI model (whose development was sponsored by AT&T and MCI WorldCom) produced the lowest cost estimates of the models considered (IITA Exhibit #2, page 17).

While the IITA has used the HAI Model 5.0a to estimate the forward-looking costs for the 50 small companies, Mr. Schoonmaker has made clear his, and the IITA's, substantial reservations and concerns regarding the validity of estimated forward-looking costs developed by the Model, particularly when taken to an individual company level.

The HAI cost model was run for each of the 50 small companies with the 12 categories of default input changes recommended by Mr. Schoonmaker and as set forth on IITA Exhibit #2, Attachment 3. Certain of the default inputs were modified to reflect the operation of rural companies as compared to the large urban Bell Companies, whose operations are generally reflected in the default inputs. Other inputs were modified to reflect the specific circumstances in Illinois rural areas as compared to the wide variety of geographic conditions throughout the United States (IITA Exhibit 2, page 26). A total of twelve default inputs in the following categories were changed: (a) the distribution of aerial, buried and underground feeder, distribution and interoffice plant; (b) structure sharing; (c) switching investment; (d) cost of capital; (e) network operations expense; (f) local number portability cost; and (g) carrier-to-carrier billing costs.

Each of the default input changes recommended by Mr. Schoonmaker and used by the IITA were intended to better reflect the forward-looking costs of the 50 small Illinois companies. From the 12 categories of input changes recommended by Mr. Schoonmaker and used by the IITA, seven (7) produced increases in the amount of costs estimated, four (4) caused decreases in the costs estimated, and one (1) had no effect with the forward-looking costs being estimated. (IITA Exhibit #4, Attachment 1) The results of the default adjustments caused these components to increase from $61.01 to $91.67.

The IITA's HAI cost model universal service results for the 50 small companies were set forth on IITA Exhibit #2, Attachment 5 Revised. Using the 50 small companies' existing rates as the affordable rates and taking into account federal USF support the companies receive, the 50 companies collectively have an Illinois universal service eligibility of $73,479,482. While developed in accordance with the criteria contained in § 13-301(d), the IITA is neither recommending nor requesting that the Commission establish a universal service fund level based upon these forward-looking cost estimates.

2. AT&T/MCI Adjustments

MCI WorldCom disagrees with the input changes that IITA made to the HAI model based upon its opinion that the joint effect of the selective change in default inputs (a) provides an extremely high estimate of the forward-looking economic cost of the supported services, (b) inflates the required fund size, (c) raises the estimated costs of providing access services and (d) understates the size of the subsidies contained in access rates. In fact, according to MCI, the selective input changes render the forward-looking cost modeling exercise meaningless as a determinant of the IITA member support needs. MCI notes that the HAI results as proposed by Mr. Schoonmaker would purportedly show a universal service funding need of $73 million, which is regarded by IITA as "well beyond the needs of the small Illinois companies in total." (Schoonmaker March 23, 2001 Direct Testimony at 46). MCI concludes that, with the exception of the input change to reflect the absence of number portability costs, the default values contained in the HAI should have been used.

AT&T proposed five categories of input changes to the model. The first two of these input changes adjust distribution and feeder fill factors to more current levels. These changes, in effect, update the HAI model from version 5.0a to its most current version, 5.1. In the third input change fiber cable investment is updated to more current rates. AT&T's fourth input change makes the cost of debt, cost of capital, and debt ratio consistent with the values set for Ameritech Illinois in ICC Docket 96-0486/0569 (Consolidated). These changes result in a revised cost of money of 9.52%. AT&T's fifth proposal would recognize additional "entry details" to update depreciation lives to those prescribed by the ICC for Ameritech Illinois LRSIC studies.

3. Intervener Adjustments

Leaf River Telephone Company ("LRTC") submitted company specific HAI input changes (L.R. Ex. 1). LRTC proposed 9 changes, 8 of which involved the same inputs changes suggested by IITA but with LRTC information. These changes included buried vs. aerial plant, distribution and feeder cable, switching expense, cost of capital, corporate overhead factor, billing/bill inquiry expense, and carrier-to-carrier customer service billing expense.

Home Telephone Company also provided company specific HAI input changes. These included changing the distribution plant placement input from a 5% aerial plant assumption to 2%, as well as a similar change to the feeder plant input copper aerial fraction. With regard to the feeder plant input on fiber cable, the aerial and buried cable fractions were reduced to zero. Central office switching investment per line was based upon the latest available financial data. Home Telephone Company's debt to equity ratio and pretax cost of debt were also used as inputs. The Billing and Bill Inquiry inputs were adjusted by calculating Home Telephone's Company specific costs for this function by accumulating the cost components for the local business office billing and inquiry functions from their most recent cost separations study. In addition, four additional variables from the model default values were changed including, an adjustment to the Corporate Overhead Factor and three input variables related to outside plant material cost.

4. Staff Adjustments

In Staff's opinion, the IITA adequately supported its recommendations for input changes 1 (plant type assumptions) and 3 (structure sharing assumptions). Staff is also in agreement with the IITA concerning input change 7 (cost of capital) and 9 (cost for local number portability). The remainder of IITA's recommended changes falls into one of two categories. Either no support other than the opinion of Mr. Schoonmaker is offered, or the study submitted is based only on a small group of companies that may be eligible for USF support. If the IITA intends to propose an input change that increases the economic cost per line for all companies, then it must justify that such change is necessary for all companies. Staff is also concerned with the use of results from a minority of companies as being representative of all of the companies seeking funding. Thus, Staff has recommended that all of IITA's input changes, with the exception of input changes 1, 3, 7, and 9, should be rejected in favor of default values.

Staff has also reviewed the recommendations of other parties to the case. MCI provided testimony that supported IITA input change 7, but rejecting all other input changes. In Staff's opinion, however, MCI advanced no compelling evidence to refute the validity of IITA input changes 1, 3 and 9. MCI did not offer any alternative input changes to the model. Therefore, Staff declines to alter its recommendations concerning the HAI model or input changes to the model based on MCI's arguments.

Leaf River offered a set of nine input changes to the HAI model that coincide with, or alter, the recommendations of IITA witness Schoonmaker. Home Telephone also offered a set of thirteen input changes to the HAI model. Staff has serious concerns regarding the propriety of the input changes proposed for both of these carriers because the input change recommendations are based on embedded costs of the companies, and are not appropriate for use in the HAI model. Therefore, Staff rejected all of the input change recommendations put forth by this witness.

AT&T also rejects all of the input changes recommended by the IITA. This includes the four input changes that Staff considered acceptable (IITA input changes 1, 3, 7, and 9).

5. Commission Conclusion

In Sections B, D and F, we conclude that the use of a forward-looking cost model is appropriate in setting the legislatively permitted proxy costs and the HAI Model should be run across all of the small companies as a group to determine the proxy costs of providing the supported services. A considerable amount of the record is consumed with various parties' attempts to adjust the Model results by changing or using different inputs to the Model. Each party claims their choice of inputs, and accompanying Model results, as the appropriate forward-looking cost of the supported services. The qualifying amounts contained in the record using the various inputs for the HAI Model are: $73,479,482 developed by the IITA (IITA Exhibit #2, Attachment 5 Revised); $45,022,530 developed by the Staff (Staff Exhibit 12, Schedule 1); or $29,929,721--the results produced by using the default inputs (AT&T's Initial Brief, page 21).

The Commission need not engage in the questionable exercise of determining at this time which of each of the suggested inputs at variance with the default inputs should be adopted. The IITA and each of the small companies are requesting support based on the rate-of-return showing not the qualifying economic costs formula results. That amount, for all small companies seeking support, is $12,799,298. The qualifying amount at the default input levels, the IITA's input levels, or the Staff's input levels all exceed the level of support sought. As a result, we conclude that the small companies qualify at all proxy cost levels.

The FCC has recognized that additional time is needed to develop suitable rural input values. We agree as it pertains to the Illinois small companies. We also agree with the IITA that the appropriate goal in selecting inputs to a cost model is to use inputs that "best reflect" the forward-looking costs of the companies being examined. Since the forward-looking costs of the small companies for the supported services will be re-examined again at some point in the future, the Staff and the parties should continue to work toward that goal.

D. Subsidy issues

Section 13-301(e)(2) of the Act (which is made applicable to the inquiry here) requires the Commission to:

> Identify all implicit subsidies contained in rates or charges of incumbent local exchange carriers, including all subsidies in interexchange access charges, and determine how such subsidies can be made explicit by the creation of the fund.

In an effort to identify subsidies in the access charges of the requesting carriers, the IITA utilized the HAI Model 5.0a access charge module to estimate the forward-looking costs of carrier access charges. Mr. Schoonmaker introduced IITA Exhibit #2, Attachment 6 Revised, into evidence. Line 57 of that Attachment shows that for all of the small companies, the estimated forward-looking costs of carrier access exceeds existing access revenues by $20,933,351. Using this proxy, Mr. Schoonmaker opined that no subsidies exist in the present carrier access rates of the Companies taken as a whole.

Both Verizon and AT&T made proposals relating to access charges. Verizon used the IITA's HAI cost model results to argue that the small companies' access charges are too low by $20.7 million and the small companies should raise access charges by that amount, or at least half of that amount <u>now</u>. Verizon recommends that the Commission "break the mirror" for the small companies with regard to access charge consistent with the Commission's actions in Consolidated Docket Nos. 97-0601 and 97-0602 pertaining to Verizon and Ameritech.

AT&T would use individual company HAI access results or any subsidy in access charges as demonstrated to totally remove that individual company from universal service funding qualification.

In response to Verizon, the IITA responded that, in light of the rate-of-return or need demonstration, any increase in the small companies' access charge revenues would result in a reduction in the size of a §13-301(d) Universal Service Fund. Since interexchange carriers pay the majority of access charges, and local exchange carriers would pay more of a universal service fund, if the funding methodology is based on intrastate retail revenues, the motivation behind Verizon's recommendation is clear. IITA argues that Verizon's recommendation is not mandated by the statute, which only requires an identification of subsidies.

In terms of Verizon's suggestion that this may be the time to "break the mirror" for the small companies and adopt cost based rates, the IITA admits that there may be a need for Illinois regulatory action with regard to access charges, including breaking the mirror, if significant reductions occur in small company access charges as a result of the FCC's consideration of the MAG Plan. However, in the IITA's view those access charge issues should be reserved for a subsequent phase of these proceedings or a separate proceeding, so that they may be had once the FCC completes it USF inquiry and the level of Federal support is more certain.

In terms of AT&T's proposal to eliminate any USF qualification even if the company failed AT&T's test by $1.00, the IITA posits that this could lead to "unacceptable" rates for basic service for certain individual companies in the $60-$90 range. Beyond this, if those individual companies were to, in fact, reduce access charges, and therefore access revenues, it would only serve to increase, in light of the rate-of-return analysis, the necessary amount of any §13-301(d) Universal Service Fund. AT&T would apparently be indifferent to this outcome since, as indicated above, a reduction in access charges would benefit interexchange carriers, such as AT&T, while the local exchange carriers, such as Ameritech and Verizon, would primarily pay a higher Universal Service Fund. IITA concludes that AT&T's proposal is, once again, not mandated by the statute and should be rejected by the Commission.

The Commission has reviewed the arguments of the parties and concludes as follows. While the Company specific HAI access charge module suggests that a small number of the small companies may be receiving a subsidy from access charges, the point is immaterial for a number of reasons. First, as we determine in Section F of this Order, the HAI model should be run across all the small companies to determine the proxy cost of providing supported telecommunications services. Similarly, we conclude that the HAI results on interexchange access should also be looked at as a whole. When this is done, the results show that the costs of providing access are greater, across all the companies, than the revenues being received, leading to the conclusion that no subsidies are being generated by this revenue stream.

Second, even if we were to examine the HAI results on a company by company basis or to be convinced that something were amiss vis-à-vis access charge costs and revenues, the Verizon and AT&T proposals must still fail because the Commission can find no requirement in Section 13-301(e)(2) that would support either. Either proposal would require the Commission to take some action affecting the rates of the small companies, either by ordering access charge rate increases (Verizon's proposal) or an access charge driven USF income reduction (the AT&T proposal). Under Section 13-301(e)(2), however, the Commission is simply charged with, as part of this investigation, the identification of implicit subsidies and the manner in which implicit subsidies may be made explicit. While the Commission has a long history of attempting to reduce or eliminate subsidies in many contexts, there is simply no requirement in Section 13-301(e)(2) that it do so in this proceeding. Accordingly, the proposals of Verizon and AT&T are rejected.

The Commission, however, agrees with IITA that at some time in the near future it may be necessary, whether in an additional phase of this docket, or in a new docket, to examine the access charges of the small companies, with an eye to establishing cost based rates, as was recently done in the case of the two largest ILECs in Illinois. This inquiry should, however, not commence until some sort of certainty concerning small LEC access charges and final USF funding levels are reached at the Federal level, to prevent the sort of running and halting that has affected this docket and other dockets addressing rural company costs being concurrently addressed at the FCC. With this in mind, we note that the HAI studies did suggest that some of the small companies may be receiving access charge revenue in excess of costs and hereby commit to a third phase of this docket that will address, at a minimum, the issue of possible access charge subsidies within those companies and the manner in which the subsidies, if any may be made explicit.

