STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	)	
	)	
Proposed general increase in rates for delivery service. (Tariffs filed August 31, 2005)	)	**05-0597**
	)	
	)	

INITIAL BRIEF OF THE CITIZENS UTILITY BOARD, THE COOK COUNTY STATE'S ATTORNEY'S OFFICE AND THE CITY OF CHICAGO

CITIZENS UTILITY BOARD

Julie Soderna
Melville Nickerson
208 S. LaSalle, Suite 1760
Chicago, Illinois 60604
312-263-4282
312-263-4329 fax
jsoderna@citizensutilityboard.org
mnickerson@citizensutilityboard.org

THE CITY OF CHICAGO
MARA S. GEORGES
CORPORATION COUNSEL

Ronald D. Jolly
Senior Counsel
J. Mark Powell
Assistant Corporation Counsel
City of Chicago
30 N. LaSalle St., Suite 900
Chicago, Illinois 60602
312-744-6929
rjolly@cityofchicago.org
mark.powell@cityofchicago.org

RICHARD A. DEVINE
STATE'S ATTORNEY OF COOK COUNTY

Mark N. Pera, Supervisor
Marie D. Spicuzza, Deputy Supervisor
Allan Goldenberg
Environment and Energy Division
Assistant State's Attorneys
Cook County State's Attorney's Office
69 West Washington, Suite 3130
Chicago, Illinois 60602
312-603-8600
312-603-9835 (fax)
mpera@cookcountygov.com
mspicuz@cookcountygov.com
agolden@cookcountygov.com

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I. INTRODUCTION

Pursuant to section 16-108 of the Public Utilities Act ("Act" or "PUA"), which establishes a process for the development and approval of delivery services tariffs ("DSTs"), ComEd initiated this proceeding, *inter alia*, to establish the terms and rates that Commonwealth Edison Company's ("ComEd" or the "Company") residential ratepayers will pay post-restructuring. ComEd has failed to meet its burden of proof to demonstrate the justness and reasonableness of its proposed rates and should not be allowed to recover overstated and unsupported costs. There are a number of areas in which the Company has overstated its rate base, operations, maintenance, depreciation and other expenses in the revenue requirement. If allowed to collect these inflated costs and expenses, ComEd would unlawfully be overcharging its customers.

The Citizens Utility Board ("CUB"), the Cook County State's Attorney's Office ("CCSAO"), and the City of Chicago ("City") join together (collectively "CUB-CCSAO-City") in this brief and urge the Illinois Commerce Commission ("ICC" or "Commission") to reject ComEd's proposal to increase rates for delivery services, and to reduce ComEd's costs in accordance with the proposed disallowances set forth herein.

Legal Standards and Ratemaking Principles

In its determinations in the present proceeding, the Commission must be mindful of four governing legal ratemaking principles. The first and guiding principle in ratemaking before this Commission is that "[a]ll rates or other charges made, demanded, or received … shall be just and reasonable." 220 ILCS §5/9-101. While public utilities are entitled to just and reasonable compensation for the services they render, it is unlawful to exact more from the public than the services rendered by the utility are reasonably worth. *United Cities Gas Co. v. Ill. Commerce Comm'n*, 163 Ill.2d 1, 23-24 (1994). The Commission has the authority to review, approve, and modify utilities' tariffs to ensure that the rates embodied in such tariffs are, in fact, just and reasonable and available on a nondiscriminatory basis. 220 ILCS §§ 5/16-104(d); 16-108(a); 16-108(c).

Second, the Commission "shall include in a utility's rate base only the value of such investment which is both prudently incurred and used and useful in providing service to public utility customers." *Id*. §5/9-211.

The third governing ratemaking principle is that rates must be cost-based. *Id*. §5/16-108(c). The PUA states that the utility may recover the costs of owning, operating, and maintaining transmission and distribution facilities. *Id*. §5/16-108(c).

Fourth, the burden of proof is on the utility – "in whole and in part" – to establish the justness and reasonableness of its proposed rates. *Id*. §5/9-201(c). Moreover, the Commission has adopted orders and regulations that are specifically applicable to DST proceedings. Those procedures establish just as clearly as the Act that ComEd also has the burden of production of evidence relevant to the Commission's determination on the justness and reasonableness of the Company's proposal.

From the foregoing, it is clear that the Commission's mandate in this matter is to determine whether the rates proposed by the utility are prudent, fair, just, and reasonable. Moreover, the burden to prove the prudence, justness and reasonableness of the proposed rates falls squarely upon ComEd.

Substantive Standards and Policies Governing Requested Rates

On December 16, 1997, the Governor signed into law the Electric Service Customer Choice and Rate Relief Law of 1997 (hereafter "Electric Choice Law") as an amendment to the the Act. The overarching policy objective of the Electric Choice Law is to provide customers with choice concerning their electric service by promoting competition. The Electric Choice Law contains specific legislative findings detailing the goals and objectives of the law. The legislative findings recognize that "[a]ll consumers must benefit in an equitable and timely fashion from the lower costs for electricity that result from retail and wholesale competition…" *Id*. §5/16-101(e). Perhaps most important to the residential electricity consumers in the state, the Act promotes consumer protections "to ensure that all customers continue to receive safe, reliable, affordable, and environmentally safe electric service." *Id*. §5/16-101(d). These legislative directives must be carefully considered in conjunction with the legal requirements in this proceeding.

In stark contrast to the goals and objectives articulated in the Electric Choice Law, competition has not developed for residential consumers, as was contemplated by the legislature. The Commission set residential delivery service rates in Docket 01-0423 in contemplation of the entry of retail electric suppliers serving residential customers. Not one single residential customer actually paid these rates, however, as not one single electric competitor has chosen to serve residential customers to date; all residential consumers currently continue to be served under ComEd's bundled rates, which have been frozen since 1997. This proceeding is of profound significance to Illinois consumers and residential customers in particular, as such customers must pay the resulting rates, whether competition for residential electric supply develops or not. The rates that are set in this case will be the Commission's first look at rates that will actually be paid by residential customers for unbundled electric delivery service. As a result of the end of the transition period, and the end of the legislated rate freeze, if ComEd's proposals were adopted, residential customers would be exposed to drastically higher electricity rates. ComEd's proposal would mean a 26% increase in rates – just for the delivery portion of the bill. Thus, in addition to the ratemaking principles articulated above, the Commission must also be mindful of the rate shock that would occur if ComEd's proposals were adopted.

CUB-CCSAO-City presented the testimony in this case of three witnesses[1]: 1) Edward C. Bodmer (cost of capital); 2) Michael J. McGarry (accounting); and 3) Steven Ruback (cost of service and rate design).

II. STATEMENT OF UNCONTESTED ISSUES

A. Issues That No Party Contests

1. Test Year

2. Elements of Rate Base

a) 21 Capital Project Additions

b) Staff Adjustment Related to ComEd Schedule B-2.1

c) Pro Forma Capital Additions and Construction Work in Progress

CUB-CCSAO-City witness Michael McGarry initially raised an issue with respect to ComEd's accounting for construction work in progress ("CWIP") and its pro forma for 2005 capital additions. CUB-CCSAO-City Ex 2.0 at 10, L. 216-220. This issue was resolved by an agreement among the parties and presented in testimony. At the hearing on March 23, 2006, witness McGarry agreed that a reasonable resolution is that the requested amounts of CWIP should be included in the pro forma additions, and, correspondingly, the CWIP to be included in rate base should be reduced to 70% of the 2005 level, leading to an addition to rate base of $41.16 million. Mar. 23, 2006 Tr. at 910-911. The ALJ allowed corrected schedules to be filed.[2]

On April 3, 2006, ComEd filed on e-docket ComEd Ex 45.0, an affidavit of Jerome P. Hill with revised schedules 1 and 3. The schedules had various updates that detailed the

[1] The City of Chicago and CUB also presented the testimony of Christopher C. Thomas (City-CUB Ex 1-4); and the City of Chicago presented the testimony of Steven Walter (City Ex 1 and 2).

[2] See Corrected CUB-CCSAO-City Ex 5.01, e-docket March 29, 2006.

resolution of the CWIP. The affidavit noted that "the CWIP value of $41,047,000 shown on Schedule 1 Revised, page 7 reflects the resolution to use 70% of the December 2005 CWIP balance. This result is slightly lower than the $41,160,000 used by Staff witness Griffin, CCC witness McGarry and me in our respective cross-examinations." ComEd Ex 45.0, e-docket, April 3, 2006. The Commission should adopt Mr. Hill's updated, lower CWIP value as a complete resolution of this issue.

d) Pro Forma "New Business" Capital Additions and Revenue Credit Against Operating Expenses

Mr. McGarry raised an issue with respect to pro forma capital additions to its plant in service for "new business." CUB-CCSAO-City Ex 2.0 at 8, L. 185-186. Mr. McGarry noted that ComEd had not included an offset for the revenues associated with the additions of new customers. However, this issue was resolved based on ComEd's inclusion of $13.7 million in other revenue, which balances out the inclusion of capital additions to rate base. *See* CUB-CCSAO-City Ex 5.01, Schedule MJM-8).

3. Elements of Operating Expenses
   a) Advertising Expense Adjustment
   b) Staff 2005 Wage and Salary Adjustment
   c) Post-Retirement Healthcare Benefits
   d) Tax Consultants
   e) Employee Arbitration Settlements
4. Elements of Rate Design and Tariffs
   a) Rider PM
   b) Rate MSPS7
   c) Rate RESS7
   d) Rider FCA
   e) Rider RCA
5. Other
   a) Original Cost Audit
   b) Exelon GSA-Reporting Requirements

B. Proposals to Which Certain Parties Have Agreed
1. Elimination of Rate 87
2. Condominium Common Area Reclassification
3. Modifications to ComEd Business Processes to Aid RESs and Customers

a) Rider SBO7
b) Definition of "New Customer"
c) Definition of retail versus wholesale peak and off-peak periods
d) Clarification of Switching Rules
e) Timely Revision to RES Handbook
f) Inclusion of "Frequently Asked Questions" on PowerPath"
g) Relief From Minimum Stay Requirement
h) Provision of Information to RESs
(i) 867 and 810 Billing Data available after 1:00 PM
(ii) Weekly Pending Disconnection Report
(iii) Customer Current Rate and Supply-Type Information on PowerPath
(iv) DASR Eligibility on PowerPath
(v) Customers' TOU data on PowerPath
i) Allocation of Uncollectible Expenses

4. Other
a) Rider ZSS7
b) Rate BES-L

III. ARGUMENT ON CONTESTED ISSUES

A. Total Revenue Requirement and Base Rate Revenue Increase

In its direct case, ComEd proposed a total increase in its delivery services revenue requirement of $387,910,000. The proposed total revenue requirement of $1,895,546,000 is more than 20% above the level approved in the previous DST case (ICC Docket No. 01-0423).

