REBUTTAL TESTIMONY

of

SHEENA KIGHT

Finance Department

Financial Analysis Division

Illinois Commerce Commission

Commonwealth Edison Company

Proposed General Increase in Rates for Delivery Service

Docket No. 05-0597

February 27, 2006

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WITNESS IDENTIFICATION

Q. Are you the same Sheena Kight who previously testified in this proceeding?

A. Yes, I am.

Q. Please state the purpose of your rebuttal testimony in this proceeding.

A. The purpose of my rebuttal testimony is to respond to the rebuttal testimony of Commonwealth Edison Company ("ComEd" or the "Company") witnesses J. Barry Mitchell (ComEd Ex. 20.0) and Samuel C. Hadaway (ComEd Ex. 21.0).

RECOMMENDATION

Q. Please provide your evaluation of Mr. Mitchell's rebuttal testimony concerning your recommendations.

A. Mr. Mitchell's rebuttal contained nothing to change my opinion of ComEd's cost of capital or capital structure. In my judgment, the overall cost of capital for ComEd is 7.86%.

RESPONSE TO MR. MITCHELL

General Misconceptions

Q. Is Mr. Mitchell correct when he stated that "S&P benchmarks show unmistakably that electric utilities with a business profile score of '4' and

an 'A' credit rating are not highly leveraged and should have a common equity ratio of between 48% and 55%"?[1]

A. No, Mr. Mitchell is incorrect. The S&P benchmarks are guidelines.[2] A company can have a credit rating of A even if its equity ratio[3] falls outside the guidelines S&P publishes. For example, there were six companies listed in the January 27, 2006 S&P's "U.S. Utility and Power Ranking List" with an "A-" credit rating and a business profile score of 4 for which data needed to calculate the benchmark ratios were available from S&P Utility Compustat. The mean common equity ratio for the six companies for the years 2002-2004 was 46.1%.[4] This is below the 48% to 55% benchmark range Mr. Mitchell described. Further, the common equity ratio for electric companies with an "A" credit rating and a business profile of 4 ranged from a minimum of 19.9% to a maximum of 63.7% in 2004.[5] The minimum is below the benchmark range for a credit rating of "A" irrespective of business profile.[6] This illustrates that a company with a business profile of 4 can achieve ComEd's target credit rating of "A-" even if its debt ratio is not within S&P's benchmark range.

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[1] ComEd Ex. 20.0, p. 5.

[2] Standard & Poor's, "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," June 2, 2004, p. 4.

[3] S&P publishes guidelines for total debt/ total capital. The equity ratio for a company that does not have preferred stock issued equals 1- (total debt/ total capital).

[4] S&P Utility Compustat II.

[5] *Id.*

[6] Standard & Poor's, "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," June 2, 2004.

Table 1 presents the coverage ratios for the financial guidelines for the business profile "4" as well as those resulting from Staff's capital structure and capital costs[7] and ComEd's proposed capital structure and capital costs.

Table 1

	AA	A	BBB
Financial Guideline Ratios			
FFOIC	4.2-5X	3.5-4.2X	2.5-3.5X
FFO/Debt	28-35%	20-28%	12-20%
Staff Proposal			
FFOIC		3.78X	
FFO/Debt			18.04%
ComEd Proposal[8]			
FFOIC	5.42X		
FFO/Debt	28.62%		

Table 1 also illustrates that ComEd's proposed capital structure results in ratios that are commensurate with an "AA" credit rating, instead of the "A-" credit rating ComEd purports to target.[9]

Q. Mr. Mitchell claims that you proposed a BBB credit rating for ComEd. Is this correct?[10]

A. No. I stated that the ratios that resulted from my proposed capital structure and costs for ComEd indicated a level of financial strength of at least a BBB credit rating. Table 1 shows that under Staff's proposal, ComEd's FFO/Debt ratio falls

[7] The coverage ratios presented under Staff Proposal are calculated from the rate base, cost of capital, and other costs that compose Staff's proposed revenue requirement presented in Staff's Rebuttal Testimony.
[8] ComEd's ratios include TFI's and the associated interest and revenue.
[9] ComEd Ex. 20.0, p. 6.
[10] *Id.*

in the top third of the BBB range. However, the table also shows that ComEd's FFOIC ratio is in the middle third of the A range. Together, the two ratios indicate that Staff's proposed rates are sufficient to support financial strength that is commensurate with a credit rating of "A-."