E. Affordable Rate

Once the economic cost of providing the supported services has been established, the statute requires the Commission to determine whether that cost exceeds the "affordable rate," which is to be established in the first instance by the Commission. The term is undefined and was subject to various interpretations by the parties to this docket.

1. IITA Position

The IITA, noting that Section 13-301(e)(4) (which is made applicable to inquiries under Section 13-301(d)) establishes the minimum affordable rate as the rates in effect at the time any USF fund is established, urges the Commission to do just that. IITA argues that the issue of affordability should be judged by the Commission in the context of the public policy goal of providing "universal" local telephone service and that the concept of affordability must be judged in terms of a standard that will provide service at a rate where the vast majority of customers can, and will, purchase local telephone service at the determined price.

IITA also urges the Commission to bear in mind that the affordable price, which they are determining, is the rate for basic service; but the affordability of that service will depend not only on the rate for basic service but the additional rates and charges which the customer must pay, such as the federal subscriber line charges, federal, state and municipal taxes, and mandatory surcharges if they are to receive basic service. IITA Exhibit #4, Attachment 8, shows the difference for each of the 50 small companies between their average local service rate and the total payment for local service. As shown on that attachment, the numerical average for the small companies show that customers must pay an additional $7.56 per month for the federal subscriber line charge, taxes and mandatory surcharges. A $15.00 rate for basic service would, in fact, require on the average a customer to pay $22.56 in order to obtain basic service.

According to IITA, the FCC has given state Commissions the responsibility of taking into account such factors as local calling areas, socio-economic factors, etc. in determining the availability of universal service (IITA Exhibit 4.0, page 34) because customers use telephone service for a variety of communications needs. These include such things as arranging medical services and ordering prescriptions, checking on the availability and costs for materials and services for a wide variety of personal needs such as home and car repair, purchase of clothing, recreational needs, communicating with educators regarding their children's educational needs, participating in community and church activities, contacting emergency services and essential government functions, as well as maintaining social contact with friends and family. Customers of companies with large local calling areas find that most of these communications needs fall within the local calling area and are provided through the provision of basic local service. For customers of small companies, basic service in a local calling area is most usually restricted to the exchange in which they live. Very few of the previously enumerated communications needs will be met by basic service. In most situations, to meet those communications needs, the customer must purchase intrastate toll service at usage sensitive prices, which will lead them to incur charges beyond the rate for basic local service (IITA Exhibit 4.0, pages 35 and 36). IITA goes on to note that the companies' current rates are at levels for the most part previously approved by the Commission as "just and reasonable" and authorized by statute.

The use of each small company's existing rates as the affordable price is given further support by the information contained in the testimony of Harrisonville witness Thomas L. Hoops (Harrisonville Exhibit 4). Illinois telephone penetration at current rate levels is 91.8%. Only six states have a lower penetration rate. This would lead to the conclusion that existing Illinois rate levels may be already at or above an affordable price.

IITA's final point concerning the affordable rate is based upon the consensus that appears to exist between the Staff and all parties that the funding methodology for a § 13-301(d) Fund established in these dockets should be based upon intrastate retail revenues and that Funding Carriers should recover their funding obligations through a uniform percentage surcharge on customer bills. In response to an IITA Data Request, Staff has estimated in its response (IITA Exhibit #4, Attachment 9) that year 2000 Illinois intrastate revenues, excluding wireless, equal approximately $4.622 billion.

Based on this estimate, Staff went on to calculate that for a $12,000,000 Universal Service Support Fund, a surcharge on a $30 customer bill for intrastate telecommunications services would amount to 7.8¢ per month. (At the Fund size of $12,799,298, less accounting adjustments, recommended and requested by the IITA, the surcharge on a $30 customer bill for intrastate services would be approximately 8.3¢ per month.) To assure that universal service is available at an affordable price in the rural areas served by 50 companies, using Staff's example, the cost remains at less than $1.00 per year in surcharges on a customer bill. Interveners joined IITA in urging the Commission to adopt the company specific rates as the affordable rate.

While AT&T does not disagree with utilizing actual end-user rates, it argues that, in light of the fact that some companies have reduced rates over the past ten years, the companies should be required to use the highest rates charged over the last ten years as the affordable rate.

2. Staff Position

Staff's position is that the affordable rate should be set at $24 for residence subscribers and $27 for business subscribers. (Staff Ex. 3.0 at 14) Staff examined the following four factors before establishing an affordable rate level: (1) rates paid by Illinois telephone subscribers who are similar to high cost area subscribers, (2) affordable rates set by states that have high cost funds, (3) the impact on penetration rates, and (4) the ability of low-income subscribers to pay. (Staff Ex. 3.0 at 9 to 13)

Staff notes that Verizon witness Dr. Beauvais' testimony indicates that the average residence subscriber in Verizon's Illinois territory pays $22.23 per month for telephone service. (Verizon Ex. 4.0 at 10) Verizon operates in many of the same counties in which high cost area companies operate. (Staff Ex. 9.0 at 3) Verizon subscribers will not receive service subsidized by IUSF funds. Consequently, the minimum affordable rate the Commission can establish without treating subscribers of high cost area companies more favorably than Verizon subscribers is $22.23 per month. If the affordable rate is set at less than $22.23 per month then high cost area subscribers will be asked to pay less for their telephone service than similarly situated Verizon subscribers, which would violate the first principle of horizontal equity. (Staff Ex. 9.0 at 3)

Staff further notes that states with high cost funds set affordable rates at different levels. Wyoming, which is an almost exclusively rural state, has established an affordable rate of $34 for telephone service. (Staff Ex. 3.0 at 14) Median household income in Wyoming is similar to the simple average median income of the Illinois counties where small rural telephone companies operate. (Staff Ex. 9.0 at 6) The Wyoming affordable rate suggests that rates up to $34 are within the ability of households, even low-income households, to pay.

Empirical evidence demonstrates that even a sharp increase in telephone rates will have little impact on the number of households who subscribe to telephone service. The demand elasticity for primary residential telephone service is approximately -0.01, which means that if telephone rates double, only 1% of subscribers will drop service. (Staff Ex. 3.0 at 12) This result is confirmed by the evidence of Wyoming, which has a higher penetration rate than Illinois (95% vs. 91.3%) even though telephone rates in Wyoming average $26, more than in Illinois. (Staff Ex. 3.0 at 14)

Finally, Staff examined what a low-income household could afford to pay. Based on its analysis Staff concluded that if the affordable rate were set at $24, total expenditures on basic telephone service, including surcharges such as the federal subscriber line charge and taxes, would constitute approximately 2.5% of the income of a household earning $15,000 a year. (Staff Ex. 3.0 at 11) Staff believes that this is not an unreasonable proportion.

Staff argues that the affordable residence rate should be set at the same or close to the same level across all companies. (Staff Ex. 3.0 at 6) Since the affordable rate is a rate that even a low-income household is able to pay, it does not matter in which exchange the low-income household is located. The rate will be affordable for any household in any exchange. If a different affordable rate were set for each company seeking IUSF funding, subscribers of one company would be treated more favorably than subscribers of another company, violating the second fundamental principle of horizontal equity. (Staff Ex. 3.0 at 6 - 8)

While admitting that the Commission cannot appropriately look wholly to household income to determine an affordable business rate, Staff notes that in Illinois, business rates are typically a few dollars higher than residence rates. This would suggest that a business subscriber could afford to pay more for telephone service than a residence subscriber. Consequently, the affordable business rate should be set at $27. (Staff Ex. 9.0 at 6)

In addition to proposing affordable rates, Staff also proposed that the affordable rates would be "imputed" for purposes of determining IUSF eligibility, regardless of whether an individual IITA company chooses to increase end-user rates. Each IITA company would either increase end-user rates over several years (which would replace corresponding amounts of lost USF support), or would choose to maintain current end-user rates and otherwise adjust to any reductions in IUSF support associated with imputation of the affordable rates. In Staff's view, it is proper to place such a choice on each individual IITA company, since each company is most familiar with its own circumstances, and the circumstances of its customers.

Staff cannot predict how many IITA member companies will raise end-user rates in response to reductions in IUSF support, but believes that some rate increases will occur if the Commission adopts Staff's recommendations. Staff believes, however, that the Commission may, in its discretion, direct that such rate and revenue impacts be spread over a period of years, or be "phased in," in order to ameliorate "rate shock" and related adverse consequences. In fact, this is an approach that Staff recommends. (Staff Ex. 3.0 at 15-16) In Staff's opinion, the five-year period recommended in Staff testimony is sufficient to ensure no substantial end-user hardship will result. (Id.) Staff recognizes, however, that choosing the appropriate phase-in period requires an exercise of Commission judgment, and that, if the Commission determines a phase-in period is warranted, a shorter or longer phase-in period might properly be adopted.

3. MCI WorldCom Position

MCI WorldCom suggests that, at a minimum, the Commission establish a weighted average uniform affordable rate of approximately $23.70, reflecting an average of the lowest rates paid by residential and business customers in Verizon South and McCleod USA service territories in Illinois. MCI WorldCom notes that other parties have suggested affordable rates based on: the average rate for all Verizon customers; the highest rate currently being charged by any of the IITA companies; and a rate that would equate to 2.4% of the income for a household earning at just above the poverty level. These alternative suggestions result in affordable rate levels between $20 and $35 per month. MCI WorldCom stated as its final position that the Commission would be justified in establishing affordable rates higher than those produced as a result of the melded Verizon South/McLeod USA rates.

MCI WorldCom takes Staff's imputation proposal one step farther and recommend that the entire difference between an individual company's revenues from existing rates and the amount of revenues an individual company would receive from a Commission-determined affordable rate be imputed to the company now as a means to limit or reduce the fund size.

4. Verizon

Verizon witness Dr. Beauvais provided testimony concerning the development of a reasonable affordable rate for purposes of meeting Section 13-301(d). Dr. Beauvais stated: "[a]s a matter of equity, Verizon's customers should not be required to pay more for their basic local services plus have a surcharge applied to support the majority of IITA customers, just so that those IITA customers can enjoy lower bills for basic service than do Verizon's customers." (Beauvais Reb., Verizon Ex. 4.0, p. 8). To arrive at a comparable affordable rate, Dr. Beauvais started with Verizon's recurring monthly charge for basic services to residential and small business customers, $16.99 per month. *(Id.* at 9.) He then added an addition $5.23 per month for usage. *(Id.* at 10.) The $5.23 figure was the mean amount of home exchange and extended area usage actually experienced by Verizon's customers. Such a dollar amount is consistent with approximately 100 local calls per month, with 80 calls being local calls charged at $0.034 per calls and the remainder using Verizon's Extended Area Service rate. *(Id.)* Dr. Beauvais' calculation of the $5.23 usage figure used the actual demand patter of Verizon customers.

While Verizon utilized the actual demand of its customers to calibrate the amount of local charges, the IITA members provided no such demand information at all. IITA did not take issue with Dr. Beauvais' statement estimating local usage in Illinois to be approximately 100 calls per month for residential customers. They did utilize it to show that if all calls were home exchange calls in their territory, this would amount to $3.40 in local usage charges (based on Verizon's rate) since the IITA members do not offer their customers multi-exchange calling on anything other than the basis of retail toll. IITA's own calculation showed that this would result in a total charge of $20.39 for local service, excluding taxes and other surcharges. (IITA Reply Br., p. 9). In other words, the IITA has essentially stated that the comparable minimum rate for its own territory is $20.39, based on the prices that Verizon customers actually pay for such a demand pattern.

Verizon contends that there are many reasons why an amount no less than $22.23 should be the affordable rate for IITA companies whose current rates are lower than that figure, and certainly no less than the $20.39 that the IITA members calculate themselves. First, the Verizon territory from which this rate is calculated is substantially similar to the territory served by the IITA companies. (Beauvais, Tr. 375). As such, Verizon serves territory that is just as rural as many of the IITA companies. Second, the record contains no evidence that IITA customers are less able to afford basic telephone service than similarly situated Verizon customers. Dr. Beauvais noted that a comparison of median household incomes between Verizon and IITA member companies shows little difference. (Beauvais Reb., Verizon Ex. 4.0, p. 9).

Verizon demonstrates that its proposed affordable rate of $22.23 relates directly to customer density and operating characteristics similar to that of the IITA members. Verizon claims its proposal is reasonable, affordable today, and supported by the record. Additionally, Verizon believes that its proposal comports with the Act and reflects sound regulatory policy. Verizon pointed out that the Commission could balance the interests of customers who may benefit from the establishment of an intrastate USF, and those customers upon whom a surcharge may be imposed. The minimum affordable rate should be set at a level no less than what customers subject to a surcharge are required to pay, $23.22 per month. In the alternative, the minimum affordable rate should be set at the level calculated by the IITA, $20.39.

5. Responses

Interveners, the IITA, and Staff responded to the various affordable rate proposals.

a. Interveners

Interveners, after first noting that the various recommendations regarding an affordable rate would result in raising basic rates to between $22.23 and $27.00, further note that none of these recommendations include the Additional Charges of 911 surcharges, federal subscriber line charges, ITAC charges or taxes (hereafter "Additional Charges") (T.465-6, Staranczak); (T.386-7, 392, Beauvais); (T.546-7, Sands). When taken with the IITA estimation that the Additional Charges would be, on average, $7.56 more than the basic charges (IITA Ex. 4 at 40), Interveners posit that the total customer charge would equal approximately $30.00 to $35.00.