In its direct testimony, CUB-CCSAO-City witness McGarry recommended that ComEd's proposed pro forma adjustments to net delivery services revenue requirement be reduced by $165.372 million ($245.2 million after applying the revenue conversion and interest synchronization), consisting of $155.3 million to return on rate base, $13.347 million to operations and maintenance expenses, $5.094 million to depreciation and amortization, and an offset of taxes (*i.e.*, a positive number) of $8.379. The recommended reduction to ComEd's rate base consisted of the impact of the costs of CUB-CCSAO-City's proposed cost of capital and a reduction of net utility plant in service of $240.7 million. This was made up of three components: New Business Plant additions ($187.969 million), CWIP Double Count ($53.891

million) and Cost of Removals ($0.874 million).

In his rebuttal testimony, Mr. McGarry withdrew his recommendation with regard to the cost of removals. When combined with a recalculation of depreciation rates in his analysis, this change resulted in a $241.394 million recommended adjustment to ComEd's requested increase in capital additions.

During the hearings, CUB-CCSAO-City reached resolution with the Company with regard to the CWIP and new business issues and made agreed adjustments. ComEd filed updated figures with regard to the adjustment to CWIP with ComEd's Witness Hill's Exhibit 45, which reflects the numbers agreed to between all the parties at hearing (*see* section II.a.2.c. above). Taking into consideration the resolution of both the new business (*see* section II.a.2.d. above) and CWIP issues, CUB-CCSAO-City's capital additions adjustment was modified to $17.592 million. *See* CUB CCSAO City Ex 5.01, Schedule MJM-8, filed March 29, 2006.

In conclusion, CUB-CCSAO-City recommend that ComEd's proposed revenue requirement be reduced by $162,645,000 ($247,217,000 after revenue conversion and interest synchronization) to $1,718,517,000 from ComEd's position on rebuttal.

B. Rate Base

1. Depreciation and Amortization Reserve

As indicated in our pre-trial memo, CUB-CCSAO-City no longer contest this adjustment. In direct testimony, CUB-CCSAO-City witness McGarry originally recommended that the Company reduce its 2005 Plant Additions by $35.8 million and record this amount as a reduction to Account 108 – Accumulated Reserve for Depreciation. CUB-CCSAO-City further recommended that ComEd reduce its estimated retirements by $32 million to reflect the reclassification of dollars from plant additions to Accumulated Reserve for Depreciation.

However, ComEd correctly noted in rebuttal testimony that a transfer of dollars from Account 101 – Utility Plant in Service to Account 108 – Accumulated Reserve for Depreciation would not have any effect on ComEd's rate base as presented. Upon review of the calculation, CUB-CCSAO-City withdrew schedule MJM-5 of CUB Exhibit 2.02 and no longer contest this adjustment. *See also* March 23, 2006 Tr. at 912; CUB-CCSAO-City Ex 5.01, Schedule MJM-5 (withdrawn), e-docket March 29, 2006.

2. General Plant - Functionalization and Amount
3. Intangible Plant - Functionalization and Amount
4. Pension Asset
5. Accumulated Deferred Income Taxes
6. Customer Deposits
7. Budget Payment Plan
8. Materials and Supplies Inventory
9. Procurement Case Expenses [Rate Base Effect]
10. Rate Case Expense [Rate Base Effect]
11. Other

C. Operating Expenses

1. Distribution O & M

CUB-CCSAO-City recommend that the Commission reduce ComEd's operation and maintenance ("O&M") expenses by $13.347 million based on the premise that ComEd has a responsibility to pass along any savings that result from capital investments along its customers. March 23, 2006 Tr. at 967; CUB-CCSAO-City Ex. 2.0 at 17-18, L. 368-385. ComEd's O&M expenses have steadily declined between the years 2001 through 2004 due to ComEd's investment of over $2 billion dollars in its distribution plant facilities. *Id.* at 15, L. 332-336. Specifically, ComEd's investment in its distribution plant facilities reduced O&M cost through greater efficiency and productivity. ComEd Ex. 14.0 (Corrected) at 13, L. 256-257. CUB-CCSAO-City maintain that ComEd's reduction in O&M expenses for the years 2001 through 2004 should be the benchmark for ComEd's O&M expenses in the coming years as ComEd continues to invest in its distribution facilities.

Mr. McGarry testified that, in part and as a result of the Company's continued accelerated investment in distribution plant since 2001, ComEd has experienced a steady and significant decline of total expenses that are associated with distribution O&M. CUB-CCSAO-City Ex 2.0 at 15, L. 332-336. Mr. McGarry testified that since 2001, the Company has experienced an average reduction of 8.2% per year in its distribution operations and maintenance expenses. CUB-CCSAO-City Ex 2.0 at 16, L.338-339. This equates to a nearly $82.5 million reduction over the period 2001 to 2004, and an average decline of $27.5 million per year. *Id*. at 16, L. 339-341. Mr. McGarry opined that this is a result of the significant capital investments the Company made during that period. *Id*. at 16, L. 348-351. In fact, the Company itself acknowledges that its operations include the use of better and more efficient technologies and equipment. March 21, 2006 Tr. at 254-55. Conceptually, it is akin to the difference in maintenance expenses between a brand new car and a five-year-old vehicle. The new car obviously requires substantially less maintenance of its basic components like brakes, shocks and spark plugs. Likewise, much of ComEd's plant infrastructure is new and will require less maintenance on a going-forward basis. CUB-CCSAO-City Ex 5.0 at 10, L. 191-193.

The Company does propose certain specific known and measurable adjustments to its distribution operations and maintenance expenses, including the 2005 wage and salary pro forma adjustment, elimination of the $1500 employee benefit payment, storm restoration costs, incentive compensation, and normalization of the Exelon Way Employee reductions, which collectively reduce the total distribution O&M by $2.027 million or 0.73%. However, ComEd fails to acknowledge the inherent overall increase in productivity that is achieved with the use of better and more efficient technologies and equipment, and the Company's incentive compensation program. CUB-CCSAO-City Ex 5.0 at 10, L. 191-193. Thus, a productivity adjustment should be made to reflect the fact that the Company's distribution expenses are declining as a result of ComEd's significant investment in upgrading its facilities.

ComEd believes that the downward trend in O&M expenses cannot be sustained in future years. ComEd Ex. 14.0 (Corrected) at 13, L. 259-260. Nevertheless, ComEd did not present any evidence to support its position. During cross-examination, ComEd Witness Mr. DeCampli testified as follows:

> Q. It is your position that ComEd cannot sustain the decrease in operational and maintenance expenses carried over into 2005; is that correct?
> A. That's correct.
> Q. Mr. DeCampli, have you attached any analysis, spreadsheets, if you will, to support your rebuttal testimony, ComEd Exhibit 14.0 which support your opinion?
> A. No.

March 23, 2006 Tr. at 982.

> Q. Mr. DeCampli, isn't it also true that you haven't attached any forecasts or spreadsheets which would support your position that ComEd cannot sustain or continue to decrease its operational and maintenance expenses for the year 2005?
> A. That's correct.

Id. at 983. ComEd has presented no evidence to support its conclusion that O&M expenses will continue to decline. In fact, on cross-examination, Mr. Costello testified that actual O&M expenses for 2005 are trending down from previous years. March 21, 2006 Tr. at 251. Mr. Costello further testified that "[c]ertainly a big driver has been the capital improvements we've made in our system, trying to improve reliability across all of Commonwealth Edison." *Id*. at 254. It is precisely the impact of the capital improvements that prompted Mr. McGarry's adjustment. ComEd's conclusion that the downward trend in O&M expenses cannot be sustained in future years is not supported by the record, is without merit and should be rejected.

CUB-CCSAO-City propose a 4.75% downward adjustment to the Company's proposed distribution expenses (which is equivalent to $13.347 million of the Company's proposal before applying other pro forma adjustments). CUB-CCSAO-City Ex 2.0 at 17, L. 368-370. Mr. McGarry developed this recommended disallowance by observing actual data from 2001 through 2004, which reflects a downward trend in distribution O&M costs. Notably, Mr. McGarry did not conceptually base his proposed adjustment on the fact that a downward trend exists – he merely used that trend to calculate the proposed adjustment (to be conservative, Mr. McGarry applied a 3.45% inflation adjustment to that trend). A $13.347 million reduction in ComEd's distribution expenses is justified given the historical data produced by ComEd demonstrating that ComEd's investment strategy has reduced its operational and maintenance expenses. The Commission should ensure that ComEd passes along the benefit of these reduced expenses to ratepayers.

2. Pension and Other Post-Retirement Expenses
a) Fair Value Adjustment to Pension Costs

3. Administrative & General Expenses

a) Functionalization
b) Overall Amount

c) Corporate Governance Expenses

CUB-CCSAO-City agree with Staff that corporate governance costs should be allocated based on actual cost information, rather than projected. Corporate governance costs are allocated using the Modified Massachusetts Formula ("MMF"), which uses gross revenues, total assets, and direct labor as inputs to the allocation formula. Staff Ex. 1.0 at 9, L. 177-179. ComEd calculated the test year MMF based upon 2004 *projected* gross revenues and direct labor, as well as assets at their September 30, 2003, value. Staff witness Dianna Hathhorn recommended an adjustment to allocate the test year costs based on actual 2004 data, rather than projections. *Id*. at 9, L. 182-184.