Q. Please comment on Mr. Mitchell's observation that you "make no case that ComEd's target rating is unreasonable."[11]

A. I do not oppose the Company's decision to target an A- credit rating; hence, I have no reason to make a case against it. Nevertheless, my decision not to oppose that decision should not be construed as an endorsement of the A- credit rating as optimal from a cost of capital standpoint. The same reasons stated in my direct testimony that make determining the optimal capital structure problematic[12] also make determining an optimal credit rating problematic.

Q. Does Mr. Mitchell correctly assert that the ComEd ratios reflecting Staff's revenue requirement proposal are historical?

A. No. I calculated the ratios from the rate base, cost of capital, and other costs that compose Staff's proposed revenue requirement for establishing rates that will become effective January 2, 2007. Thus, the ratios reflecting Staff's proposal are forward-looking, not historical.

[11] *Id*., p.7.
[12] ICC Staff Exhibit 4.0, p. 7.

Long-Term Debt

Q. Mr. Mitchell claims that you did not use the balances and amortization amounts provided by the Company and presented in ComEd Exhibits 20.5a and 20.5b in determining the Company's embedded cost of debt.[13] Please comment.

A. I used the balance presented in ComEd Exhibit 20.5a. However, as explained below, I did not use the balances and amortization provided in ComEd Exhibit 20.5b, since not all numbers reflected straight line amortization. The loss on reacquired debt presented in my long-term debt schedule reflects the use of straight line amortization. To determine the loss on reacquired debt I presented in ICC Staff Exhibit 4.0 Schedule 4.2, I began with the ending balances for unamortized loss and gain on reacquired debt presented on pages 24a and 24b of ComEd's 2004 Form 21 ILCC. I then set the annual amortization of loss to that which would recover that loss in equal amounts each year (i.e., straight-line amortization), which is consistent with the Commission's rule regarding the amortization of Unamortized Loss on Reacquired Debt.[14] Finally, I calculated the ending balance for June 30, 2005 by subtracting 6-months of amortization from the unamortized balance at December 31, 2004. In addition, I made an adjustment to reflect the generation-related unamortized loss on reacquired debt that was written off in December 1997.[15] This adjustment was also provided in ComEd Ex. 20.5a.

[13] ComEd Ex. 20.0, p.28.
[14] 83 IL Administrative Code, Section 415.380: General Instruction 17.
[15] Company supplemental response to Staff data request SK 1.02.

To illustrate, the unamortized balances of loss on reacquired debt for the 8.750%, Series 30 as of December 31, 2004, are the same on ICC Staff Exhibit 4.0, Schedule 4.2 and ComEd Ex. 20.5b. However, the June 30, 2005 unamortized balances differ. The annual amortization of Series 30 loss is approximately $90,900 using straight line amortization. Therefore, the June 30, 2005 balance should equal the December 31, 2004 balance of $772,849 minus half of the $90,900 annual amortization, or approximately $727,400. However, ComEd Ex. 20.5b lists the June 30, 2005 balance as $647,306. The approximately $80,000 difference between the two June 30, 2005 balances indicates that ComEd's balance does not reflect straight line amortization.

Transitional Funding Instruments

Q. In your direct testimony, you stated that Staff was still investigating whether the Transitional Funding Instruments ("TFI's") and the associated cash flows should be removed when calculating the credit metrics for ComEd.[16] What conclusions have you drawn from your investigation?

A. Following Standard and Poor's policy of removing TFI's and the associated cash flows from its calculation of the benchmark ratios[17] might ultimately lead to a higher rate of return on rate base for ComEd, a result that ComEd's TFI issuance was supposed to avoid.[18] Therefore, the analysis of the effect of ComEd's capital structure and cost of capital on its financial strength should not include a TFI Adjustment.

[16] ICC Staff Exhibit 4.0, pp. 11-12.
[17] Hereafter, the removal of TFI's and the associated cash flows from the calculation of the S&P benchmark ratios will be referred to as the "TFI Adjustment".
[18] Order, Docket No. 98-0319, July 21, 1998, pp. 21-23, and 38.

Q. Please describe the TFI Adjustment.

A. The TFI Adjustment comprises three adjustments: (1) removal of $1,150 million in Transitional Funding Trust Notes (“TFTNs”) from ComEd’s balance of debt; (2) removal of $65.3 million in TFTN interest from ComEd’s total interest charges; and (3) removal of $340 million in annual TFTN redemptions from ComEd’s operating cash flows.

Q. How did you determine that excluding the TFI’s from the credit metric calculations would ultimately lead to a higher rate of return on rate base for ComEd?