Interveners point to Staff Witness Dr. Staranczak's testimony, where he suggested that the Commission consider the Additional Charges in establishing the affordable price (T.477) but was unclear about what he was recommending to the Commission for the affordable price. Interveners note that Dr. Staranczak testified that he would find an affordable rate between $25 and $35 acceptable, with $35 on the high end including all Additional Charges (T.467, 486), but that this conflicted with his pre-filed testimony in which he recommended that the highest affordable price be $34, exclusive of all Additional Charges (Staff Ex. 9 at 6).

In terms of Staff's various affordable price methodologies, Interveners criticize them as follows. In order to reach his affordable price, Dr. Staranczak began with a Bureau of Labor statistic indicating that the average urban wage-earning household in the United States spends approximately 1.2% of its income on local telephone charges (Staff Ex. 3 at 11). Yet Dr. Staranczak admits to arbitrarily doubling the 1.2% expenditure per household without any basis whatsoever (T.479-80). As Dr. Staranczak testified, "[I]t is far from clear at this stage what the appropriate price for these services should be" (Staff Ex. 9 at 2).

Dr. Staranczak indicated that the purpose of an affordable price is to make it affordable for low-income subscribers (T.475). Even though the Staff's proposed $24 price is more than $10 above the national urban average, Staranczak felt that $24 is what low-income people can afford (T.479, 486). By low-income households, Staranczak did not mean those eligible for Lifeline compensation but rather those just above Lifeline (T.487), yet this is precisely the wrong approach, because, according to Interveners, the public policy in 13-103(a) is for all citizens to receive services at affordable rates. Contrary to Staff's recommendation, the public policy does not exclude Lifeline households. Lifeline support is not sufficient for low-income households to maintain universal service, with the increases in the current rate that the Staff proposes. Rural Lifeline households receive only $7.50 per month (Ameritech Ex. 2 at 14-15; 83 Ill.Adm.Code 757; 47 CFR 54.403), and Staff seeks to raise current rates to $24 (excluding Additional Charges). An increase of that magnitude will wipe out most, and in many cases, all of the amount of Lifeline support low-income households now receive.

For example, Alhambra's current rate is $17.14, $6.86 below the Staff's $24 target. Less than $1 of support would remain after the increase. Montrose's current rate is $17.98, $6.02 below the Staff's proposal, and less than $1.50 would remain after the increase. Any low-income household whose carrier is at $16.50 or below would have its entire Lifeline support eliminated by an increase to a $24 affordable price. Crossville's current rate is $16.36, Glasford's is $4.03, New Windsor's is $15.69, Oneida's is $12.13, Viola's is $12.62, and Woodhull's is $14.21. (IITA Ex. 2, Attach. 5 REVISED). Increases for Lifeline customers of these companies will be more than offset by an increase in the proposed affordable price of $24, leaving a net negative impact to those Lifeline households.

Interveners note that there is no evidence in the record on the number of households that will be affected by the erosion of Lifeline support by Staff's proposed increase in affordable price. Ameritech pointed out that low-income households would be affected most by an increase in affordable price and invited Staff to comment on this issue (Ameritech Ex. 2 at 14-15). Notwithstanding this, Staff failed to investigate and develop the record on the effect of a $24 rate on low-income consumers.

Dr. Staranczak estimated that the national urban price is between $18 and $20 (T.470-471). According to FCC sources, the national urban average rate for local exchange service is $20.18, the national median rate is $19.57 for urban areas, and the national urban average residential rate is $19.87. These figures include all Additional Charges (Harrisonville Ex. 4 at 8-9; IITA Ex. 4 at 8). IITA Ex. 4, Attach. 8 lists the Additional Charges for all Illinois companies and demonstrates that most companies' current rates for local service are above the national average and median rates so the current rates are the most reasonable and affordable rates. On the other hand, taking the national average urban rate of $20.18 and subtracting $7.56 of Additional Charges, equals an affordable price of between $12 and $13 (IITA Ex. 4 at 38-39). Interveners conclude that the wisest policy at this time is to establish the affordable price at the current price.

b. IITA

While not changing the IITA's primary recommendation, Mr. Schoonmaker, in his Rebuttal Testimony, recommended a rate "in the neighborhood of $13-$14 based on current national average rates for total service costs less a $6 estimate of other charges" if the Commission believed it necessary to establish one uniform statewide affordable rate (IITA Exhibit 4.0, page 40).

Noting that Staff witness Staranczak based his recommendation of a $24 per month residential rate on the Bureau of Labor statistics indicating that the average urban wage-earning household spends 1.2% of their income on local telephone charges (Staff Exhibit 3.0, page 11), IITA argues that he arbitrarily doubled the percentage to 2.4%. The $24 per month recommendation is driven by the doubled percentage {(($15,000 x 2.4% ▾ / 12) – 6 = $24}. Had Staff witness Staranczak simply used the Bureau of Labor Statistics as the basis for his recommendation, it would have led to an affordable rate recommendation of $9 {(($15,000 x 1.2% ▾ / 12) – 6 = $9)}. IITA finds Staff's recommendation simply not credible since it is the result of a mathematical calculation resulting from an arbitrary doubling of a governmental statistic underlying the Staff's recommendation. Staff witness Staranczak acknowledges that the percentage he chose is arbitrary (Staff Exhibit 3.0, page 11, and Transcript, page 480).

Staff's entire approach underlying its affordable rate recommendation is demonstrated by another option of Staff witness Staranczak. At page 11 of ICC Exhibit 3.0, Staranczak indicates that he considered the Ameritech Band C rate level of $9, plus average residential calling of 100 calls per month at 4¢ per call, as a possible benchmark. However, rather than recommending the resulting $13 per month as an affordable rate, Staff once again simply doubled that amount and indicated that an affordable rate would be "about $26." On cross-examination, Staff witness Staranczak acknowledged that selecting 200% of the Ameritech rate is arbitrary (Transcript, page 480).

According to IITA, MCI WorldCom's blended affordable rate of $23.70 is based upon rates charged by Verizon South and Illinois Consolidated Telephone Company, which have the same weaknesses as Verizon's rates. MCI WorldCom witness Sands chose not to calculate the impact on fund size related to his proposal (MCI WorldCom's Initial Brief, page 10).

Harrisonville witness Hoops presented testimony using FCC data that the national urban average rate, including the federal subscriber line charge, taxes and mandatory surcharges as of October, 1999, was $19.87 (Harrisonville's Exhibit 4, page 16). Based on Dr. Staranczak's estimate of $6 per month for those charges and using the FCC average data, an affordable rate would be $13.87. (On the average, a customer of an Illinois small company pays $7.56 for the federal subscriber line charge, taxes and mandatory surcharges as shown on IITA Exhibit #4, Attachment 8.)

IITA witness Schoonmaker's recommended affordable rate of $13-$14, if one is set by the Commission on a statewide basis for the small companies, is not only in line with the national average rate, less the federal subscriber line charges, taxes and mandatory surcharges discussed above, but is close to or higher than the options considered by Staff as a basis for their recommendation had witness Staranczak not arbitrarily doubled the percentages or rates used.

The Staff, Verizon and MCI WorldCom all recommend imputing revenues to the small companies based upon their higher affordable rate recommendations, thereby avoiding recommending to the Commission actual customer rate increases by the small companies. Staff, in their Initial Brief at page 31, states, "an individual company is not obligated to raise its rates to the affordable level." Staff witness Hoagg, while acknowledging that some companies will increase rates, includes that some companies can "make appropriate adjustments, such as cost reductions, efficiency improvements and actions to enhance revenues from non-supported lines and other services, such as usage and special access" (Staff Exhibit 11, page 3).

Under IITA's proposal, the amount of universal service support is being limited by the need or rate-of-return showing; and if higher affordable rate levels are imputed but not charged, a company will not be able to earn the rate-of-return recommended by the Staff.

If revenues from higher affordable rates are imputed to the companies, IITA believes that rate increases will occur and will be based on the Commission's determination in this proceeding.

c. **Staff**

IITA propose the affordable rate be set at each company's current rate because (1) higher rates might adversely affect the penetration rate, Initial Brief at 17, (2) that the telephone bill for IITA subscribers already includes some $7.56 in surcharges, Initial Brief at 16, and (3) the FCC has given state Commissions the responsibility to examine such factors as local calling areas, social demographic factors etc in determining the availability of universal service and consequently the Commission can set different affordable rates based on these factors, Initial Brief at 16. These claims, however, are without merit.

First, the empirical evidence submitted in this proceeding conclusively demonstrates that even a substantial increase in residence rates will reduce penetration rates only slightly. (Staff Initial Brief at 29.) Penetration rates are more sensitive to household credit ratings and the size of the long distance bill than the price of local service. (Tr. at 469.) This is borne out by data from Wyoming, which has a higher penetration rate than Illinois, even though rates for telephone service are much higher than in Illinois. (Staff Ex. 3.0 at 14.) Staff estimates that if the average rate paid by IITA subscribers increased from $18 currently to $27, then penetration rates would fall by approximately 0.5%. If household incomes rise during the five year transition period proposed by Staff, then the decline in the penetration rate will be less than 0.5%.

It is true that IITA subscribers pay surcharges, such as the federal subscriber line charge and taxes, that average $7.56 per month. However, similarly situated Verizon subscribers also pay surcharges in this range, pushing their average bill to about $30. In fact, all telephone subscribers in Illinois have the same kind of surcharges added to their telephone bill. Likewise, Wyoming telephone subscribers, whose telephone bill inclusive of surcharges would exceed $30 per month, appear able to "afford" these additional surcharges, judging by penetration rates in that state. Since IITA customers are not uniquely burdened by these surcharges, and because Staff has taken into account surcharges when it set its affordable rate, the surcharge argument as articulated by the IITA is irrelevant and immaterial.

Finally, the FCC has given state Commissions the option of examining demographic and social factors as well as the size of local calling areas when setting an affordable rate. The IITA, however, has not suggested any possible combination of social and demographic factors that justify an affordable rate of $4.00 for Kinsman Telephone Company but also rationalize an affordable rate of $21.18 for the Flat Rock Telephone Company – or, indeed, $22.23 for Verizon customers. Nor has the IITA presented any evidence that would justify five different affordable rates in LaSalle County. In fact, IITA has not presented any evidence with respect to income, demographics or size of local calling areas to explain why affordable rates should differ by company the way that IITA proposes they differ.

More fundamentally, the IITA affordable rate proposal violates two basic principles of horizontal equity. First, if adopted, it would result in more favorable treatment of its member company subscribers than it would of similar Verizon subscribers. More specifically, IITA's subscribers would pay lower prices than Verizon subscribers for telephone service, yet still receive subsidies that are denied Verizon subscribers. Second, IITA's proposal would treat subscribers of some companies that receive subsidies much more favorably than subscribers of other companies that receive subsidies. Some IITA company subscribers would pay prices $15 less than other IITA member subscribers, and still receive the same kind of subsidies. IITA's affordable rate proposal is therefore unjust and unfair, and should be rejected. Finally, the IITA argue that the cost of implementing its affordable rate proposal, in terms of surcharges on the bill of other telephone subscribers is not large. (Initial Brief at 18.) This argument, however, is thoroughly specious. The Commission should not endorse an irrational and unjust system of pricing just because it may not cost much. It is vital to remember that, regardless of whether the subsidy is large or small, it is still a subsidy. In other words, some telephone subscribers are paying part of the phone bills of other telephone subscribers. Indeed, in some cases urban subscribers of very modest means will absolutely pay part of the phone bills of wealthy rural subscribers. The unfairness inherent in this should be reduced to a minimum – by setting the affordable rate at rational levels, as recommended by Staff. The Commission should implement public policy that is equitable, and balances the interests of all affected parties in a fair manner. This, the IITA proposal fails to do.

Leaf River et al. and Grafton et al., repeat many of the same arguments put forth by the IITA in an effort to establish the affordable rate at current levels and these arguments should be rejected for the reasons articulated above. Leaf River et al. further contend that higher telephone rates may adversely affect the penetration rates for Lifeline subscribers. (Initial Brief at 17.) Staff again notes that subscribers in Wyoming, even Lifeline like subscribers, on average pay much higher rates for telephone service than Staff's proposed affordable rate, yet penetration rates in Wyoming are higher than in Illinois. Staff further notes that Verizon's rural subscribers, on average, already pay rates that approach Staff's proposed affordable rate. Yet there is no evidence that the penetration rate for Verizon's subscribers, even its Lifeline subscribers, is any different than that for small rural companies, even though rates for small rural companies are currently lower – in some cases far, far lower – than rates for Verizon's rural customers.

Finally, Staff notes that there has been no evidence presented in the proceeding to demonstrate that Staff's affordable rate, once adjustments for Lifeline subsidies are taken into account would not be "affordable" to Lifeline subscribers.