During cross-examination, ComEd witness Houtsma confirmed that the MMF allocators used to allocate corporate governance expense are based on projected or budgeted information rather than actual data:

> Q. In your response -- or, sorry, in the company's response, it states when possible, projected values for the upcoming budget are generally used when available. Historical values are used when budget information is not readily available. Is that correct?
> A. Correct.

When asked whether the allocators could be generated using actual data, Ms. Houtsma stated the following:

> Q. It is possible, though, for the company to go back and sort of regenerate those allocators based on actual data if and when that actual data is available, correct?
> A. It's possible to do the calculation. As practical matter, it's -- the reason that it's not used is because that data doesn't become available until after the books are closed so you have to go through this iterative process that is really very difficult and cumbersome to administer, and it doesn't result in a substantially different answer. So the consistent practice that's been applied has been to use the budgeted data again with a check after the fact to make sure there hasn't been a material change.

March 21, 2006 Tr. at 360.

Thus, ComEd could – and does – conduct an after the fact calculation using actual data to develop the MMF allocators; it just chose not to do so for practical reasons. For purposes of exacting the most precise level of corporate governance charges to be collected from the regulated utility and charged to ratepayers, and to maintain compliance with the just and reasonable and known and measurable standards articulated in the Commission's rules, CUB-CCSAO-City propose that the Company regenerate the corporate governance allocators using the most recent actual 2004 values for these inputs, to better match the historical test year with actual

2004 activity. This would result in a $663,000 decrease to corporate governance charges included in ComEd's test year A&G expense.

d) Exelon BSC Expenses

Mr. McGarry testified that ComEd's General Services Agreement ("GSA") expenses should be reduced to account for the costs associated with the divestiture of Exelon business entities that did not clearly benefit ratepayers. CUB-CCSAO-City Ex. 5.0 at 38, L. 750-753. The large increase in the level of corporate governance services charged to ComEd as a result of Exelon Corporation's sale of the Enterprise Businesses should be rejected by the Commission. CUB-CCSAO-City witness McGarry recommends that the Commission disallow $5.791 million in costs that did not benefit ratepayers. CUB-CCSAO-City Ex. 2.02, Schedule MJM-14, (rev. Mar. 20, 2006).

4. Salary and Wage Expense
5. Severance Expense
6. Incentive Compensation
7. Uncollectibles Expenses

Mr. McGarry testified that the Company's requested uncollectible expense should be reduced to account for annual variability with a downward trend. CUB-CCSAO-City Ex 2.0 at 24, L. 519-528. ComEd's uncollectible expenses fluctuated from 2000 through 2004. For example, ComEd's uncollectible expenses ranged from a low of $37 million in 2004 to a high of $51 million in 2002. CUB-CCSAO-City Ex 5.0 at 24, L. 536-537. Overall, ComEd's policies and practices were successful in steadily reducing its uncollectible expenses from 2000 through 2004. This downward trend is expected to continue as ComEd institutes stricter credit policies and implements internal risk scoring systems that are now part of ComEd's operating policies. *Id*.

In his direct testimony, Mr. McGarry presentedhe results of his analysis of a reasonable adjustment to the Company's uncollectibles expense:

> Based on the Company's FERC Form 1, account 904, the uncollectible expense amount for 2003 and 2004 was $45,907,378 and $37,053,694 respectively. This represents a 19% reduction in the uncollectible expense. If the continued decline in uncollectibles is realized as ComEd references in their response to TEE 3.07, this amount should be reduced for this rate case. If we conservatively use a 14% decline, this would reduce the uncollectible expense to $9,380,364.

CUB-CCSAO-City Ex 2.0 at 24, L. 536-541.

In rebuttal testimony, Mr. McGarry supported Staff witness Ebrey's proposed 15% downward adjustment to the Company's uncollectibles expense. Ms. Ebrey takes issue with the Company's requested uncollectible expense, as it is higher than the overall Company uncollectibles rates in every one of the last five years as reported in ComEd's FERC Form 1 statements. Staff Exhibit 2.0 at 26, L. 562-565, Schedule 2.5, at 2. Further, ComEd's request represents a 33% increase over the 2004 uncollectibles rate. Mr. McGarry supports Ms. Ebrey's recommendation to use a five-year average rather than the test year amount for the calculation of the expense to be included in the Company's revenue requirement, because this approach is more consistent with the Commission's practice of normalizing expenses with high annual volatility. Moreover, it is a better indication of ComEd's actual uncollectible expense than the test year number and reflects the downward trend resulting from ComEd's collection efforts and credit policies. Although Ms. Ebrey's and Mr. McGarry's respective methodologies were developed in a slightly different manner, their ultimate conclusions are substantially similar (Mr. McGarry's initial recommendation was a 14% reduction, and Ms Ebrey's was a 15% reduction). CUB-CCSAO-City Ex 5.0 at 23, L. 453-457; Staff Ex. 2.0 at 26, L. 562-567. The Commission should adopt Staff's proposal to reduce ComEd's uncollectibles expense by 15%; in the alternative, the Commission should adopt Mr. McGarry's adjustment and reduce uncollectibles by 14%.

8. Charitable Contributions

9. Procurement Case Expenses

CUB-CCSAO-City support Staff's proposed disallowance of $2.364 million of ComEd's estimated legal fees and expenses related to the procurement proceeding in Docket 05-0159 as an operating adjustment. CUB-CCSAO-City Ex. 5.0 at 27-32, L. 542-626; Staff Ex. 1.0 at 19, L. 400-402. As Staff witness Ms. Hathhorn stated, "[a]dopting ComEd's proposal would charge customers who only take delivery services from ComEd with costs related to ComEd's procurement proceeding and operations." Staff Ex. 1.0 at 19, L. 400-402. Furthermore, Mr. McGarry opined that "it is important to associate prudently incurred costs of the utility, or in this case, costs that are specifically associated with a service with those customer who use the service." CUB-CCSAO-City Ex. 5.0 at 29, L. 566-568. Mr. McGarry uses the analogy of the auto service station to illustrate his point -- a customer who receives an oil change from the service station would not be charged a disposal fee associated with tire disposal, even if that customer could potentially have benefited from a new set of tires. *Id*. at 30, L. 589-592. Likewise, the costs associated with the procurement case should be borne only by those customers who are taking competitive power.

10. Rate Case Expenses

ComEd has failed to provide sufficient justification for its requested 67% increase in rate base expense over that approved in the Company's last DST case (Docket No. 01-0423). In fact, the proposed rate case expense adjustment of $9,193,000 is almost as much as the two previous DST cases combined (Dockets 99-0117 and 01-0423). ComEd's extraordinary request must be viewed carefully by the Commission, as much of the amount includes projections of costs not yet incurred.

In conformity with the ratemaking principles and requirements ComEd must demonstrate that its rate case expenses are known and measurable. 83 Ill. Admin. Code § 285. Nevertheless, ComEd included amounts in its forecasts that are not known and measurable and do not appear reasonable. CUB-CCSAO-City Ex. 5.0 at 20-21, L. 399-408. Mr. McGarry therefore recommended that ComEd's proposed rate case expenses be reduced by $1.036 million, which represents the difference between the 2005 known and measurable expenses and ComEd's original estimate, as set forth in its Schedule C-10 filing, plus 41.8% of ComEd's estimated 2006 rate case expenses ($0.2599 million). *Id*. at 21-22, L. 417-444. The basis of this adjustment is the ratio of actual expenses paid to experts and consultants in 2005 (41.8%) applied to the estimated expenses as originally filed on Schedule C-10 ($910,000). *Id*. at 22, L. 432-433.

In its supplemental response to DLH-2.03, the Company provided an update of actual costs incurred through December 31, 2005, for its external consulting services, expert witnesses and legal fees in this docket. The total fees paid and accrued through December 31, 2005 were $5.047 million. CUB-CCSAO-City Ex. 5.0 at 21, L. 420-423. On April 13, 2006, ComEd also filed Exhibit 48.0 as a further supplemental response to Staff data request DLH 2.03. This exhibit "lists the amounts paid or accrued for work performed through March 31, 2006, and presents the amounts forecasted to be incurred through the remainder of the rate case proceeding." ComEd Ex. 48.0 Supplement 5. The total requested rate case expense is now $9,832,973, or $639,856 more than what the Company originally requested in its filing. Importantly, the updated amount still includes about $1.784 million in projected expenses, thus continuing to violate the Commission's known and measurable standard. Further, the projected amounts are allocated to litigation of the instant proceeding. Considering the parties are now at the post-hearing briefing stage of the case, ComEd's projected $1.784 million in rate case expense appears unwarranted and unreasonable on its face.

CUB-CCSAO-City did not have the opportunity to submit discovery on the data contained in ComEd Exhibit 48.0, nor have we been able to effectively review the data. In any case, the time for submitting additional testimony regarding any conclusions or recommendations on this additional information has long passed. Because the parties have not had the opportunity to investigate the reasonableness of these costs, and because the Company's request continues to include substantial amounts of projected expenses, CUB-CCSAO-City maintain that the rate case expense must be decreased by $1.296. CUB-CCSAO-City Rebuttal Ex. 5.01 Schedule MJM-13.1 and MJM-13.2.

11. Environmental Expenses
12. PSEG Merger Savings
13. Depreciation Expense
14. Payroll Taxes
15. Income Tax Expenses
16. Gross Revenue Conversion Factor
17. **Exelon GSA**

In 2001 in docket 00-0295 the Commission approved the Company's petition for the approval of its general services agreement ("GSA") with Exelon. Exelon Business Service Company provides a number of corporate, transactional and energy delivery services on behalf and for the subsidiaries of Exelon. The premise behind establishing a "shared services" organization is to gain cost savings and efficiencies by reducing or eliminating duplicate and redundant costs across a number of subsidiaries or operating units. CUB-CCSAO-City Ex. 2.0 at 20-21, L. 448-552.