A. When the TFI’s are excluded from the credit metric calculations, Staff’s cost of capital recommendation would result in an FFO/Debt and FFOIC ratios within the low to middle benchmark range for a BBB credit rating. If the Commission concluded it were appropriate to impute a capital structure that would achieve credit metrics consistent with A-/BBB+ credit ratings, the equity ratio would need to be increased to approximately 45.5%. Table 2 presents the effect of the TFI Adjustment on the FFOIC and FFO/Debt ratios under Staff’s cost of capital proposal (“Staff Proposal”). Table 2 also presents the common equity ratio, combined with Staff’s proposed costs of common equity and debt, that would produce credit metrics similar to those that Staff’s cost of capital proposal produces without the TFI Adjustment (“Target A-/BBB+”).

Table 2-ComEd Financial Ratios with TFI Adjustment

	Equity	A	BBB	BB
Financial Guideline Ratios				
FFOIC		3.5-4.2X	2.5-3.5X	1.5-2.5X
FFO/Debt		20-28%	12-20%	8-12%
Staff Proposal	37.11%			
FFOIC			3.06X	
FFO/Debt			13.91%	
Target A-/BBB+	52.00%			
FFOIC		3.69X		
FFO/Debt			18.19%	

Combining a capital structure with a 45.5% common equity ratio and 54.5% debt ratio with Staff's recommended costs of debt and common equity would result in a 8.17% cost of capital. In Docket No. 98-0319, ComEd claimed that its proposed use of the proceeds from issuing TFTN's would lower its cost of capital."[19] Consequently, it would be unfair to ratepayers to authorize ComEd a higher rate of return on rate base on the basis that the TFTN's require ComEd to maintain a higher common equity ratio than had the TFTN's not been issued.

Because the TFTN's had a AAA credit rating while ComEd was rated BBB when the TFTN's were issued on December 16, 1998,[20] the interest rate on the TFTN's is lower than that which ComEd would have paid had it issued conventional debt at that time. Hence, I examined ComEd's cost of capital had it issued conventional debt instead of TFI's. On December 15, 1998, the 10-year corporate bond yield for electric companies with a credit rating of BBB was

[19] Order, Docket No. 98-0319, July 21, 1998, pp. 21-22.
[20] Standard & Poor's Ratings Direct; Commonwealth Edison Company SEC Form 10-K, December 31, 1998, p. 25.

6.32%.[21] Replacing the TFTN's in the long-term debt schedule with conventional debt at a rate of 6.32% increases the embedded cost of debt from 6.48% to 6.65%. At an embedded cost of debt of 6.65%, Staff's proposed capital structure, rate base and non-cash operating expenses results in a FFOIC ratio of 3.67X, a FFO/Debt ratio of 17.74%, and an overall cost of capital of 7.96%. Even if one were to assume that ComEd had issued conventional debt rather than TFTN's, Staff's capital structure recommendation is consistent with the financial strength commensurate with an "A-/BBB+" credit rating.

In summary, the imputed capital structure of 45.5% equity and 54.5% debt that is necessary to maintain TFI-adjusted financial benchmarks indicative of an A-/BBB+ credit rating, would increase the overall cost of capital from 7.96% to 8.17%. Since the TFTN's were supposed to reduce ComEd's cost of capital, I recommend that the Commission not impute a capital structure with a higher proportion of common equity on the basis of ratios calculated with the TFI Adjustment.

[21] Standard and Poor's, "Utilities & Perspectives," December 21, 1998, p. 9

RESPONSE TO DR. HADAWAY

Q. Dr. Hadaway states that combining Mr. McNally's 10.19% cost of equity recommendation with your capital structure "entirely ignores the additional financial risk that Ms. Kight's capital structure represents and would fail to meet any financial test of reasonableness."[22] Please comment.

A. I presented an analysis of the financial impact of Staff's recommendations in my direct testimony. That analysis shows that Staff's recommendations produce financial ratios indicative of at least a BBB rating.[23] In addition, I previously demonstrated on pages three and four that the results of Staff's recommendations are indicative of a financially sound company; thus, Staff's approach most definitely does not fail to meet any financial test of reasonableness, as Dr. Hadaway claims. Indeed, Table 1 on page 3 of this testimony shows that the Company's cost of capital recommendation reflects a degree of financial strength commensurate with a AA credit rating, which suggests that a downward adjustment to Dr. Hadaway's cost of equity recommendation would be in order for consistency with the lower financial risk associated with the Company's proposed capital structure.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

[22] ComEd Ex. 21.0, pp. 6-7.
[23] ICC Staff Exhibit 4.0, p. 8.