Leaf River et al.'s argument, taken to its logical conclusion, is that the Commission should never raise the telephone rates of small rural companies at any time, because this may adversely affect the penetration rate of these small rural companies. Further, to prevent the rural companies' rates from rising, the Commission should tax other telephone subscribers in Illinois, even though these telephone subscribers may currently pay higher telephone rates than subscribers of small rural telephone companies, and even though the tax itself might cause some subscribers who are taxed to drop service. In other words, Leaf River, et al., appear to believe that their customers should receive a subsidy so they can continue to enjoy lower rates – regardless of the effect this has on the telephone subscribers throughout the state who are compelled to provide the subsidy. Accordingly, Leaf River et al.'s affordable rate plan is unjust, violates fundamental principles of horizontal equity and should therefore be relegated to the ash heap of poor public policy proposals.

Verizon contends that the affordable rate should be set at a level equal to what a similar Verizon subscriber pays. However, an affordable rate can reasonably be set at a level higher than a similar Verizon subscriber pays. There are two reasons for this. First, small rural company subscribers will receive subsidies from the IUSF while similar Verizon subscribers will not. If small rural company subscribers are to enjoy subsidies they can logically be expected to pay a higher rate than similar Verizon subscribers before being eligible for those subsidies. Second, if Verizon subscribers can "afford" to pay $22.23 per month currently, then IITA subscribers can afford to pay at least this amount and in all probability can "afford" to pay more than this amount for telephone service since median household income for small rural company subscribers is similar to median household income for Verizon subscribers. The ability of households to pay more than $22.23 a month is supported by the experience in Wyoming, where rates in excess of $26 per month appear to be "affordable" and where median household income is similar to that of rural counties in Illinois.

6. Commission Conclusion

The establishment of an affordable rate is a determination that must carefully balance the interests of those receiving USF subsidies with those that will pay for USF subsidies. An affordable rate must also be set at a level that does not impose economic hardship on subscribers. Under Section 13-301(d), the Commission is not limited to setting an affordable rate equal to the existing rates charged by IITA members. The Commission may establish an affordable rate higher than existing rates, so long as the record supports such a finding.

The Commission concludes, based on the evidence before it, that Verizon's affordable rate of $22.23 per month, excluding taxes and surcharges, is the affordable rate we adopt for the State of Illinois. No parties refuted that the majority of Verizon's service territory, particularly the territory upon which Verizon's affordable rate was calculated, is comparable to IITA members with respect to customer density, economic demographics, and operational requirements. The rate is also reasonably comparable to rates in urban areas. Moreover, this rate is affordable today, as Verizon's customers presently pay the rates proposed by Verizon witness Dr. Beauvais. Accordingly, the Commission concludes that for purposes of Section 13-301(d), the minimum affordable rate must be set at $22.23 per month, excluding taxes and surcharges.

By arriving at this conclusion, the Commission rejects the IITA's and Interveners' assertion that the affordable rate should be the existing rates. The Commission finds unconvincing, both on legal and policy grounds, the argument that a rate higher than existing rates is improper because it will lead to rate increases and rate shock. First, the IITA members have had over ten years in which to adjust rates to better reflect the cost of providing service. Indeed, in Dockets 83-0142 and 98-0679 the Commission recognized that both the High Cost Fund and DEM Weighting fund would be temporary. Rather than rebalancing rates and working to ensure that access prices recovered costs, the IITA members have chosen to do nothing and simply rely upon the continued subsidization provided by the DEM Weighting Fund and the Illinois High Cost Fund. Other Illinois ratepayers should not be subjected to excessive surcharges because the IITA members have elected to not actively reduce their dependence on subsidies.

Moreover, the Commission has the discretion under the Act to set an affordable rate at a level higher than existing rates. Indeed, even the IITA recognized that the Commission has such discretion. (IITA Reply Br. at 4.) Here, the Commission is establishing a minimum affordable rate that is already affordable to customers comparable to that of the IITA members. IITA's argument that Verizon's local usage includes an Extended Area Service (EAS) whereas the smaller companies do not is unconvincing. First, the FCC has not set an amount for local usage, and therefore this Commission is free to limit that amount to the local exchange area. Second, it is unfair for Illinois ratepayers paying the subsidy to pay for **all** local usage of the subsidized subscribers. Likewise, the statute explicitly requires the IUSF to be offset by federal support. All IITA members receive federal funding to support local usage, and this federal support adequately compensates for any perceived disparity in Verizon's local usage amount calculated in the affordable rate.

Additionally, IITA's proposal is contrary to sound regulatory policy. The Commission finds persuasive Dr. Beauvais' testimony that Illinois ratepayers who are similarly situated to the customers of IITA members, and who are subject to the imposition of a surcharge to fund an intrastate USF, should not have to pay a higher rate than the customers of IITA members benefiting from the surcharge. The IITA and the Interveners offer no compelling argument to support the disparate treatment of similarly situated customers. Indeed, IITA's proposal does not create an equitable balance between the interests of the IITA members' subscribers, who benefit from a subsidy, and other subscribers, who pay the subsidy. IITA's proposal was based upon setting the affordable rate at the current rate of each eligible company at the time the fund is established. This would perpetuate the existing system of subsidies and irrational pricing. IITA's proposal, if implemented, would treat USF subscribers with considerable favor, in excess of that received by subscribers of other Illinois telephone companies.

Accordingly, the IITA's proposed intrastate USF must be modified to reflect the affordable rate adopted by the Commission. Consistent with the calculations Verizon has provided, the size of the IITA's proposed fund must be reduced by approximately $6.2 million, plus the adjustments necessary to give effect to the three Staff accounting adjustments discussed in Section G. 5 below.

F. HAI and ROR Adjustments

The most contentious issue in this docket concerns the advisability of examining universal service funding on a company specific basis. As found previously in this Order, the Commission is convinced that the HAI model, when run in the default mode, demonstrates the need for some continuing level of support across the fifty or so companies that have been receiving funds from the HCF and DEM weighting funds and which were specifically made subject to this proceeding by legislative enactment. The question now before the Commission is whether that decision should be further refined. The discussion centers on two pieces of evidence adduced by all the small companies. The first pieces of evidence are the "snap shot" earnings analyses ("ROR"), which look at the major components of rate base and expense that would be analyzed with more particularity and at length in a typical Commission rate case. The second pieces of evidence are the HAI runs done on each company, which attempt to isolate the forward-looking cost of providing universal service. The question is what to do with them.

1. IITA Position

IITA's position is that the HAI results should be ignored and the ROR relied upon in determining the level of support that each company should receive. IITA argues that, in determining how, if at all, to use the HAI Model results, the Commission should focus on its right to determine and use proxies as authorized by §13-301(d) and the reality of this proceeding. The reality is that although not required by the statute, the small companies have, in accordance with the Commission's desire, presented a need showing in simplified rate-of-return analysis. The IITA and each of the small companies are requesting for each of the companies seeking support at this time the amount demonstrated by the need showing not the economic cost formula results set forth in § 13-301(d). Collectively, that amount of support is $12,959,292. The small companies are not seeking universal service funding in any of the following qualification amounts contained in the record resulting from the statutory formula using the HAI Model results: $73,479,482 developed by the IITA (IITA Exhibit #2, Attachment 5 Revised); $45,022,530 developed by Staff (Staff Exhibit 12, Schedule 1); or $29,929,721--the results produced by using the default inputs (AT&T's Initial Brief, page 21).

According to IITA, the determination of the appropriate application of the HAI would be more challenging if any of the small companies were seeking any of the HAI suggested fund levels, but this is not the reality. Since the small companies are seeking only the amount of support demonstrated by the rate-of-return (need) showing of each company seeking support, the HAI qualification amounts become irrelevant, other than to show, on a generalized basis, that the costs of providing supported telecommunications services exceed the affordable rate. The Commission should accept, for the purpose of this proceeding, the use of the overall costs developed by the HAI Model for all small companies compared to revenues and federal support for the total group of companies to determine whether all 50 companies, as a whole, pass the statutory test. Line 57 on IITA Exhibit #2, Attachment 5 Revised, demonstrates that using this proxy the test is passed.

The need or rate-of-return showing is clearly limiting and controlling and the use of the HAI Model results, in any fashion that seeks to further limit or deny universal service support, is both punitive and unreasonable. IITA agrees with Ameritech's position concerning the use of the HAI Model results, as set forth on page 8 of its Initial Brief, where Ameritech states as follows:

> Ameritech Illinois supports limiting the use of the HAI model to a general acknowledgement that 13-301(d) permits the use of proxy cost models rather than company-specific cost models. The HAI model's use should be limited to demonstrate only that on average, for all of the small companies, the forward-looking costs exceed their current revenues exclusive of any external funding. However, the Commission's Order should acknowledge that the HAI model could not accurately predict the

degree to which such costs exceed revenues, nor can it be used for any cost/revenue comparisons for any individual company. The Commission should not use the HAI model for determining the amount of any High Cost Funding needs.

2. Staff's Position

The Staff recommends that the Commission determine which local exchange telecommunications carriers ("companies") are eligible to receive USF funds by using both forward-looking cost modeling based upon the HAI model, and rate-of-return ("ROR") analysis. The Staff readily concedes that both HAI model results and ROR analyses have shortcomings. Accordingly, the Staff recommends that HAI results be used to determine eligibility for funding, since Section 13-301(d) requires the use of "economic costs" – a term that clearly means forward-looking costs – to determine eligibility. *See* 220 ILCS 5/13-301(d) (a carrier is eligible for support if "economic costs of providing services for which universal service support may be made available exceed the affordable rate established by the Commission[.]")

However, the Staff notes that HAI appears to significantly overestimate the IITA carriers' costs of providing supported services. *See* infra. Basing funding upon the HAI model would result in a fund of nearly $60 million by any estimate. Staff Ex. 1.0, Schedule 1. Thus, Staff recommends that, once eligibility has been determined, the Commission utilize an ROR analysis to determine actual funding levels. Two scenarios present themselves. In the first, where individual company ROR figures do not exceed HAI results, the company would receive funding at the ROR level. Second, where HAI forward-looking cost estimates exceed ROR results, the support provided (if any) should also equal that indicated by ROR analysis. In Staff's view, providing IUSF support in excess of what is required under ROR analysis would be totally inappropriate, especially in light of HAI's tendency to overestimate costs. To allow a company to receive a subsidy in excess of its need indicated by ROR would require the general body of Illinois ratepayers to subsidize a company that does not, by its own analysis, require a subsidy in order to provide affordable basic services.

Companies whose indicated eligibility under embedded cost ROR analysis exceeds indicated eligibility under forward-looking HAI results should be given until approximately September 2002 to prove that its ROR analysis is valid, and the requested subsidy is actually required. Staff recommends use of this "grace period" because the ROR evaluations performed in this proceeding were reviews to determine eligibility, and are not detailed "rate case" type reviews of each company's ROR. If a particular company cannot, or will not, demonstrate that the disparity between its HAI results and its ROR results do not stem from overstated ROR results, the Commission should consider adjusting downward IUSF funding for next year. Staff finds this is a principled and reasonable solution to the funding issue, which balances the interests of IITA companies, their ratepayers, and ratepayers in other parts of the state who contribute to the fund but are unlikely to benefit directly from it.

Finally, in recognition of what Staff considers to be legitimate concerns about over-reliance upon individual company HAI results, and also to ameliorate any immediate adverse impacts upon individual IITA companies and end users, Staff recommends that the Commission decline to immediately reduce any carrier's funding eligibility to the amount dictated by HAI results alone. Staff originally recommended a phase-in over a five-year period in order to minimize "rate shock," reduced penetration levels, and related adverse consequences. Thus, in the first year, an eligibility amount indicated under ROR results would be reduced by 1/5 of the total difference between the indicated eligibility under ROR and the indicated eligibility under HAI. During cross examination, Staff Witness Hoagg clarified this position by indicating that the first reductions in revenue would not be expected to occur until the first anniversary date of the establishment of the fund, or, sometime in the fall of 2002.

3. AT&T

AT&T, while not objecting to the use of the HAI results as proffered by IITA, suggests that they should be used on an averaged basis, as opposed to an individual company basis.

4. Verizon

Verizon presented evidence that showed that adjusting the IITA's company's price levels which are currently below Verizon's average basic rate of $22.23 would have an annual impact of increasing revenues of $6.3 million for those companies. (Verizon Ex. 4.0 p. 12; Verizon Exhibit ECB-2.) Excluding the 12 companies that subsequently withdrew from requesting the subsidy under the USF, the revenue increase is $6.2 million. Verizon believes that any fund subsidy should be reduced by this amount based upon establishing the $22.23 as a floor for the affordable rate for those seeking USF subsidies. Verizon also urged the Commission to further reduce any such fund by $1.2 million based upon its witnesses' review of the increase in the 2001 USF High Cost Loop Support ("HCLS") in addition to a reduction of $1.8 million for the increase in FCC announced intention to increase in the loop support to rural LEC's for 2001. (Verizon Ex. 5.0, p. 2-3.)

4. Responses

IITA argues that Staff, while insisting that rate-of-return results be used to limit and cap the small companies' USF qualification amounts, seeks to use the HAI Model results for individual companies to potentially limit in the future the amount of a company's funding. While using the rate-of-return results as a required cap, Staff throughout its Initial brief criticizes the rate-of-return results with loose statements such as, rate-of-return results could mask "inefficient operations, waste, fraud and gold plating" (Staff's Initial Brief, page 7). The IITA observes that there is not one single item of evidence in this record to support Staff's statement as applied to the rate-of-return analyses submitted by any and/or all of the small companies. Staff's unsupported allegations are nothing more than a "bootstrap argument" to support Staff's position that the individual company HAI results be used in Staff's proposed manner. Staff's position could, in future years, wrongfully deny a small company the ability to earn Staff's recommended rate-of-return, since the amount of funding is already capped by the need or rate-of-return showing. Staff's proposed future use of individual company HAI results should be rejected.