The record in this case gives cause for concern with respect the GSA. Notably, ComEd's expenses under the GSA have increased substantially from 2003 to 2004. The rates charged under the GSA have not been yet been reviewed for reasonableness. When asked on cross-examination whether she had done an analysis of the market-based price of the rates at which GSA services are charged to ComEd, ComEd witness Houtsma responded that she had “not personally done that analysis, although I know … analyses [are] done within the company … I didn't … directly review them prior to responding to this [data request],” nor had she reviewed them in preparation for the testimony in this case. March 21, 2006 Tr. at 363-64. Thus, there is no evidence in this case to demonstrate the reasonableness of the rates charged to ComEd under the GSA.

The Commission should evaluate the rates Exelon charges to ComEd (which are supposed to be charged “at cost” as defined by Securities and Exchange Commission Rules) for all services to determine whether they are reasonable when compared to rates charged by other outside sources for similar services. CUB-CCSAO-City recommend that the Commission conduct an audit of ComEd’s GSA expenses to determine whether the $253.6 million of such expenses incurred by ComEd is fair and reasonable.

18. Other

D. Revenues

1. Weather Normalization
2. Increase in Non-DST revenues
3. Other

E. Rate of Return

1. Capital Structure - *ComEd’s Common Equity-Laden Capital Structure Is Not Just and Reasonable and Should Be Rejected by the Commission.*

ComEd proposes a capital structure consisting of 45.80% long-term debt and 54.20% common equity. ComEd Ex. 7.1. All other parties submitting testimony on the proper capital structure for the utility agreed that ComEd’s proposed capital structure is weighted with far too much common equity. Because common equity is significantly more expensive than long-term debt, the excess common equity in ComEd's proposal substantially increases the utility's revenue requirements and, thus, costs for customers. *See e.g.*, IIEC Ex. 3.0 at 17, L. 390-99.

In her direct testimony, Staff witness Sheena Kight proposed a capital structure consisting of 62.89% long-term debt and 37.11% common equity. Staff Ex. 4.1. CUB-CCSAO-City witness Edward C. Bodmer initially recommended a capital structure of 69.6% long-term debt and 30.4% common equity. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 22, L. 638-39. IIEC witness Michael Gorman proposed a capital structure consisting of 50% long-term debt and 50% common equity in his direct testimony. IIEC Ex. 3.0 at 18, L. 425-26, Sch. MPG-2 at 1. In their respective rebuttal testimonies, both Mr. Bodmer and Mr. Gorman adopted Staff witness Kight's proposed capital structure of 62.89% long-term debt and 37.11% common equity. CUB-CCSAO-City Ex. 4.0 (Revised) at 2, L. 50-57; IIEC Ex. 7.0 at 6, L. 124-31.

The difference between the unified recommendations submitted by Ms. Kight, Mr. Bodmer and Mr. Gorman and ComEd's go-it-alone approach is the treatment of the goodwill asset created at the time of the Unicom-PECO merger that led to the formation of Exelon, ComEd's parent corporation. The Unicom-PECO merger created a $4.926 billion goodwill asset that is recorded on ComEd's balance sheet. IIEC Ex. 7.0 at 5, L. 105-06. Because goodwill does not produce revenues or cash flows, it cannot be treated as debt. *Id.* at 8, L. 185-86. As a result, the goodwill on ComEd's balance sheet increases ComEd's equity balance. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 23, L. 676-78.

ComEd proposed to remove a portion of the goodwill asset from its balance sheet for purposes of determining the appropriate capital structure. Specifically, ComEd suggested that $2.292 billion be removed from the common equity balance. ComEd Ex. 18.0 at 26-27, L. 585-88. ComEd witnesses Kathryn M. Houtsma and J. Barry Mitchell asserted that the remaining portion of the goodwill asset -- some $2.634 billion -- should remain as part of the utility's common equity balance. March 22, 2006 Tr. at 483-84 (Houtsma); March 30, 2006 Tr. at 2473 (Mitchell). The $2.634 billion goodwill asset that ComEd claimed should be included in the utility's common equity balance is associated with its decision to transfer its nuclear plants to an affiliate's plants that ComEd no longer owns. IIEC Ex. 7.0 at 5, L. 113-18. The ComEd witnesses went through rote accounting exercises in an effort to explain the utility's position that the goodwill asset associated with nuclear plants that ComEd no longer owns should inflate its common equity balance. ComEd Ex. 18.0 at 26-27, L. 575-91; March 22, 2006 Tr. at 483-84 (Houtsma); March 30, 2006 Tr. at 2473 (Mitchell). However, these obtuse recitations did little more than cloud the record.

The respective testimonies of Mr. Bodmer, Ms. Kight and Mr. Gorman cut through the confusion that ComEd tried to create. Each of these witnesses pointed to a fundamental fact that showed ComEd's arguments to be little more than accounting sophistry. Mr. Bodmer, Ms. Kight and Mr. Gorman each testified that the costs approved in this proceeding must be shown to support distribution and transmission assets needed to provide service to customers. However, the $2.634 billion goodwill asset that ComEd contended should be included in its common equity balance has nothing to do with providing delivery services to ratepayers. In particular, Mr. Bodmer, Ms. Kight and Mr. Gorman testified, respectfully, as follows:

- "[G]oodwill has no benefits to delivery service customers." CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 23, L. 669-70.

- "Since rates are based on original cost rate base, capital structure should also reflect the amount of capital originally invested in a utility's assets (assuming that capital structure is reasonable from a cost standpoint), not reassessments of the fair value of the capital invested. Therefore, I agree that ComEd' capital structure, which reflects estimates of fair value for financial reporting purposes, should be adjusted to reflect depreciated original cost. [Footnote omitted.]" Staff Ex. 4.0 at 5, L. 85-90.

> Ms. Kight went on to explain that ComEd's proposal to reverse its write-down of utility plant would be appropriate if the utility still owned the nuclear plants or received assets of commensurate value when it transferred the plants. Because that did not occur, Ms. Kight concluded that ComEd's proposed "capital structure does not reflect that amount of capital originally invested in ComEd's remaining assets. As a result, ComEd's proposed capital structure overstates the amount of capital in use as of December 2004 and June 2005." *Id*. at 5, L. 91-101.

- "Goodwill is not a transmission and distribution utility asset, and common equity that was created at the same time the Goodwill asset was recorded does not represent investor capital supporting transmission and distribution assets." IIEC Ex. 7.0 at 8, L. 173-75.

- "Staff witness Kight was correct to adjust common equity by removing the full amount of the Goodwill asset. The Company's smaller common equity adjustment doesn't reflect the reality that the nuclear generating assets were written-down, which reduced common equity, and that these nuclear assets were transferred to an unregulated affiliate at the restated value." *Id*. at 8, L. 176-80.

Perhaps the most compelling and striking evidence that demonstrated the artifice of ComEd's position occurred during the cross-examination and re-direct examination of IIEC witness Mr. Gorman. During cross-examination by Staff, Mr. Gorman testified that ComEd includes more than $11 billion in capital on its balance sheet. Yet, the utility has a little more than $6 billion in rate base. March 29, 2006 Tr. at 1986. Mr. Gorman explained the discrepancy.

> So, clearly, there's a significant mismatch between the capital on the balance sheet and the amount of rate base. That difference in -- from my perspective, that difference in the capital in rate base is largely attributable to almost a five billion dollar goodwill asset which is not the transmission and distribution utility asset. And that asset -- that goodwill asset is completely supported by common equity.
>
> So the amount of capital -- ComEd's common equity in that 11 billion dollar capital component needs to be reduced by the value of that goodwill asset. That's supported only by common equity or roughly five billion dollars -- or no, 4.96 billion dollars. So when you take ComEd's common equity and reduce it by 4.96 billion dollars of common equity and say that's supporting the goodwill

> asset and the remaining common equity is supporting transmission and distribution utility plant, then you get a capital structure that roughly matches rate base.

Id. at 1986-87.

On re-direct examination, Mr. Gorman testified regarding IIEC Redirect Ex. 1, a table he created that effectively demonstrated the mismatch between the amount of capital ComEd shows on its balance sheet and the capital in rate base included in this case. IIEC Redirect Ex. 1 is reproduced below.

IIEC Cross Ex. 1

COMMONWEALTH EDISON COMPANY

Capital Supporting T&D Rate Base

Line	Test Year	Amount (000)	Source
1	Total Unadjusted Capital (1)	$11,874,770	ComEd Ex. 7.1, Schedule D-1 and WPD-1
2.	T & D Rate Base	6,189,171	Schedule A-2
3.	Incremental Capital Above Rate Bases	5,685,599	Line 1, less Line 2
4.	Good Will/Other Intangibles	4,926,000	ComEd Ex. 7.0 at 7
5.	Incremental Capital Excluding Good Will	759,599	Line 3, less Line 4

(1) Total Capital $9,582,770, add book common equity adjustment of $2,292,000 made on WPD

Mr. Gorman explained that in creating IIEC Redirect Ex. 1, he added back into ComEd's total outstanding capital the $2.292 billion that ComEd witness Mr. Mitchell recommended be removed from the common equity balance to arrive at a Total Unadjusted Capital of $11,874,770,000 (Line 1). March 29, 2006 Tr. at 2056-57. Mr. Gorman then subtracted the transmission and distribution rate base that ComEd proposes in this proceeding -- $6,180,171,000 (Line 2) -- from the Total Unadjusted Capital, leaving a difference of $5,685,599,000 (Line 3). *Id.* at 2057. That difference is roughly equal to the $4,926,000,000 in goodwill and other intangibles on ComEd's books. *Id.* Mr. Gorman concluded:

> That additional capital clearly is not being used to finance transmission distribution utility rate base. What is it being used to finance? Mostly, the goodwill asset that I identified in my testimony. The goodwill has a balance of 4 billion 926 million dollars. So most of that incremental capital, that's the subject here, is financing the goodwill asset, which is a distinct asset and separate from the assets included in the company's transmission and distribution regulated utility rate base. Goodwill is supported by common equity. It's important to remove the common equity from the $11 billion total capital to identify what capital's available to support, and the cost associated with financing, for regulated utility transmission and distribution utility rate base.

Id. at 2057-58.