IITA asserts that AT&T's proposed averaged proxy use of HAI USF results does not affect the fund size but has the effect of moving money from one small company to another. The proposal is without merit and not even supported by the individual companies who would benefit. AT&T's proposal should be rejected.

5. Commission Conclusion on HAI and ROR

The Commission has reviewed the evidence and the provisions of Section 13-301(d) of the Public Utilities Act, and finds that, of all the competing proposals advanced in this proceeding, the one advocated by Verizon is most consistent with our duties under the statute and our obligation to serve the public interest.

As an initial matter, we find that the General Assembly did not intend that we merely continue to authorize, on a recurring and ongoing basis, the current scheme of intrastate high cost support, through which we blindly ratify the request of high cost companies to provide support at whatever level they believe that they need. The General Assembly, by adopting Section 13-301(d), clearly directed us to review, and to the extent we conclude necessary, establish subsidized universal support. Furthermore, we find that we have the obligation, consistent with principles of equity, to ascertain each funded company's actual need for support. Should we fail to do so, we would be compelling ratepayers of non-IITA companies to bear a greater burden than necessary to support the costs associated with serving their fellow citizens in areas served by IITA companies, a result we consider inequitable and unjust. Additionally, we must balance these considerations with our statutory responsibility for maintaining universally available service.

We are confronted with a number of obstacles to achieving this goal. First, the HAI modeling tool submitted by the IITA, and the results associated with it, at least at this stage in its development, have some important shortcomings. While we conclude that companies must demonstrate forward-looking costs in this proceeding if they wish to receive funding, we are not convinced that HAI results are reliable enough at this point to be used as the **sole** criterion of IUSF funding levels for individual IITA companies. We note that the FCC has recently made a similar finding. We concur with Staff's assessment that the one generalization that we can safely make regarding the HAI model is that it tends to significantly overestimate the costs rural companies incur in providing supported service. This is evident from the fact that the model, using default input, generates a fund size for all companies of $30 million.

Likewise, while the rate of return information submitted by the IITA companies is useful, we do not have unlimited confidence in ROR results as a basis for determining any individual company's eligibility for, and required level of, USF support. We note that, in the great majority of cases, the ROR results submitted by the IITA companies in this proceeding are the first such filings that we have seen from these companies in many years. Accordingly, we have little basis for comparison to prior years. Moreover, the filings submitted in this proceeding were necessarily cursory, and we understand that while Staff scrutinized the filings with as much care as possible under the circumstances, very substantial time constraints have confronted the Commission and the other parties throughout this proceeding. Finally, ROR results, by their very nature, do not reveal information specific to the costs and revenues of the set of services that we determine to be potentially eligible for IUSF support. Rather, ROR results apply to the entire company on an overall basis. ROR therefore is inherently an inappropriate tool for the task at hand, and cannot be relied upon to the exclusion of forward-looking cost analyses. Accordingly, we cannot place much reliance upon the ROR information available to us.

We find that_Verizon's proposal best serves the competing needs that we must take into account. Likewise, we find that Verizon's proposal uses both HAI and the affordable rate in a responsible manner to attempt to solve the admittedly vexing questions of funding eligibility and fund size. As stated earlier, the results of the HAI determine that a need exists to establish a fund. Under Verizon's proposal, each company requesting funding would be required to demonstrate the need for such funding, through the use of the affordable rate and their current rate. This methodology then considers how much the IITA members are requesting and offsets that amount by the difference between their affordable rates and their current rates netted against the amount IITA members receive from federal funding. The amount sought by IITA is $12,799,298 less accounting adjustments discussed below. (TR at 50-51, September 10, 2001) Based upon the affordable rate of $22.23, the subsidy amount IITA members are requesting should be reduced by $6.2 million. Additionally, all federal support should be netted against the Illinois fund.

Several parties, including Verizon, contend that the fund should be further reduced by $3 million because of recent enactments by the FCC. The record before us, however, is insufficient to allow us to accept the proposal because no party was able to show the exact amount of increased funding that the requested carriers will receive. Therefore, we will examine this issue in the next phase of this docket.

The Commission further finds that the amount of the fund should be reduced by the impact, if any, of the accounting adjustments accepted by the Commission in this Order. The Commission notes that any administrative expenses may increase the amount of the fund.

G. Accounting issues

After reviewing the ROR analyses provided by the small companies, Staff proposed adjustments, a number of which were not accepted by the companies. The adjustments include: the treatment to be afforded leased equipment (Moultrie); the treatment to be afforded pro forma adjustments for anticipated Interstate Special Access revenues (Gridley); and adjustments to cash working capital balances (Frontier companies and Alhambra).

1. Moultrie Independent Telephone Company

Staff argues that Moultrie Independent Telephone Company ("MITCO") improperly seeks to include in its Rate of Return Funding Deficiency ("Funding Deficiency") a lease expense associated with the lease of certain unregulated operating assets from an affiliate, Moultrie InfoComm Inc. ("MII"). Including this lease expense is improper because it violates the public interest. The transfer allows MITCO to pass off the difference between the cost of the lease and the cost of the plant, as if it was owned by MITCO, to either MITCO's ratepayers or the state ratepayers paying into the IUSF.

The assets in question were formerly owned by MITCO and then sold to MII, which is a wholly owned subsidiary of MITCO's sole owner, Moultrie MultiCorp, Inc. ("Multi"). MITCO witness, Mr. Buzz Wheeler, described the transaction as, "...Moultrie (meaning MITCO) sold certain non-regulated property and facilities (i.e., buildings and motor vehicles) to an affiliate, and subsequently leased back portions of those assets needed to carry out the activities of the <u>regulated utility</u>." Moultrie Exhibit 2.0 at 2 (emphasis added). The property was leased back to MITCO, and was also leased to Moultrie MultiCorp, MII and One-Eleven Internet Services. Id. at 3; Tr. at 576.

Staff witness Smith, in his Rebuttal Testimony, provided an adjustment that removed the lease payment from the funding deficiency calculation. For ratemaking purposes, Staff witness Smith treats the property as if it were still directly owned by MITCO. Staff Exhibit 6.0, Schedule 6.11, p. 2 of 2. In Supplemental Rebuttal Testimony, Mr. Smith updates this adjustment to reflect information received following the submission of Rebuttal Testimony. Staff Exhibit 6.0S, Schedule 6.11S, p. 2 of 2.

MITCO characterizes the transfer as a sale of property and notes that the "lease expense to Moultrie has declined steadily since the inception of the lease arrangement and is now substantially less than it was for 1998. All this works in favor of the ratepayer." Moultrie Exhibit 2.0 at 6.

Staff disagrees with all three assertions. In regards to MITCO's characterization of the lease as a sale of property, Staff notes that there were no tax consequences of the transfer and no effect on the bottom line of Multi. In terms of the claimed positive effects on ratepayers, Staff responds that this is not the case. In fact, the transfer allows MITCO to include the cost of the lease payments in its funding requirement calculation, thereby increasing its revenue requirement, and resulting in two negative consequences to ratepayers. First, the increased revenue requirement is passed along to MITCO's ratepayers through increased rates. Staff Exhibit 6.0 at 13. Second, and in the alternative, if MITCO's ratepayers do not incur the additional cost, that additional cost is cast upon the state ratepayers through the IUSF. Since IUSF is intended to subsidize the difference between a company's economic costs and affordable rates, and MITCO's costs exceed affordable rates, there is no basis for such recovery, even if the transaction did not appear to be calculated to increase rates or USF contributions.

Staff finds MITCO claims that the lease rates have decreased over time irrelevant because the sale/leaseback arrangement allows MITCO to manipulate the lease amount so that it makes lease payments to an affiliate to lease the property, whereas without the sale/leaseback arrangement the property would still be used by a MITCO affiliate without paying lease charges, and hence without increasing MITCO's revenue requirement. MITCO and its affiliates are in a win-win situation because they gain the benefit of using the property, and there is no real loss of money since MITCO and MII are subsidiaries of Moultrie MultiCorp. If lease expense is not included in the calculation of the funding deficiency the additional expense is not passed along to MITCO's ratepayers, and the amount of IUSF subsidy to be provided to MITCO is not artificially increased.

Second, MITCO has, as it concedes, see Moultrie Ex. 2.0 at 2, et seq., severely compromised its right to receive federal support as a result of the sale-leaseback transaction. Quite simply, NECA believes that MITCO is violating federal rules by accounting for the transaction in the manner it has, and has withheld a substantial portion of MITCO's federal support. Id. To the extent that this results in a revenue shortfall, MITCO will, presumably, increase its rates to an unaffordable level, or seek an increased level of intrastate support. Neither of these outcomes is acceptable; neither MITCO's ratepayers nor Illinois ratepayers in general should be compelled to make good a deficiency which would not exist but for MITCO's non-substantive actions.

In this instance the payment of lease expense by MITCO for property that was formerly owned directly by MITCO places MITCO's customers at risk of being exposed to a revenue requirement that is greater than it would be if MITCO still directly owned the property. This risk can, and should, be eliminated by calculating MITCO'S funding requirement as though Moultrie MultiCorp had not moved the property from one subsidiary to another. Staff Exhibit 1.0 at 13. While it would be possible, and rather simple, to determine the revenue requirement associated with the property, which was transferred, as though that property had not been transferred, MITCO declined the opportunity to provide such a calculation. Staff Witness Smith testified that the National Exchange Carrier Association calculation of withheld funding can reasonably substitute for the difference between the revenue requirement as if the property were currently recorded on the books of MITCO and the revenue requirement associated with the sale/leaseback payments made by MITCO to its affiliate. Staff Exhibit 6.0 at 15. Giving effect to this adjustment results in MITCO's proper Revised Revenue

Requirement is, or ROR Deficiency, is $595,769 as shown on Staff Exhibit 16.0, Schedule 16.11, page 1 of 2, line 28.

MITCO responds variously that: Staff failed to adduce any documentary evidence that the transfer had no tax consequences, from which it may be inferred that such consequences did occur; Staff's proposal would unjustly interfere with MITCO's right to contract; Staff's position is based upon theories of monopoly regulation and ignores MITCO's evidence concerning the downward trend of lease expenses over the short run past; Staff inappropriately relies upon the actions of NECA in withholding funds based upon the same transaction because NECA was wrong in doing so in the first place; and Staff position would amount to a regulatory takeover of MITCO's unregulated parent company.

2. The Frontier Companies

The following six Frontier Companies are requesting IUSF support:

?? Frontier Communications of DePue, Inc. ("FC of DePue")[1]
?? Frontier Communications of Illinois, Inc. ("FC of Illinois")
?? Frontier Communications of Lakeside, Inc. ("FC of Lakeside")
?? Frontier Communications-Midland, Inc. ("FC-Midland")
?? Frontier Communications-Prairie, Inc. ("FC-Prairie")
?? Frontier Communications-Schuyler, Inc. ("FC-Schuyler")

a. Staff Position

Staff identified several adjustments for each of the Frontier Companies. Staff and the Frontier Companies agreed upon adjustments to accumulated deferred income taxes, Federal High Costs Loop Fund Support, depreciation expense, accumulated depreciation, and directory advertising expense and revenues. Staff and the Frontier Companies do not agree on the inclusion of the Commission-ordered cash balance requirements in rate base.

Turning to the issue of Commission-ordered cash balance requirements, Staff proposes that the six Frontier Companies remove it from each of their rate bases. Staff witness Voss testified that, with the inclusion of the Commission-ordered cash balance requirement in rate base, each of "the six Frontier Companies would be earning two returns on the same funds: one return by including the Commission-ordered cash balance requirements in rate base and the second through the Cash Management Agreement." Staff Exhibit 7.0, at 19, lines 355-358. In rebuttal testimony, the Frontier Companies responded, and acknowledged, "the Frontier Companies would have earned two returns on the Commission-ordered cash balance as initially proposed."

[1] Frontier of DePue provided testimony in this phase of the docket, and withdrew their request for funding prior to the commencement of hearings. (IITA Exhibit 10, Attachment 4, Revised).

Frontier Companies Exhibit 2.0, at 3, lines 9-10. The Frontier Companies then proposed to include the Commission-ordered cash balance requirements (line 11 of page 1 of each Frontier Company Schedule 2.01-2.06) in total rate base (line 13 of page 1 of each Frontier Company Schedule 2.01-2.06) and to include inter-company interest income as an adjustment to increase operating revenue. Frontier Companies Exhibit 2.0, at 3, lines 10-20.

Staff opposes the inclusion of any amount of the Commission-ordered cash balance requirements in rate base with or without the inclusion of interest income. In the Illinois Universal Service Funding Calculation, each of the Frontier Companies is earning a return on its projected additions for the years 2001 and 2002. Staff witness Voss, in addressing the Commission-ordered case balance requirements in testimony, stated: "[a]dditionally, the six Frontier Companies will also be earning a return on the investments attributable to the 2001 Capital Budget and the 2002 Extraordinary Expenditures through the inclusion of those plant investments in rate base." Staff Exhibit 7.0, at 19, lines 358-61. Staff did not oppose the Frontier Companies' proposed additions to net regulated plant. These additions were listed on Frontier Companies Exhibit 1.0, Schedule 1.07 at lines 4 and 5; the sum of the Additions to Net Regulated Plant for each of the Frontier Companies is presented below:

Company Name	Plant Additions
FC of DePue	$ 534,471
FC of Illinois	$4,759,444
FC of Lakeside	$ 257,886
FC-Midland	$ 980,039
FC-Prairie	$ 839,187
FC-Schuyler	$ 599,109

During cross-examination, Frontier Companies witness Phillips explained that these amounts for plant additions were included in each company's Total Rate Base for the Illinois Universal Service Funding Calculation. Tr. at 341-5.

The amounts the Frontier Companies provide in rebuttal still include the Commission-ordered cash balance requirements in rate base. The Frontier Companies propose to include the following amounts as shown on Frontier Companies Exhibit 2.0, Schedule 2.07:

Company Name	Commission-Ordered Cash Balance Requirements
FC of DePue	$ 534,471
FC of Illinois	$4,759,444
FC of Lakeside	$ 257,886
FC-Midland	$ 980,039
FC-Prairie	$ 839,187

FC-Schuyler	$ 599,109

Frontier Companies witness Phillips also explained and verified that these amounts for the Commission-ordered cash balance requirements were included in each company's Total Rate Base for the Illinois Universal Service Funding Calculation. Tr. at 339-41 & 345.

During redirect examination, Mr. Phillips agreed with his counsel when asked: "[w]ould you for the record indicate the Commitment 18 in the ICC's Order of Docket 99-0237? Does that require the Frontier-retained funds at an individual company to meet the next year's capital expenditures?" Tr. at 346. Still during redirect examination on Transcript pages 346 and 347, Mr. Phillips attempts to explain the ongoing nature of these cash balance requirements:

> Q. So in 2001 you would be required to have funds to meet the 2002 requirements?
>
> A. Yes.
>
> Q. So, in addition to paying for your capital expenditures in 2001, then the cash balance that you are required to have has to also be replenished so as to be big enough to cover 2002 capital expenditures as well?
>
> A. Yes, it does.
>
> Q. And this would repeat itself in 2002. You were required, not only to have enough funds to meet the 2002 capital budget, but to meet the 2003 capital expenditures?
>
> A. Yes, that would require on an ongoing basis that we, for any given years, that we have both funds for a current capital program to meet those expenditures but to also meet the following year's capital expenditures.

Staff argues that the Frontier Companies should not be permitted to include any amount of the Commission-ordered cash balance requirements in rate base. The Frontier Companies have included these funds in rate base twice: first as the Commission-ordered cash balance requirements necessary to pay for future plant additions and second as the proposed plant additions. Frontier Companies witness Phillips agreed with the need to keep the cash balance requirements "replenished." Tr. at 347. However, Frontier Companies Exhibit 1.0, Schedule 1.07, shows the Extraordinary Capital Expenditures for the three-year project, and shows the variability of the costs from year to year:

Company	Extraordinary Capital Expenditures 2002	2003
FC of DePue	$ 367,136	$ 0
FC of Illinois	$3,325,680	$2,157,090
FC-Prairie	$ 734,272	$ 346,374

Staff believes that the Frontier Companies should not be able to twice-earn a return on the same funds.

As stated above, and on page 10 of Frontier Exhibit 1.0, Frontier Companies witness Phillips relies upon Commitment 18 of this Commission's Order in Docket No. 99-0237 ("Commitment 18") to assert that funds retained to support the following year's capital expenditures should be included in working capital. Tr. at 346; Frontier Exhibit 1.0 at 10. This reliance is misplaced since Commitment 18 of the 99-0237 Order does not address the ratemaking treatment of the Commission-ordered cash balance requirements. Moreover, Commitment 18 is one of 22 voluntary commitments made by the Petitioners in that reorganization proceeding, ICC Order, Docket No. 99-0237, at 25, and the Frontier Companies are bound by that commitment since they were among the joint applicants to that proceeding. Therefore, the Frontier Companies have no basis to allow a ratemaking treatment from the commitments made when seeking approval of a reorganization. Thus, Staff argues that the Commission-ordered cash balance requirements should not be included in rate base.

b. Frontier Position

Frontier, in its Initial Brief, argues that the Commission should allow "Commission-ordered cash balance requirements" to be included within the cash working capital requirement and, thus, in rate base.

As Frontier witness Jack D. Phillips testified, the Commission has required the Frontier Companies, by the Commission's Orders in Docket Nos. 99-0237 and 00-0552, to retain funds to support, at a minimum, the following years capital expenditures. Condition 18, appearing at pages 9 and 10 of the Commission's Order in Docket No. 00-0552 states as follows:

> "18. Fund transfers from any Frontier Illinois ILEC (Company, or collectively Companies) to affiliated companies during any calendar year shall not exceed free cash flow for the most recently completed calendar year.
>
> "Fund transfers" shall be defined as the amount of common dividends, stock repurchases or other funds directly or indirectly invested, loaned, or advanced to affiliated companies. However, "fund transfers" excludes advances to the holding company

pursuant to the Cash Management Agreement approved by the Commission in Docket No. 90-0271 on September 11, 1990.

"Free cash flow" shall be defined as the Companies' net cash from operations, including changes in working capital, less construction expenditures, less maturing debt, less mandatory redemptions of debt and preferred stock, plus capitalized interest (AFUDC), plus any undistributed free cash flow, less net cash advanced during the year to the holding company pursuant to the Cash Management Agreement approved by the Commission in Docket No. 90-0271 on September 11, 1990. For the purpose of this test, free cash flow for the Companies shall be aggregated.

"Undistributed free cash flow" shall be defined as free cash flow, less fund transfers, plus the balance of undistributed free cash flow at the end of the preceding year. For the purpose of this calculation, the balance of undistributed free cash flow as of December 31, 1997 shall equal the balance of cash and cash equivalents on hand as of that date.

The construction expenditures amount to be reflected in the calculation of free cash flow will be the greater of the combined Companies' annual construction budget for the following calendar year or the "capital spending availability commitment" to be established as follows for the following calendar year. For purposes of this calculation, the capital spending availability commitment shall be a minimum of $1.75 million in 2001 and an amount for each year following 2001 established by the following formula:

$$(\text{Capital Spending Availability Commitment}_{n-1})\ \frac{(\text{GDP chain - type price index}^*_{n-2})}{\text{GDP chain - type price index}^*_{n-3}}$$

Where n = the year for which the capital spending availability commitment is to be established. *Indicates Fisher chained index as released by the Bureau of Economic Analysis as of August 1, of the year n-1.

If the Companies believe that the above formula produces an unreasonable result for any year following 2001, the Companies may petition the Commission for appropriate relief.

Within 30 days following each relevant transaction as specified above (excluding transactions pursuant to the Cash Management

> Agreement), the Companies shall submit an informational report to the Commission's Director of Finance and the Manager of the Telecommunications Division showing compliance with the financial test including a cash flow statement and supporting calculations.
>
> If Citizens' senior debt is rated at least Baa2 by Moody's or its successors or BBB by Standard & Poor's or its successors, or if no Frontier Illinois ILEC is owned or controlled by Citizens, upon notification of the Office of the Chief Clerk, the Director of Finance and the Manager of the Telecommunications Division, compliance with the test will not be necessary and the submission of informational reports may be suspended. (Emphasis added)

As indicated in the Commission's Order in Docket No. 00-0552, at page 18, Staff witness "Mr. McNally indicated that commitment #18 would ensure that the eight Frontier Illinois ILECs retain sufficient funds to maintain service quality at a reasonable level by placing a limitation on the funds that could be paid out in dividends or otherwise transferred to its affiliates."

In the adjustments proposed by the Frontier Companies, they increased rate base by the amount of each Companies' 2001 capital budget (Staff/IITA Standard Adjustment #4--Significant or Extra-ordinary Plant Investment Changes). Frontier then, using the amount of the 2001 Ordinary Construction Budget, as a proxy since that was the best estimate available, made an adjustment on line 11, because of the Commission ordered cash balance requirement. (It appears that the use of the same dollar amount for both adjustments has led to confusion as discussed below. However, the 2001 Ordinary Construction Budget amount was an appropriate standard adjustment to rate base and an appropriate proxy for the Commission ordered cash balance requirement as long as one further adjustment was made as hereinafter discussed.)

According to the Frontier Companies, the Commission in condition #18 mandated that each Frontier Company retain in 2001 not only the amount necessary to pay for 2001 capital expenditures, but replenish that amount to pay for 2002 capital expenditures as well (Transcript, page 347). In 2002, the same would be true as it pertains to amounts necessary to pay for 2003 capital expenditures (Transcript, page 347).

In Staff witness Voss' testimony, he asserted that the Frontier Companies were proposing "double recovery" by earning two returns from the same asset.

Mr. Phillips, in his Rebuttal Testimony and Schedules, acknowledged that Mr. Voss was correct in one regard. As originally proposed by Frontier, the Frontier Companies would earn a return on the actual short term investments under the Cash

Management Agreement and a return based on the proposed adjustment. To correct this, in each of the revised Frontier Schedules (Frontier Revised 2.01 through 2.06), Mr. Phillips increased revenue for the interest earned under the Cash Management Agreement at its existing rate of 7.66% (see Frontier, Attachment 2.07). With this adjustment, there is no double recovery in light of the requirements of condition #18 set forth above.

The end result of these proposed adjustments for the Frontier Companies is to allow each of the Companies to recover the difference between what they are earning on very short term investments because of the "Commission ordered cash balance requirements" and a longer term investment (Transcript, page 349). That difference is 279 basis points (Transcript, page 349). The Schedule attached to this Initial Brief reflects the amount of the 279 basis points adjustment.

c. Frontier Replies to Staff

In Frontier's Initial Brief, at page 5, it suggested that Frontier's use of the same number; i.e., the 2001 Ordinary Construction Budget, both as a 2001 adjustment to plant and as a proxy for the amount of the Frontier Companies' 2002 Construction Budget, appears to have caused confusion. In Frontier's view, a review of Staff's Initial Brief on the Frontier adjustment issue gives credence to that suggestion.

Staff presented two charts: one showing the amount of the 2001 plant addition adjustments to rate base and the second showing the Commission ordered cash balance adjustment as proposed by Frontier. The charts are apparently intended to emphasize that the dollar amounts of the adjustments are the same and induce Staff's position that the Frontier Companies' proposal would have allowed the Frontier Companies to earn two returns on the Commission ordered cash balance.

After first noting that the first year of any fund established in these dockets will likely run from October 1, 2001 to September 30, 2002, Frontier states that under the simplified rate-of-return analysis agreed to by Staff and the IITA, companies were allowed to make adjustments to actual year 2000 operating results to reflect changes that would occur during the initial time period any new fund would be in effect. A specific line item (line 11) was included in the form to allow companies to reflect Commission ordered cash balance requirements.

Commitment 18 of the Commission's Order in Docket No. 00-0552 (set forth in its entirety at pages 3 and 4 of the Frontier's Initial Brief) requires each of the Frontier Companies to retain, in hand, a cash balance (or invest short term under the Commission approved Cash Management Agreement) in the year 2001 not only amounts necessary to pay for the amount of 2001 plant additions but also to refurbish those cash balances in the amount of the Companies' 2002 Construction Budgets.

The Frontier Companies argue that these are two different amounts of money-- not one on which a double recovery is sought as claimed by Staff. The 2001 plant additions are being made, paid for, and included in net regulated plant this year. Staff did not object to this adjustment. (Staff's Initial Brief, page 56, and top chart on page 56). The Commission ordered cash balance requires each of the Frontier Companies in 2001 to replenish cash in an amount equal to the 2002 Construction Budget, as well. As set forth in Mr. Phillips' testimony and the Frontier Companies' Initial Brief, Frontier Companies use the 2001 Ordinary Construction Budget as a proxy to determine the amount of the 2002 Ordinary Construction Budget. While the same amount of dollars, it is a separate and different amount of money that must be available to replenish the coffers after paying for 2001 plant additions in order to meet the cash balance requirements related to the 2002 Construction Budget.

The testimony of Mr. Phillips, as set out on page 57 of the Staff's Initial Brief, correctly states that the cash balance requirement is ongoing and that in 2002, after paying for 2002 plant additions, the Companies are required to replenish their respective coffers sufficiently to pay for the amount of the 2003 Construction Budget. The Staff's chart on page 58 of its Initial Brief correctly shows that extraordinary capital expenditures in 2003 are projected to be less than 2002 for the three companies listed. In aggregate, the Frontier Companies will have a higher level of extraordinary capital expenditures in 2003 than 2002. The Staff's chart omits planned expenditures of $1,468,544 for Frontier-Midland and $1,054,988 for Frontier-Lakeside (Frontier Companies Exhibit 1.0, Schedule 1.07, page 2 of 2). None of this is, however, relevant to the amount of an appropriate adjustment to be made in this proceeding for a need determination of each Frontier Company related to the first year of a § 13-301(d) Fund.