In sum, the record shows that ComEd alone supports its proposed capital structure. All other witnesses testifying about this issue agreed that ComEd's proposed capital structure is laden with excess common equity. The primary source of the excess common equity is a goodwill asset that has nothing to do with transmission and distribution assets that ComEd includes in its rate base. The goodwill asset is wholly unrelated to the objective of this case – determining the costs needed to provide utility service. The goodwill asset merely inflates the common equity component of the utility's capital structure and, therefore, the rates that customers must pay. As a result, the Commission should adopt the capital structure proposed by

Staff witness Kight and adopted by CUB-CCSAO-City witness Bodmer and IIEC witness Gorman.

2. Cost of Long Term Debt - *ComEd's Proposed Cost of Long-Term Debt Should Be Reduced to 6.23% to Exclude Debt Issues That Will Mature Before January 1, 2007 -- the Date that Rates Set in This Case Become Effective.*

ComEd proposes a long-term debt cost of 6.50%. ComEd Ex. 7.1 at 1. CUB-CCSAO-City witness Mr. Bodmer demonstrated that ComEd's cost of debt is overstated and should be reduced to 6.23%. Mr. Bodmer explained that ComEd's calculation of its long-term debt cost includes debt issues that will mature before the rates in this case will become effective (*i.e.*, January 1, 2007). CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 33, L. 1005-08. Mr. Bodmer argued that because these debts will mature at or near January 1, 2007, they will not affect the utility's interest expense once the new rates are in place. *Id*. at 34, L. 1012-14.

Rather than include the cost of debt that will mature at or near the time the new rates become effective, Mr. Bodmer testified that it is appropriate to assume that the maturing debt will be refinanced. *Id*. at 34, L. 1019-20. As a proxy for the cost of the maturing debt, Mr. Bodmer used the cost of debt that Exelon issued to fund partly ComEd's pension obligations – costs the utility will incur when the new rates are in place. *Id*. at 34, L. 1023-28. The cost of the Exelon-issued debt is fixed at 4.813%. Moreover, the amount of the Exelon debt issue allocated to ComEd ($803 million) is approximately equal to the amount of debt maturing before or near January 1, 2007 ($807 million). *Id*. at 34, L. 1026-31; CUB-CCSAO-City Ex. 1.01 at 2. Replacing the cost of the maturing debt with the cost of the Exelon-issued debt reduces ComEd's cost of long-term debt from 6.5% to 6.23%. CUB-CCSAO-City Ex. 1.01 at 3.

Debt issues that will mature at or near the time rates go into effect are not relevant for ratemaking purposes. The Commission should exclude these debt issues from the calculation of

ComEd's cost of long-term debt. Instead, the Commission should adopt Mr. Bodmer's proposal to use the cost of the Exelon-issued debt as a proxy for the debt that will mature on or near January 1, 2007. Doing this provides a truer representation of ComEd's debt cost when the rates established in this case are in place.

3. Cost of Common Equity

Traditionally, because the cost of common equity is not a directly observable number, regulatory commissions have had to rely on subjective models, such as the capital asset pricing model ("CAPM") and the discounted cash flow model ("DCF"), to estimate a utility's cost of common equity. As Mr. Bodmer explained, cost of capital discussions are often opaque and include such esoteric topics as "adjustments to beta for mean reversion, quarterly versus annual discounting in the DCF model, complex statistical research on the equity risk premiums, questions about inflation risk in long-term bonds and so on." CUB-CCSAO-City Ex. 4.0 (Revised) at 5, L. 128-31. As discussed in more detail in the "Market-to-Book Ratio" section below, this often difficult and confusing process has led to returns that are higher than the utilities' actual cost of capital. *See* CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 40-45, L. 1205-1370. Mr. Bodmer testified that as long as this process produces returns above utilities' actual cost of capital, the utilities and Wall Street interests have strong incentives to perpetuate this obtuse process. CUB-CCSAO-City Ex. 4.0 (Revised) at 5, L. 142-45.

However, this case presents a unique opportunity for the Commission in that there is direct, observable data from less biased sources that the Commission can use to determine the appropriate cost of common equity for ComEd. In particular, CUB-CCSAO-City witness Bodmer developed his recommended cost of common equity based on his review of valuations conducted by three leading investment banks – Morgan Stanley, JP Morgan and Lehman

Brothers – for the merger between Exelon and PSE&G. Mr. Bodmer testified that the valuations done by the three investment banks are a far more reliable indicator of investor needs than the subjective models used to bridge evidentiary gaps "that arise because the level of return required to induce real investors to provide capital for the firm is not directly observable." CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 5, L. 145-46. Mr. Bodmer explained that the coincidence of the Exelon-PSE&G merger

> provides evidence of the rate of return required by investors from three major investment banks on whom such real world transactions depend. In published documents relating to the merger we have more direct expressions of investor expectations than is usually the case. The return on equity component used by investment banks in valuing free cash flows is the incremental return required by equity investors, exactly the same thing that [ComEd witness] Dr. Hadaway is estimating in his analysis. Given the availability of such practical information, the Commission should not prefer the indirect and theoretical over the more direct, actual data available for its consideration.

Id. at 6, L. 151-59.

This information is especially valuable because while investment banks and regulatory commissions use different methods to measure the cost of debt and to determine capital structures, "the cost of equity capital in the weighted average cost of capital is the same under the regulatory definition as it is for valuation analyses." *Id*. at 10, L. 305-08. Moreover, in determining ComEd's cost of common equity, the investment banks and the Commission share a common goal – to establish "the opportunity cost that measures required returns for investments of similar risk." *Id*. at 17, L. 503-05. While ComEd witness Hadaway criticized Mr. Bodmer's use of investment bank valuations for determining his recommended cost of common equity, on cross-examination, Dr. Hadaway agreed that the cost of equity for valuation purposes has the same theoretical purpose as the cost of equity for regulatory purposes. March 30, 2006 Tr. at

2415.

Further, investment banks have no axe to grind when conducting valuations. Mr. Bodmer pointed out that investment banks are in a highly competitive business that requires them to keep abreast of new research and to innovate quickly to ensure that their valuations are accurate. Failing to determine accurately a company's cost of equity can result in a merger not taking place or, alternatively, acquisitions to be over-priced. CUB-CCSAO-City Ex. 4.0 (Revised) at 5, L. 149-54. In contrast, traditional methods for estimating a company's cost of equity do not face the same level of real world scrutiny. The CAPM and DCF models are subject to manipulation in terms of selection of financial data used and modeling approaches. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 5, L. 125-26. Moreover, the persons applying the CAPM and DCF models often are pursuing an agenda that calls into question the impartiality of their analysis. For example, ComEd paid Dr. Hadaway a substantial sum of money to present his cost of common equity testimony. CUB-CCSAO-City Ex. 4.0 (Revised) at 6, L. 182-85. As Mr. Bodmer noted, for this sum of money, one can expect that "ComEd will get the most aggressive arguments possible to support a high return on equity." *Id*. at 6, L. 185-86. As noted above, investment banks have no such bias; indeed, their success depends on providing unbiased, objective advice.

- ***Using the Weighted Cost of Capital Determined by Morgan Stanley, Mr. Bodmer Concluded that ComEd's Cost of Common Equity Should Be 7.74%.***

Because investment bank valuations are a direct proxy for investment requirements and, therefore, are inherently more objective than subjective applications of theoretical cost of equity models, Mr. Bodmer took advantage of publicly available information regarding estimates of the weighted cost of capital developed by Morgan Stanley, Lehman Brothers and JP Morgan as part of the ongoing Exelon-PSE&G merger to establish his recommended cost of equity. Lehman

Brothers and JP Morgan produced a weighted cost of capital for Exelon, while Morgan Stanley developed a weighted cost of capital for ComEd and PECO. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 36, L. 1070-71. Because Morgan Stanley developed a weighted cost of capital for ComEd, Mr. Bodmer based his cost of common equity analysis on Morgan Stanley's results.

Morgan Stanley estimated a cost of capital for ComEd of between 5.25 and 5.75%. *Id*. at 36, L. 1071-72. In discovery, CUB asked ComEd to provide cost of common equity component of Morgan Stanley's weighted cost of capital. The utility responded that it did not have the information. *Id*. at 38, L. 1137-39; CUB-CCSAO-City Ex. 1.03. Putting aside ComEd's failure to provide information that its corporate parent undoubtedly has, Mr. Bodmer inferred the cost of capital used by Morgan Stanley by making certain assumptions about ranges of ComEd's debt to capital ratio and incremental debt costs. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 38, L. 1153-58. Mr. Bodmer's analysis showed that the range of the cost of common equity for ComEd is between 6.20% and 8.11%. *Id*. at 38-39, L. 1160-74. Based on his best estimate of ComEd's debt to capital ratio and incremental debt costs, Mr. Bodmer concluded that the utility's cost of common equity for this case should be set at 7.74%.

In his rebuttal testimony, ComEd witness Hadaway criticized Mr. Bodmer's use of the investment banks' valuations, claiming that "Mr. Bodmer's approach is fraught with personal judgment and considerable subjectivity." ComEd Ex. 21.0 at 19, L. 437-38. To back up his assertion, Dr. Hadaway modified two assumptions used by Mr. Bodmer to derive a return on equity of 11.45%. *Id*. at 20, L. 444-45. Dr. Hadaway concluded that his exercise demonstrates the sensitivity of Mr. Bodmer's approach. *Id*. at 20, L. 454-46.