In connection with this separate and different adjustment related to the Commission ordered cash balance requirement, as stated in Mr. Phillips' testimony and the Frontier Companies' Initial Brief, this year's cash balance adjustment has been offset by an upward adjustment to income reflecting the amounts earned on the short term investments under the Cash Management Agreement.

The end result of these proposed adjustments for the Frontier Companies is to allow each of the companies to recover the difference between what they are earning on very short term investments because of the Commission ordered cash balance requirements and a longer term investment (Transcript, page 349). That difference is 279 basis points (Transcript, page 349). The Schedule the Frontier Companies' attached to their Initial Brief reflects the amount of the 279 basis points adjustment. On this issue, the Frontier proposed adjustments are correct and should be allowed.

The Frontier Companies conclude, as set forth in the Frontier Companies' Initial Brief and Reply Brief, the Commission should find that the Frontier Companies should recover in the first year (October 1, 2001 to September 30, 2002) of a § 13-301(d) Fund, the following amounts: Frontier-Illinois ($313,594); Frontier-Midland ($387,343);

Frontier-Lakeside ($7,172); Frontier-Prairie ($48,976) and Frontier-Schuyler ($211,651).

d. Staff Replies to Frontier

Staff, in its Reply Brief, argues that the Frontier Companies should not be allowed to include "Commission-ordered cash balance requirements" in rate base.

Staff notes that the Frontier Companies, in their Initial Brief at pages 3 through 6, continue to argue that the "Commission-ordered cash balance requirements" should be included in rate base. The Frontier Companies argue that, through Commitment 18 of each Order, "the Commission has required the Frontier Companies, by the Commission's Orders in Docket Nos. 99-0237 and 00-0552 to retain funds to support, at a minimum, the following year[']s capital expenditures." Frontier Companies Initial Brief at 3. Commitment 18 pertains to "[f]und transfers from any Frontier Illinois ILEC . . . to affiliated companies . . . . " Order, Docket No. 99-0237, September 28, 1999, at 9, and Order, Docket No. 00-0552, December 12, 2000, at 9.

Staff notes that the Frontier Companies proposed adjustment to recover a return on the "Commission-ordered cash balance requirements" results in a transfer of the capital cost of its merger to each ratepayer that supports the Illinois Universal Service Fund. The "Commission-ordered cash balance requirements" should not be included in rate base. Including them in rate base allows the Frontier Companies to improperly designate a voluntary merger commitment pursuant to 220 ILCS 5/7-204 as a capital cost. Section 7-204 states that this designation, or determination, is to be made in merger proceedings – which in this case were Docket Nos. 99-0237 and 00-0552. Subsection 7-204(c) of the PUA describes the disposition of merger savings and merger costs:

> (c) The Commission shall not approve a reorganization without ruling on:
>
> (i) the allocation of any savings resulting from the proposed reorganization; and
> (ii) ***whether the companies should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of costs eligible for recovery and how the costs will be allocated.*** (Emphasis added.)

Any returns on the "Commission-ordered cash balance requirements" are "costs incurred in accomplishing the proposed reorganization." Since the Frontier Companies knew that they would have to retain funds to support, at a minimum, the following year's capital expenditures, they were aware of the additional cost imposed upon them as part of Commitment 18. The Frontier Companies, as stated in the

Orders for Docket Nos. 99-0237 and 00-0552, made a ***voluntary commitment*** to assure the Commission that this reorganization meets the requirements of Sections 7-204 of the PUA. On page 5 of the Order for Docket No. 00-0552, the Commission states:

> In Docket No. 99-0237 involving the merger of Global Crossing Ltd. and Frontier Corporation, the Joint Applicants in that proceeding made 22 ***voluntary commitments***, which pursuant to their agreement, were made conditions of the Commission's Order of September 28, 1999 approving that transaction. In order to assure the Commission that this reorganization meets the requirements of Section 7-204, the Joint Applicants have made similar commitments. The 22 modified ***voluntary commitments*** are set forth in Amended Attachment 1.3 to Joint Applicants' Exhibit 1.00, the Direct Testimony of F. Wayne Lafferty. Joint Applicants agree and confirm their willingness to have these commitments be made conditions of a Commission order approving the reorganization pursuant to Section 7-204(f). Joint Applicants contend that with the assurances provided by their commitments, the reorganization both meets the statutory requirements of Section 7-204 and provides additional benefits to Illinois customers. (Emphasis added.)

The Frontier Companies have no basis to dictate a ratemaking treatment in this proceeding for the voluntary conditions they offered when seeking approval of their reorganizations, since it can be reasoned that the Frontier Companies were aware of these costs during the merger, and they did not seek approval to recover, or receive, any capital costs to support the "Commission-ordered cash balance requirements" at that time. Order, Docket No. 00-0552, at 22. Further, the Commission's Conclusion did not recognize any increased capital costs to support the "Commission-ordered cash balance requirements." Id. at 23. The Frontier Companies actions are an attempt to earn a return from a voluntary commitment that was made to secure approval of the corporate reorganization by securing additional funds from each ratepayer that supports the Illinois Universal Service Fund. The Commission should reject the Frontier Companies pseudo-creation of a "Commission-ordered" rate base item and should not allow the Frontier Companies to include the "Commission-ordered cash balance requirements" in their respective rate bases.

In Rebuttal Testimony, the Frontier Companies proposed a modified position concerning the "Commission-ordered cash balance requirements." Frontier Companies Initial Brief at 6. This modified position would still allow the Frontier Companies to recover a portion of the return on the "Commission-ordered cash balance requirements." Based on the requirements of Subsection 7-204(c) of the PUA discussed above, the Commission should reject the Frontier Companies modified position.

Staff concludes by stating that the Commission should accept the following amounts as the "USF Support Based on Staff Adjusted IITA ROR Analysis with Staff Affordable Rates" as presented in column 3 on page 1 of Appendix A to the Staff Initial Brief:

Company Name	ROR Deficiency	Source
FC of DePue	$ 0	Schedule 15.09, page 1
FC of Illinois	$ 93,508	Schedule 15.10, page 1
FC of Lakeside	$ 0	Schedule 15.11, page 1
FC-Midland	$343,522	Schedule 15.12, page 1
FC-Prairie	$ 10,170	Schedule 15.13, page 1
FC-Schuyler	$183,948	Schedule 15.14, page 1

(Amounts for the ROR Deficiency that are less than zero on the appropriate Schedule of ICC Staff Exhibit 15.0 are shown as zero.)

3. Gridley Telephone Company

Staff witness Marshall testified that the Commission should not adopt Gridley's proposed pro forma adjustment to Special Access Revenues. A review of Gridley Exhibit 2, Schedule 2.01 reveals that almost all of this adjustment (approximately $275,000 of Gridley's proposed $297,444 adjustment) to Special access revenues are due to the provision of high capacity DS3 services to eight (8) customers (96 units of demand/12 months), each of whom is purchasing the service provided at the 44.736 Mbps rate. An additional $18,000 is due to the provision of high capacity DS1 services to 4 or 5 customers. High capacity DS1 and DS3 services are not within the group of nine universal services that the Illinois Universal Services Fund is designed to support. Universal service funding should, in principle, be limited to single line residential and business services. (Staff Ex. 14, at 2)

Staff notes that the Federal Communications Commission ("FCC") has addressed the issue of special access lines as it relates to universal service funding. In FCC 97-157, paragraph 64, the FCC concluded that voice grade access, and not high-speed data transmission, is the appropriate goal of universal service policies at this time. Report & Order In the Matter of Federal-State Joint Board on Universal Service, FCC 97-157, CC Docket No. 96-45 (rel. May 8, 1997) para. 64. The FCC was concerned that supporting an overly expansive definition of core services could adversely affect all customers by increasing the expense of the universal service program and, thus, increasing the basic cost of telecommunications services for all. (Staff Ex. 14)

In addition, 47 Code of Federal Regulations Part 36.611(h) states, "For universal service purposes, working loops are defined as the number of working exchange Line Cable and Wire Facilities loops used jointly for exchange and message telecommunications service . . . , excluding WATS closed end access and TWX service." This FCC definition also appears to limit universal service support. (Id.)

Of significance is that no other company in this proceeding is claiming a pro forma adjustment for changes in Special Access rates. The only access charge pro forma adjustment proposed by other companies is limited to switched access. Staff's proposed adjustment will allow Gridley to recover that pro forma adjustment. It would be inconsistent and unfair to allow Gridley to receive support for changes in Special Access rates while no other Illinois carrier receives such support. (Id.) Therefore, the Commission should accept $329,791 as the correct amount of "USF Support Based on Staff Adjusted IITA ROR Analysis with Staff Affordable Rates" as presented in column 3 on page 1 of Appendix A to this Brief.

Gridley witness Flesch takes issue with Staff's proposed adjustment to its Special Access charges. Mr. Flesch contends that this adjustment should be allowed under the agreed procedures for revenue requirement analysis in this docket and that Gridley's proposal is necessary in order to give Gridley an opportunity to earn its allowed rate of return. Flesch Rebuttal, at 5-7.

Gridley argues that under the FCC's rules for historical filers access revenues in 2000 were generated by applying rates based on average 1997 and 1998 interstate revenue requirements and demand to year 2000 interstate demand. 47 CFR Part 61.39. The key point in the analysis of Staff's arguments is that the ICC's mirroring of FCC set access rates is a rate development mechanism, not an earnings-measuring mechanism. The rates are 100% lawful under the FCC's rules and under the ICC's mirroring policy. The difference from year to year stems from the fact that the rates are usage sensitive, so if demand increases or decreases substantially in a given year, rates in corresponding years, which are set based on historical data, will be either reduced or increased. It is nothing more than a timing difference.

The level of intrastate special access revenues the Company received in 2000 versus what it will receive in 2001 is due to the inherent timing differences under the ratemaking methodology in the FCC's rules for historical filers. 47 CFR Part 61.39. Thus, due to the timing differences, the higher level of 2000 intrastate access revenues will mask the need of the Company for State universal service support in subsequent periods. In other words, the revenues from intrastate access in 2000 provided a subsidy to the supported local services. That subsidy has been removed as of July 3, 2001 when the Company was required to file new intrastate access charges, which will produce lower levels of intrastate access revenue. The Commission should recognize the "real world" effects of the intrastate access charge filing.

Current state access rules require that the Company mirror its interstate rates and rate structures, subject to certain ICC defined differences for carrier common line and local switching rates, in the intrastate jurisdiction. ICC Docket 83-0142 (4th Interim Order). The Company filed intrastate access rates with the ICC to mirror the revised interstate access rates with an effective date of July 3, 2001. The impact on the Company of the state filing is an annual reduction in state switched and special access revenue in the amount of $251,223. (Gridley Ex. 5, Schedule 5.01)

Since the effect of this known and measurable change has already begun to occur, the annual impact on state revenues due to the rate change must be subtracted from 2000 annual total operating revenues in order to accurately reflect the Company's going forward earnings level. While this higher level of revenue was available in year 2000 to subsidize the Company's need for universal service support, the Company has demonstrated and the Staff has not challenged the fact that this revenue stream has been reduced. To ignore the effect of this change understates the Company's need for universal service support for the supported services.

In terms of the fact that no other company made a similar adjustment, Gridley posits that this is also no basis upon which to deny the Company its full ROR deficiency because it does not speak in any manner to the appropriateness of the adjustment. Other companies may not have had the data in time, or they may have determined that the affect was minimal and therefore not a significant change. Gridley made the adjustment because it was significant and because it was "known and measurable," and must be accepted in accordance with the Commission's ratemaking rules.

The Company accepts the Staff's position that special access should not be on the list of supported services at this time. The Company does, however, dispute the argument of Staff that its pro forma adjustment for reduction in intrastate access revenues should be disallowed. Mr. Flesch testified that the Company is not requesting USF support for "special access" services. (Gridley Ex. 4.0, p. 6) Gridley argues that the Staff proposal overstates revenues the Company will actually receive and the Company's earnings. The Company proposes that its calculation of revenue deficiency in the amount of $514,219 should be the funded amount.

4. Alhambra-Grantfork Telephone Company

For Alhambra, Staff noted that there is a $358 difference between its Revised Revenue Requirement amount ($5,564) presented on IITA's Exhibit #4, Attachment #10 2d Revised and the amount ($5,206) presented on Staff Exhibit 15.0, Schedule 15.02, page 1, line 28, column d. This $358 difference is attributable to the failure of IITA to consider the effect of the $15,693 reduction to operating expenses for station apparatus expense on calculation of cash working capital. The Commission should accept Staff's Revenue Requirement of $5,206 as the correct amount.

5. Commission Conclusion on Accounting Issues

The Commission has reviewed the evidence and arguments of the parties and has reached the following conclusions. The Staff adjustment to the ROR showing of MITCO is accepted. The Staff adjustment to the Frontier companies is accepted. The

Staff adjustment to Gridley is accepted. Before turning to our discussion of each particular case a general observation is warranted. In these dockets, the Commission had requested and received from each small company, a truncated rate of return showing. As noted previously, that rate of return review was intended, in the first instance, to allow the Commission to conclude that, based upon the limited review necessitated by the short time frame associated with these dockets, that none of the small companies were in an over-earnings situation. Our review indicates that two companies possibly are in an over-earnings situation: FC of DePue and FC of Lakeside. We then adopted the ROR analyses as the benchmark against which to measure the potential size of the fund. To that end, Staff reviewed the submission and, as has been the practice in the past, suggested adjustments to the proposals similar to those that would have been made had the various companies come in for rate cases. While understandable, we can find no explicit requirement that rate of return adjustments, such as those contemplated under Article IX of the PUA would necessarily apply to the establishment of a USF. Rather, it would seem that the wide discretion vested the Commission under Section 13-301(d) contemplates adjustments to the size of the fund based upon the needs of the carriers, as shown by the ROR results. To that end, the acceptance of any adjustment in this Order will have no effect, and should not be cited as precedent in any ratemaking proceeding under Article IX of the PUA.