However, perhaps unwittingly, ComEd undercut its own expert. Attached to Dr. Hadaway's surrebuttal testimony was a letter that Lehman Brothers provided at ComEd's request. Although the letter was stricken from Dr. Hadaway's testimony (*see* ALJ Notice of Ruling, March 21, 2006), ComEd used the letter as a cross exhibit during its cross-examination of Mr. Bodmer. *See* March 24, 2006 Tr. at 1277-78; ComEd Cross Ex. 6. Mr. Bodmer testified that the most interesting part of the Lehman Brothers letter was the author's assertion that returns on equity "are typically 300 or more basis points more than the discount rates used in investment bank fairness opinions." ComEd Cross Ex. 6 at 3. Mr. Bodmer pointed out that if one subtracts 300 basis points from Dr. Hadaway's recommended 11.0% cost of common equity, the result is 8.00% – a mere 26 basis points more than Mr. Bodmer's proposed 7.74% return on equity. March 24, 2006 Tr. at 1284. Thus, ComEd's cross exhibit confirms the reasonableness of Mr. Bodmer's assumptions in deriving his recommended return on common equity from Morgan Stanley's weighted cost of capital.[3]

- ***Numerous Changes Since ComEd's Last DST Rate Case Support Adoption of Mr. Bodmer's Recommended Cost of Common Equity.***

Mr. Bodmer identified numerous changes that have occurred since ComEd's last DST case that support adoption of his proposed 7.74% return on common equity. At a minimum, these factors show that if the Commission does not adopt Mr. Bodmer's proposal, it should adopt a return on common equity at the low range of the estimates provided by the other cost of capital witnesses. Included in the factors identified by Mr. Bodmer are:

■ <u>Changes in Personal Tax Rates</u> – Since ComEd's last DST case, personal income tax rates on dividends and capital gains have been reduced. These tax changes mean that after-

[3] Mr. Bodmer supported his conclusion regarding the cost of equity used by Morgan Stanley by applying more traditional cost of equity models. In particular, Mr. Bodmer conducted a CAPM analysis, a DCF analysis and price to earnings ratio analysis. Mr. Bodmer's CAPM analysis yielded a range for cost of common equity of 6.69 to 7.31%. CUB-CCSAO-City Ex. 1.0 at 47, L. 1411-12. Mr. Bodmer's DCF analysis yielded a cost of common equity of 7.88%. *Id.* at 68, L. 2058. His price-to-earnings analysis yielded a cost of common equity of 7.84%. *Id.* at 68, L. 2060. Each of these results confirm that Mr. Bodmer's investment bank analysis produces a reasonable cost of equity.

tax returns have increased by a substantial amount for a given level of pre-tax return. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 11, L. 323-25; at 13-14, L. 373-97.

■ Declines in Overall Level of Interest Rates – Overall interest rates have dropped since ComEd's DST rate case. At the time the order was entered in ComEd's last rate case, the yield on 10-year Treasury Bonds was 5.42%. When ComEd filed its current DST case, the long-term treasury rate was 4.02%. Mr. Bodmer pointed out that "the difference in interest rates of 1.40% is almost twice the difference in the allowed equity return from the last case versus [the utility's] request in this case (11.75% versus 11.0%.)." *Id*. at 11, L. 326; at 14, L. 410-05.

■ Lower Business Risk for ComEd – In January of this year, the Commission approved ComEd's proposal to procure power post-2006 through an auction. The auction will allow the utility to pass generation costs directly to customers. *Id*. at 15, L. 425-26. IIEC witness Robert R. Stephens testified that this process allows ComEd to transfer "all fuel cost, power procurement costs, and other operating risk associated with generation supply from itself to customers and to wholesale generation suppliers in the market." IIEC Ex. 1.0 at 4-5, L. 90-102.

■ Lower Revenue Volatility for ComEd – As part of its rate design, ComEd proposed to increase customer charges for residential customers. If accepted, the customer charge for single family customers would increase from $7.13 per month to $9.65 per month and for multi-family customers from $2.94 per month to $9.65 per month. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 15, L. 437-40. The effect of this proposal is to increase residential customers' fixed charge, which has the necessary consequence of reducing the volumetric risk that ComEd would face. In other words, "a greater proportion of ComEd's revenues will not be subject to any variation at all in energy usage," which reduces risk for the utility. *Id*. at 15, L. 440-41.

■ Completion of large investments in distribution plant – Following a number of well-publicized and widespread outages that occurred in 1999 (which followed well-publicized and widespread outages that occurred earlier in the 1990s), ComEd undertook major capital investments in its infrastructure. In fact, according to ComEd witness John T. Costello, ComEd's requested rate base in this case is $2,572.5 million more than the level the Commission approved in ComEd's last rate case in 2001. ComEd Ex. 3.0 at 7, L. 138-40. The proposed $2,572.5 million increase in rate base since that time represents more than almost 42% of ComEd's proposed $6,189.2 million rate base in this case. *Id*. at 5, L. 91. Mr. Bodmer testified that this flurry of capital investments should "mean that rate base growth relative to sales growth should moderate, and potentially allow the [utility] to earn more than its allowed return." CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 11, L. 331-33. Mr. Bodmer's comment is supported by ComEd witness J. Barry Mitchell's statement that "we expect to finance the majority of ComEd's capital expenditures with internally generated cash...." ComEd Ex. 7.0 at 5, L. 97-98. Taken together, these statements suggest that it is unlikely that ComEd will need to access the capital market in the near future.

■ Research Indicating that Traditional Methods for Estimating Cost of Equity Are Upwardly Biased – Mr. Bodmer testified regarding a growing body of research that suggests that the CAPM and DCF models overstate a company's cost of common equity. As to the CAPM model, research indicates that the use of actual realized returns in the market risk premium that is used as an input in the CAPM model inflates a company's required cost of equity. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 16-17, L. 469-89. In fact, Mr. Bodmer cited a study stating that the "level of the [market risk premium] [has] been called 'the most debated issue in finance.'" CUB-CCSAO-City Ex. 1.0 at 48, L. 1458-60, *citing* Koller, T., Goedhart, M., Wessells, D., 2005, *Valuation Measuring and Managing the Value of Companies*, Hoboken, New Jersey, John Wiley & Sons, p. 297. Mr. Bodmer also referred to an article that concluded that "'there is consensus in the academic literature that the CAPM as taught in MBA classes is not a good model – it provides a very imprecise estimate of the cost of capital....'" CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 48, L. 1458-60, *citing* Jagannathan, R. and Meier, I. 2001, "Do We Need CAPM For Capital Budgeting?", Kellogg School of Management, Finance Department, pp. 1-3.[4]

As to the DCF model, research shows that estimating the cost of equity using analyst growth forecasts in the DCF model results in a cost of equity that is too high. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 15-16, L. 448-49, 454-56. According to a study cited by ComEd witness Hadaway, analyst "growth forecasts are overly optimistic and add little predictive power." City Ex. 1.0 at 16, L. 458-60, *citing* Chan, L., Karceski, J. and Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, April 2003, p. 643. Another study found that "if analysts' growth expectations exceed the true but unobserved market expectations about future growth [the DCF formula] would itself generate an upward biased estimate of the equity premium." *Id*. at 16, L. 464-67, *citing* Arzac, Enrique, 2005, *Valuation for Mergers, Acquisitions and Restructuring*, John Wiley & Sons, p. 44.

These are only some of the factors that Mr. Bodmer identified that show that the Commission should adopt his recommended 7.74% return on common equity.

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[4] Mr. Bodmer summarized the research regarding the market risk premium component of the CAPM model at pages 60-63. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 60-65, L. 1822-1983.

This case provides the Commission with an opportunity to adopt a cost of common equity that represents a direct proxy of investor needs. Mr. Bodmer's analysis showed that a leading investment bank recently concluded that a fair cost of equity for ComEd is 7.74%. While ComEd claimed that Mr. Bodmer's analysis was speculative and subjective, its Cross Exhibit 6 (the Lehman Brothers letter), confirmed that Mr. Bodmer's recommended cost of equity is comparable to that determined by Morgan Stanley.

Moreover, the changes that have happened since ComEd's last DST rate case, including (1) lower personal tax rates, (2) lower overall interest rates, (3) lower ComEd business risks, (4) greater ComEd revenue stability if its residential rate design proposals are adopted, (5) after its catch-up spending during 1999 and the early 2000s, fewer ComEd large distribution system capital investments and (6) academic and expert criticisms that traditional methods for measuring cost of equity overstate investors' needs – and Mr. Bodmer's market-to-book ratio analysis described in Section III.D.3.c below – all augur for adoption of Mr. Bodmer's direct and objective method for determining the appropriate cost of equity for ComEd.

Alternatively, if the Commission rejects Mr. Bodmer's recommendation, these factors show that it should select a cost of equity at the low end of the ranges submitted by the other cost of equity witnesses.

a) GDP Growth Rate – *Dr. Hadaway's Use of GDP Growth Rate in His DCF Analysis Substantially Inflates His Estimated Cost of Common Equity.*

As part of his DCF analysis, Dr. Hadaway used historic gross domestic product ("GDP") to estimate long-term growth expectations. ComEd Ex. 8.0 at 27-29, L. 599-642. All other witnesses who testified regarding cost of common equity agreed that Dr. Hadaway's use of GDP growth rate is inappropriate. Each witness testified that Dr. Hadaway's use of GDP growth rate improperly inflated his DCF result. Because Dr. Hadaway testified that his primary cost of equity recommendation came from his DCF analysis (ComEd Ex. 8.0 at 16, L. 349-50), each witness concluded that Dr. Hadaway's cost of equity recommendation was overstated. A summary of Mr. Bodmer's, Mr. McNally's and Mr. Gorman's respective criticisms of this portion of Dr. Hadaway's testimony follows.

Mr. Bodmer – Mr. Bodmer described Dr. Hadaway's use of GDP growth rate as a proxy for dividend growth as wrong both from a theoretical and quantitative perspective. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 78, L. 2377-78. Mr. Bodmer pointed out that the authors of an article cited by Dr Hadaway to support his use of GDP (ComEd Ex. 8.0 at 28, L. 624-29) "criticize the use of analyst growth rates, but the criticism is that analyst growth rates are too high, not too low." CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 78, L. 2398-99, *citing* Chan, L., Karceski, J. and Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, April 2003, p. 649. Mr. Bodmer added that these authors using a 3.5% GDP growth figure, which is signifcantly lower than the 6.6% figure used by Dr. Hadaway. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 78-79, L. 2402-11, *citing* Chan, L., Karceski, J. and Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, April 2003, p. 649. Most important, Mr. Bodmer testified that Dr. Hadaway's growth rate cannot be sustained. Using Dr. Hadaway's growth rate, his dividend payout ratio and the 32.7% retention rate of the companies in his sample would mean that the utility industry would have to average an astronomical 20.2% return on equity. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 79, L. 2424-32. Such returns are, of course, not realistic.

Mr. Bodmer also noted that using a more reasonable growth rate and Dr. Hadaway's other assumptions in his DCF analysis yields cost of equity results comparable to Mr. Bodmer's

7.74% Morgan Stanley estimate. *Id*. at 70, L. 2119-29.

Mr. McNally – Mr. McNally testified that Dr. Hadaway's economy-wide 6.6% growth rate "is not a reasonable estimate of the sustainable growth of the individual companies in his samples." Staff Ex. 5.0 at 20, L. 378-82. Mr. McNally added that "the GDP growth rate is more than two percentage points higher, an increase of almost 50%, than the highest of the other ... estimates for either" Mr. Hadaway's local distribution company ("LDC") or electric companies sample. *Id*. at 20, L. 387-89. Similar to Mr. Bodmer, Mr. McNally testified that using Dr. Hadaway's 6.6% growth rate and the retention rates of his LDC and electric companies sample implies returns on equity of 20.54% for the LDC sample and 22.31% for the electric companies sample. *Id*. at 20-21, L. 392-405. Mr. McNally concluded that Dr. Hadaway's use of the GDP growth rate "leads directly to an overstated cost of equity estimate." *Id*. at 23, L. 456-57.

Mr. Gorman – Mr. Gorman testified that Dr. Hadaway's 6.6% historical GDP growth rate is out of line with economists' projections of GDP growth. Mr. Gorman stated that "consensus economists' projections of future GDP growth over the next five and ten years is 5.5%." IIEC Ex. 3.0 at 41, L. 909-12, *citing* Blue Chip Economic Forecast, October 10, 2005. Mr. Gorman explained that Dr. Hadaway's use of historical GDP as a proxy for future growth rate is inappropriate because it overstates expected future inflation rates. IIEC Ex. 3.0 at 41-42, L. 913-18; March 29, 2006 Tr. at 2039-40.

In sum, Messrs Bodmer, McNally and Gorman each demonstrated that Dr. Hadaway's use of historical GDP as a proxy for future growth rate is not supportable and inappropriately inflates his cost of equity recommendation.

b) Investment Book Analysis

See Section III.D.3 above for CUB-CCSAO-City's discussion of Mr. Bodmer's investment book analysis.

c) Market to Book Ratio – *Mr. Bodmer's Market to Book Ratio Analysis Demonstrated that Traditional Cost of Equity Methods Overestimate Investors' Requirements.*

Mr. Bodmer testified that traditional methods for measuring a company's cost of capital overstate the needs of investors. To test his theory, Mr. Bodmer analyzed the market to book ratios of 71 utility companies. CUB-CCSAO-City Ex. 1.0 (2^{nd} Revised) at 42-43, L. 1277-87; CUB-CCSAO-City Ex. 1.04. Mr. Bodmer stated that it is commonly accepted that a company earning its expected cost of capital has a market to book ratio of one. CUB-CCSAO-City Ex. 1.0 (2^{nd} Revised) at 42, L. 1256-58. If a company's market to book ratio is above one, it is earning in excess of its expected rate of return. Conversely, if a company's market to book ratio is below one, it is earning less than its expected rate of return. *Id*. at 42, L. 1261-64.

Mr. Bodmer's analysis of the 71 utilities found that on average, these companies have a market to book ratio of 1.75. That is, these utilities are earning in excess of their allowed cost of capital. *Id*. at 43, L. 1286-87; CUB-CCSAO-City Ex. 1.04. Exelon – ComEd's parent corporation – had the highest market to book ratio of all of the utility companies analyzed (3.38). CUB-CCSAO-City Ex. 1.0 (2^{nd} Revised) at 43, L. 1285-86; CUB-CCSAO-City Ex. 1.04.

Mr. Bodmer graphed the market to book ratios and returns on equity for the 71 companies he examined. Mr. Bodmer's graph showed a strong positive relationship between a utility's market to book ratio and its return on equity. CUB-CCSAO-City Ex. 1.0 (2^{nd} Revised) at 43, L. 1298-99, 1307-17. Mr. Bodmer's graph also showed that the utility with the highest market to book ratio and the highest return on equity is Exelon. *Id*. at 43, L. 1302-03.

Also, Mr. Bodmer conducted a regression analysis on the information presented in his graph. *Id*. at 44, L. 1327-45. That analysis showed that the only significant variable affecting market to book values is the cost of equity. *Id*. at 44, L. 1329-30. That is, a higher the cost of equity translates into a higher market to book value.

Mr. Bodmer concluded that his analysis invalidated ComEd witness Dr. Hadaway's risk premium approach. *Id*. at 45, L. 1363. If Dr. Hadaway's approach were valid, the utility commission rates of return he included in his analysis would have market to book ratios nearing one. *Id*. at 45, L. 1365-67. However, Mr. Bodmer's analysis showed that the market to book ratios have consistently been far above one. This confirms Mr. Bodmer's point that utility commissions have been setting returns in excess of utilities' actual cost of capital. *Id*. at 45, L. 1367-70. Mr. Bodmer's market to book analysis also provides further support for his recommended 7.74% cost of common equity.

4. Overall Cost of Capital

A utility's overall cost of capital is a function of three things: (1) its capital structure; (2) its cost of long-term debt; and (3) its return on common equity. Using the capital structure proposed by Ms. Kight and adopted by Messrs Bodmer and Gorman (62.89% long-term debt and 37.11% common equity), Mr. Bodmer's recommended 6.23% long-term cost of debt and Mr. Bodmer's proposed 7.74% cost of common equity yields an overall cost of capital of 6.79%.

F. Cost of Service Issues

1. Embedded Cost of Service Study

a. ComEd's Embedded Cost of Service Study Improperly Fails to Take Into Account Both Class Peak And Average Demand

ComEd's embedded cost of service study ("ECOSS") allocates distribution demand costs for distribution substations, distribution lines and line transformers among rate classes solely on the basis of non-coincident peak ("NCP") demand. *See* CUB-CCSAO-City Ex. 3.0 at 4, L. 76-80; Mar. 27, 2006 Tr. at 1543-44. However, because ComEd is a "wires only" distribution utility, investments in the distribution system are justified by revenue from both peak and annual usage, and distribution demand costs are fixed, the Commission should adopt an alternative approach that takes into account both peak and average demand.

CUB-CCSAO-City witness Steven Ruback testified that the unbundling of power supply and distribution in Illinois requires a re-thinking of how demand should be allocated in ComEd's ECOSS. *Id.* at 11, L. 194-96. As Mr. Ruback explained,

> [f]rom a policy perspective, a distribution only electric utility is structurally very similar to the natural gas utilities that are regulated by the ICC. A gas distribution utility purchases capacity from pipelines and independent projects and delivers gas to customers by using distribution mains. Post restructuring, the electric utility distribution company will purchase power or their customers will purchase power through marketers. The electric utility will provide distribution service. A fair approach to electric distribution cost of service would therefore be consistent with a fair approach to natural gas distribution cost of service. . . . [t]he Commission should set fair and equitable class revenue requirements by reflecting annual usage in the cost of service distribution demand allocators.

Id. at 11, L. 196-206. ComEd witness Samuel Hadaway agreed that, as a distribution-only company, ComEd shares some characteristics with natural gas LDCs. *See* ComEd Ex. 8.0 at 2, L. 29-33. In particular, Dr. Hadaway testified that, like ComEd, LDCs are not vertically integrated utilities. March 30, 2006 Tr. at 2394.

Given these similarities, ComEd's ECOSS should allocate demand-related costs on the same basis as LDCs do -- based on average annual usage as well as peak demand. As Mr. Ruback attested, "this is the approach the Commission has taken in every natural gas distribution rate case throughout the last ten years." CUB-CCSAO-City Ex. 3.0 at 11, L. 206-08; *see*, *e.g.*, *N. Ill. Gas Co.*, ICC Docket No. 04-0779, Order at 101-02 (Sept. 20, 2005); *Illinois Power Co.*, ICC Docket No. 04-0476, Order at 64-65 (May 17, 2005); *Central Ill. Pub. Serv. Co.*, ("*CIPS*"), ICC Docket Nos. 02-0798 to 03-0009 (cons.), Order at 98 (October 22, 2003); *Central Ill. Light Co.*, ICC Docket No. 02-0837, Order at 90-91 (Oct. 17, 2003). In the *CIPS* case, the Commission explained that the rationale for using the Average and Peak ("A&P") method to allocate LDCs' distribution demand costs is that distribution facilities "exist because there is a daily need for such facilities," not just because there is a need to serve coincident peak demand. ICC Docket Nos. 02-0798 to 03-0009 (cons.), Order at 98. Thus, the "A&P method properly emphasizes the average component [of demand] to reflect the role of year-round demands in shaping transmission and distribution investments." *Id.* Similarly, customer demand on ComEd's system does not occur only on a single day out of the year. CUB-CCSAO-City Ex. 3.0 at 13, L. 247-49. In light of these similarities, ComEd's distribution demand-related costs should be allocated based partly on annual usage, as are LDCs' demand costs.

In addition, there is an economic justification for allocating ComEd's distribution demand costs partly on average utilization of distribution facilities. In particular, as Mr. Ruback asserted, ComEd's distribution system would not be built if the utility's investment in the system could not be recovered through revenue from annual as well as peak usage. *Id.* at 18, L. 367-69. Indeed, revenues from kilowatt-hour charges, which reflect average rather than peak usage, represent approximately one-third of ComEd's $1,895,546,000 proposed revenue requirement. ComEd Ex. 25.0 at 8, L. 166-70; CUB-CCSAO-City Ex. 6.0 at 5, L. 114-15. This is a significant share of the revenue requirement, and is comparable to the roughly 42 percent of ComEd's revenue requirement attributable to revenue from demand (kilowatt) charges. CUB-CCSAO-City Ex. 6.0 at 5-6, L. 115-16. Without the revenue from both annual and peak usage, there would be no economic justification for ComEd's distribution substations, distribution lines and line transformers. The demand allocators used in ComEd's ECOSS fail to reflect this straightforward principle.