We turn now to the actual adjustments. In terms of MITCO, the Commission agrees with Staff that recognizing the lease payments under the MITCO sale/lease-back arrangement as items of expense improperly impacts the ROR study by inflating items of expense (recovered dollar for dollar) and deflating rate base (recovered on a percentage basis). We find no merit in MITCO's arguments concerning the impropriety of this decision based upon the theory that it abrogates its ability to contract with an affiliate. It may do so just as it has in the past. And, just has always been the case in the past, ratemaking determinations will attach at the time the Commission reviews a given transaction for ratemaking purposes. The Commission similarly finds no merit in MITCO's argument concerning the possibility that NECA was incorrect in determining that funding should be withheld, because the actions of NECA are not binding upon the Commission and were not relied upon in reaching the determination here, which is based solely upon our authority to establish and size a USF under state statute. We similarly find no merit in MITCO's assertions relating to the downward trend of the lease payments, which is irrelevant to the principal at work here, that items of rate base should be recognized in rate base, no matter the nature of the item's ownership. Therefore, we accept Staff's accounting adjustment of $283,209. (Staff Initial Brief Appendix A, p. 1.)

The Commission accepts Staff's proposed adjustments of the Frontier Companies. While the operation of the Commission-ordered cash working balance for these companies is certainly confusing, Staff did show that the Frontier Companies have no basis to dictate a ratemaking treatment in this proceeding for the voluntary conditions they offered when seeking approval of their reorganizations. Further, the Commission's Conclusion in its Order in Docket No. 00-0552 did not recognize any increased capital costs to support the Commission ordered cash balance requirement. The Commission notes that the "Commission-ordered cash balance requirement" is but one of 22 voluntary comments made by the Frontier Companies during its two recent reorganizations to assure the Commission that the reorganizations meet the requirements of Section 7-204 of the PUA. Since the recovery of these capital costs was not specifically included in the reorganization Orders, the Commission does not deem it appropriate to allow their recovery in this proceeding. The ratepayers that support the Illinois Universal Service Fund should not be forced to pay for a voluntary commitment made by the Frontier Companies to secure the Commission's approval of their reorganizations.

In terms of the proposed adjustment to Gridley, the Commission accepts Staff's adjustment. While Gridley argued long and loud that the adjustment was based upon a misunderstanding of the manner in which Federal access charges are set and mirrored in Illinois, Gridley could not overcome Staff's basic understanding that the USF fund and the ROR analyses that were to be considered here were intended to reflect the costs and revenues associated with providing the services found to be supported telecommunications services. Gridley attempts to gloss over the distinction between "access charges' and "special access charges," using the terms interchangeably in argument. As noted by Staff the two are distinct. The Commission agrees with Staff that special access should not be included in the definition of supported telecommunications services making any revenue impacts of changes to this revenue stream immaterial to the matter *sub judice*.

In terms of proposed adjustment to Alhambra, the Commission views the failure to argue the issue on Brief as the acceptance of Staff's proposal.

H. Miscellaneous issues

While the Commission has disposed of the majority of the major issues, some matters remain unresolved, including implementation and the true up of funds previously contributed to the DEM weighting fund.

Staff recommends that a line item be placed on the Funded Carriers' subscriber bills identifying the amount of support being received. The Staff's proposal is contained in the testimony of Staff witness Clausen, at page 11 of Staff Exhibit 4, and depicts a bill showing a monthly line charge, less an Illinois universal service credit, with a resulting amount due.

The IITA responds that Staff's proposal would lead to customer confusion instead of customer information. The "monthly line charge" would be an amount that could only be determined by "back figuring" and is a meaningless number and can only serve to confuse customers. In light of the rate-of-return limitation, the back-figured "monthly line charge" is neither a rate for basic service that has been approved by the Commission nor representative of the economic costs of basic service as determined by the HAI

Model. As Mr. Schoonmaker observed, there would presumably be changes on a going forward basis from year to year in the amount an individual funded company receives from the Fund and would have the effect of either raising or lowering the Staff's proposed "monthly line charge," which would only further confuse customers.

The IITA notes that Mr. Clausen, on cross-examination, agreed with the validity of Mr. Schoonmaker's observations in the following exchange, appearing at pages 513 and 514 of the Transcript:

> "Q. Would you agree that the way you have depicted this charge on page 11 of your direct testimony, that what you are calling a monthly line charge is a number that would just simply have to be back figured?
>
> "A I agree.
>
> "Q. And that would not be a rate that necessarily either--first of all, it wouldn't be a rate that was approved by this Commission in some fashion?
>
> "A. No, it would not be.
>
> "Q. And also because of at least the Staff's proposals about rate of return limitation and their use of the HAI model, that monthly line charge would, as it would have to be back figured, wouldn't reflect either the embedded cost of providing these services or a forward-looking cost such as those developed by the HAI model?
>
> "A. No, it would not correspond to any of these numbers."

While, to the IITA, the above passage is reason enough to reject Staff's proposal, Mr. Clausen acknowledged at pages 11 and 12 of Staff Exhibit 4.0 that billing system changes to reflect his recommendation would not allow for early implementation. Mr. Schoonmaker, at page 61 of IITA Exhibit 4.0, confirms Mr. Clausen's suspicion by indicating that necessary changes in the billing systems would not, in his opinion, make it possible to implement any such proposal in the near future. Staff's proposal should be rejected for the reasons indicated above, and any consideration of a modified Staff proposal should be done in a subsequent phase of these proceedings.

The Commission has reviewed the arguments of the parties and concludes as follows. Staff's proposal is, as its own witness admitted, administratively peevish. Staff did not address the IITA's concerns over the possibility that performing the requisite calculations would impede the establishment of the fund, concerns the Commission find well placed. The Commission therefore concludes that the issue of possible solutions to making the funded companies implicit subsidies explicit will be addressed in the additional phase of this docket previously established to consider the same issue in the area of possible access charge subsidies.

1. True up of Dem Weighting Fund

The Commission's First Interim Order thoroughly discussed the genesis and history of the HCF and DEM Weighting Funds. The Order also concluded that the issue was not ripe for decision and put off any final decision until such time as a final funding methodology was in place. While this Order establishes a final funding methodology, considerations of administrative efficiency and the fact that we have previously committed to at least one more phase of these dockets, convince us that this determination should again be deferred. The record and issues to be considered here are voluminous and complex. The time frame for resolution is short. The issue of the final funding methodology and any possible true up is also complex, but is not as time sensitive, given the fact that any true up that may be ordered, will have no effect until such time as a final funding methodology is established. Accordingly, the Commission will take up DEM Weighting true up issues in the next phase of these dockets. It is anticipated that these issues, which have already been briefed, will be the subject of an additional interim order shortly following the expiration of the rehearing period and/of any rehearing granted following the entry of this order.

2. Implementation Issues

Following the close of the record in this case, the following parties jointly submitted a Joint Motion for Approval of Administrative Procedures and Incorporation of Administrative Procedures Within Phase 2 Order ("Motion"): IITA, Staff, Ameritech, AT&T, MCI WorldCom, Sprint, Gallatin River Communications and Interveners. The Motion sets forth agreed to procedures in implementing the fund established by this Order. The Motion establishes as funding carriers all companies holding Section 13-403, 13-404 and 13-405 Certificates, with the exception of any certificated company with projected contributions of less than $2,400 per year.

The basis for funding is intrastate retail revenues less both uncollectible expense and revenues received from any end user surcharge imposed as a result of this order. The fund will commence October 1, 2001 and the initial fund will be based upon the results of a data request for information relating to year 2000 retail revenue. The data request will be issued by Staff. The assessment will be recovered on a uniform percentage annual surcharge pro-rated across the remaining months of the fund year in the first year and on a monthly basis thereafter. The agreement provides for an annual true up of revenues collected by a carrier and the assessments paid to the fund. Carriers that have collected more than their assessment will be assessed the additional amount while carriers that have collected less than the assessment will have the difference refunded or credited. The Joint Motion moots issues concerning the recognition of carrier-to-carrier payments in establishing the funding mechanism for the USF.

The Joint Movants ask the Commission to approve the Administrative Procedures. The Commission has reviewed the proposed Administrative Procedures, finds them reasonable and concludes that they should be approved.

3. Phase In

While none of the parties were responding to the specific funding proposal adopted in this order, most, if not all, suggested a phase-in process, through which the requesting companies would be allowed to absorb any reductions in the funding levels currently being received from the HCF and DEM Weighting funds. The proposals ranged generally from three to five years. although some parties sought immediate and complete first year reductions and others sought to have the first reductions in revenue take place after the end of the first fiscal year of the plan. The Commission concludes that immediate implementation of its Findings for reductions in the Fund is appropriate, and no phase in is necessary.

4. Future Adjustments to USF

As previously discussed, several of the parties to this docket suggested that the fund established herein should be mitigated by sums expected to be forthcoming from recent enactments at the FCC. The record before us is insufficient to allow us to accept the proposal because no party was able to show the exact amount of increased funding that the requested carriers will receive. In the next phase of this docket, we will examine this issue as well as determine the necessity of and, if found necessary, the manner in which the USF fund will be adjusted in the future, and whether it is necessary for the Commission to conduct an annual review to assess the appropriate size of the fund.

IV. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) Illinois Bell Telephone Company, d/b/a Ameritech Illinois, GTE (now Verizon) North and South, and the companies that comprise the Illinois Independent Telephone Association, or IITA, which consist of small, independent local exchange companies with fewer than 35,000 access lines, and all other interveners in this proceeding are telecommunications carriers as defined by the Illinois Public Utilities Act;

(2) the Commission has jurisdiction over the parties and the subject matter of this proceeding pursuant to the Illinois Public Utilities Act;

(3) on March 16, 2000, the IITA filed, pursuant to Section 13-301(d) of the PUA, a *Petition for initiation of an investigation of the necessity of and the establishment of a Universal Service Support Fund in accordance with Section 13-301(d) of the Public Utilities Act* on March 16, 2000, which Petition was docketed as ICC Docket No. 00-0233;

(4) on May 10, 2000, pursuant to Section 13-301(d) of the PUA and our Order dated March 29, 2000 in Docket Nos. 97-0601/0602, we initiated Docket No. 00-0335, which was consolidated with the IITA Petition in Docket No. 00-0233 on March 10, 2000; and

(5) the recitals of fact and conclusions of law set forth in the prefatory portion of this order are supported by the record and are hereby adopted as the findings of fact and conclusions of law of the Illinois Commerce Commission;

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that:

A. An initial Universal Service Fund in the amount of $6.6 million, less the adjustments necessary to give effect to the two Staff accounting adjustments discussed in Section G. 5 above, plus administrative expenses, is hereby established pursuant to Section 13-301(d) of the Illinois Public Utilities Act;

B. The Fund shall become effective October 1, 2001 and shall remain in effect until dissolved by order of the Commission;

C. The services defined by the FCC as supported services shall be the state supported universal services for purposes of the Fund;

D. The Verizon proposed rate of $22.23 is adopted as the "affordable rate" for purposes of the Fund;

E. The economic costs of providing the supported services for purposes of the Fund for the IITA members as a group are, at a minimum, equal to the proxy costs of all supported services calculated by running the HAI Model 5.0 at default input levels;

F. All local exchange carriers and interexchange carriers certificated in Illinois shall contribute to the Fund on the basis of their intrastate retail revenues, consistent with Section 13-301(d) of the PUA and the Agreement submitted by the parties to this case, which is hereby approved and incorporated into this Order;

G. All carriers contributing to the Fund shall timely provide to the Fund Administrator and Staff, in the first instance, all information necessary to determine each carrier's intrastate net retail revenues;

H. All carriers contributing to the Fund shall recover their fund contributions from their end user customers via an explicit end user surcharge on the customer's bill. The surcharge shall be assessed in a competitively neutral manner consistent with existing Illinois rules and statutes;

I. All carriers contributing to the Fund shall be prohibited from recovering their funding commitments from another certificated carrier for any service purchased and used solely as an input to a service provided to such certificated carrier's retail customers;

J. The ISCECA is appointed as the Fund Administrator of the Fund;

IT IS FURTHER ORDERED that the current DEM Weighting and HCF shall expire September 31, 2001.

IT IS FURTHER ORDERED that any materials submitted in this proceeding for which proprietary treatment was requested shall be accorded proprietary treatment.

IT IS FURTHER ORDERED that any petitions, objections or motions made in this proceeding and not otherwise specifically disposed of herein are hereby disposed of in a manner consistent with the conclusions contained herein.

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 as to all matters determined herein; it is not subject to the Administrative Review Law.

By order of the Commission this 18th day of September, 2001.

(SIGNED) RICHARD L. MATHIAS

Chairman

(S E A L)