Additionally, allocating distribution demand costs, which are fixed, on the basis of peak demand is inconsistent with ComEd's proposed allocation of the Supply Administration Charge ("SAC"). CUB-CCSAO-City Ex. 3.0 at 15, L. 291-97. The SAC is a "charge set for each [bundled service] tariff designed to recover the costs that ComEd will incur to administer the supply function for full requirements electric supply customers." ComEd Ex. 9.0 (Corrected) at 47, L. 1009-11. Although supply administration charges do not vary based on energy usage, ComEd proposes to allocate the SAC among customer classes based on kilowatt-hours -- that is, average demand. *Id.* at 47, L. 1019-24. Mr. Crumrine asserted that this allocation method is appropriate even though supply administration costs are "essentially fixed" because "conceptually, they are incurred to provide supply to customers." *Id.* at 47, L. 1022-23. The same principle applies to distribution demand costs, which also are fixed: distribution facilities are used to provide for the local delivery of power and energy. *See* ComEd Ex. 11.0 at 7-8, L. 150-53. Thus, just as the SAC is allocated according to energy usage because the underlying costs are incurred to provide energy to customers, some portion of distribution demand costs should be allocated based on energy consumption (*i.e.*, kilowatt-hours). CUB-CCSAO-City Ex. 3.0 at 16, L. 309-14.

To adjust the ECOSS to reflect annual utilization as well as peak demand, Mr. Ruback applied a peak and average ("P&A") method that weighted each type of demand equally. *Id.* at 19, L. 387-94. Although Mr. Heintz and IIEC witness Alan Chalfant criticize as arbitrary Mr. Ruback's equal weighting of peak and average demand, (ComEd Ex. 25.0 at 6, L. 121-22; IIEC

Ex. 6.0 at 8, L. 141-42), these criticisms completely ignore Mr. Ruback's explanation of the basis for equal weighting. Specifically, Mr. Ruback stated that he calculated the system load factor on a coincident peak and non-coincident peak basis as 51.3% and 47.4%, respectively, but there were limitations in the load research used in his calculations. CUB-City-CCSAO Ex. 3.0 at 19, L. 389-94. Messrs Heintz and Chalfant apparently also did not review Mr. Ruback's testimony that, in the exercise of its discretion, the Commission "may assign an unequal weighting to demand and annual sales." CUB-CCSAO-City Ex. 3.0 at 19, L. 398-99; March 28, 2006 Tr. at 1659-70.

Accordingly, the distribution demand allocators used in ComEd's ECOSS should be adjusted to take into account class annual utilization of distribution facilities. This can be accomplished by assigning relative weight to both peak and average demand in allocating distribution demand costs.

2. Minimum Distribution System
3. Marginal Cost of Service Issues/Considerations
4. Other

G. Revenue Allocation

1. Equal Rates of Return

2. Class Risk Differentials — *ComEd's Proposed Inter-Class Revenue Requirement Should be Adjusted to Reflect that the Residential Class is Less Risky to Serve*

ComEd proposes to set its distribution inter-class revenue requirement based on equal class rates of return. CUB-CCSAO-City Ex. 3.0 at 24, L. 485-86. Because the residential class is less risky to serve than other classes of service, however, ComEd's proposed revenue allocation method is unfair and inappropriate.

The delivery service rates established in ComEd's previous two rate cases were not actually paid by residential customers because there were no alternative suppliers serving such customers. By contrast, the rates set in this proceeding will actually be paid by residential ratepayers. March 30, 2006 Tr. at 2306. In this case, ComEd proposes to increase the residential class revenue requirement by $135,729, 355 -- a 16 percent increase. *Id*. at 29, L. 589-90. In determining whether ComEd's rate proposals are just and reasonable, the Commission should consider carefully the impact of this proposed increase on the residential class. As ComEd President Frank Clark acknowledged under cross-examination, the consensus of the Rates Working Group of the Post-2006 Initiative was that in restructuring rates to more accurately reflect the cost of providing delivery and customer services, the Commission should consider such traditional rate design principles as reasonableness, rate continuity and avoidance of rate shock. *See* March 21, 2006 Tr. at 190; ComEd Ex. 1.3 at 28.

Mr. Ruback testified that to mitigate the impact on residential customers of large increases in ComEd's delivery service rates, the Commission should consider non-cost criteria as well as the cost of service. Disparities in the risk of serving particular rate classes is a key non-cost consideration in establishing class rates of return, as is relative class annual utilization of distribution facilities.[5] *Id.* at 28, L. 569-71. Taking class risk differentials into account also would be consistent with the well-established principle that the riskier a utility is, the higher the rate of return allowed by public utility commissions. The riskier a particular class is to serve, the higher the Commission should set the class' target index rate of return. *Id.* at 28, L. 581-82. Because residential customers are less risky to serve than other rate classes, *see id.* at 29, L. 602-03; CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 15, L. 432-41, the target index rate of return for the residential class should be lower, not higher, than the system average of 1.00. Yet, Mr. Ruback calculated that ComEd's proposed residential class index rate of return using the P&A methodology in the cost of service study is 1.24, or 24% higher than the system average; this is

[5] The Commission should recognize class risk differentials even if it rejects Mr. Ruback's proposal to adjust the ECOSS using a P&A methodology.

unjustifiable. To reflect the lower risk of serving the residential class, the Commission should set the class index rate of return at 97.5 percent of the system average. *See* CUB-CCSAO-City Ex. 3.0 at 29-30, L. 601-21. Applying this target rate of return alone would reduce the residential class revenue requirement by approximately $9.5 million. *Id.* at 30, L. 609-11; at 32, L. 666-69.

ComEd's and IIEC's unsupported assertions that the residential class is riskier to serve do not warrant rejecting Mr. Ruback's recommendations. Both Mr. Crumrine and Mr. Chalfant averred that the residential class may be riskier to serve because, unlike customers in large customer classes, residential customers pay bills based primarily on usage, which is affected by a number of factors beyond ComEd's control, such as weather. *See* ComEd Ex. 23.0 at 39, L. 835-41; IIEC Ex. 6.0 at 10, L. 195-201. Nevertheless, this testimony fails to consider that ComEd's weather normalization of billing determinants blunts the effect of weather on ComEd's ability to recover the costs of service. CUB-CCSAO-City Ex. 6.0 at 8, L. 169-71. Moreover, unlike ComEd's and IIEC's testimony regarding class risk differentials, Mr. Ruback's contention that the residential class is less risky to serve is supported by empirical data showing that ComEd faces far greater revenue losses when a single large customer leaves the system than when a residential customer does. *See id.* at 7, L. 145-48; CUB-CCSAO-City Ex. 6.01. And because excluding usage charges from proposed non-residential rates discourages load factor improvement, ComEd should include kilowatt-hour charges in non-residential customers rather than use their exclusion as grounds for ignoring class risk differentials. *See* CUB-CCSAO-City Ex. 6.0 at 8-9, L. 176-87.

Nor should the Commission give any weight to Mr. Crumrine's assertion that cost recovery from the residential class is less reliable because uncollectible accounts tend to be concentrated in that class. ComEd Ex. 23.0 at 39, L. 843-44. As Mr. Crumrine admitted on cross-examination, ComEd recovers uncollectible expenses through base rates. Mar. 30, 2006 Tr. at 2310. In fact, ComEd has included $13,129,000 in uncollectible expenses in its proposed revenue requirement. ComEd Ex. 19.0 (revised) at 56, L. 1182-84. Moreover, Mr. Crumrine acknowledged that ComEd is one of several Illinois utilities that initiated an ongoing Commission proceeding, ICC Docket No. 05-0237, in which the utilities propose amending Part 280 of the Commission's rules – provisions that relate to recovery of uncollectible expenses. *See* Mar. 30, 2006 Tr. at 2311. The purpose of the utilities' proposed amendments to Part 280 is to "enable utilities to more effectively monitor and manage credit risk, while promoting rate stability and *reducing the amount of bad debt*." *Central Ill. Pub. Serv. Co.*, *et al.*, ICC Docket No. 05-0237, Joint Verified Pet. at 1-2 (Apr. 4, 2005) (emphasis added).

Similarly, Mr. Crumrine's supposition that the residential class may be riskier because it "tends to have greater turnover" must fail. ComEd Ex. 23.0 at 39, L. 841. As Mr. Ruback countered, as long as the fees necessary for turnover are reasonable, "the risk to cost recovery should be negligible." CUB-CCSAO-City Ex. 6.0 at 9, L. 190-93.

Finally, CUB-CCSAO-City witness Edward Bodmer's testimony explaining why the residential class is less risky to serve stands unrebutted. In particular, Mr. Bodmer testified that residential revenues have "less variation related to overall economic activity (non-diversifiable risk) than revenues [ComEd] collects from other customer groups." CUB-CCSAO-City Ex. 1.0 (2^{nd} Revised) at 15, L. 435-37. In addition, ComEd proposes increasing customer charges from $7.13 to $9.65 per month for single family customers and from $2.94 per month to $9.65 per month for multi-family residences. *See id.* at 437-40; ComEd, Rate 1 -- Residential Service, ICC Tariff No. 4 (existing tariff); ComEd Ex. 10.9 at 1; *see also* March 30, 2006 Tr. at 2308-09. As

Mr. Bodmer explained, these increases in customer charges, which are fixed, imply that a greater proportion of ComEd's revenues will not be subject to any variation at all based on energy usage. CUB-CCSAO-City Ex. 1.0 (2^{nd} Revised) at 15, L. 437-41.

Because it fails to reflect class risk differentials, ComEd's proposed inter-class revenue allocation is unfair and should be rejected. Instead, the Commission should set the target index rate of return for the residential class below the system average, as that class is less risky to serve than ComEd's other customer classes.

3. Other

H. Rate Design

1. Customer Class Delineations

a) Residential –*The Commission Should Reject ComEd's Proposal to Consolidate the Single- And Multi-Family Subclasses Into One Class*

ComEd's residential customers currently are divided into four subclasses: (1) single-family space heat; (2) single-family non-space heat; (3) multi-family space heat; and (4) multi-family non-space heat. In this proceeding, ComEd proposes consolidating these subclasses into a single customer class. Because CUB-CCSAO-City and Attorney General ("AG") witnesses have established that ComEd's proposal is untenable, it should be rejected.

For years and through numerous rate cases, ComEd split the residential class into single-family and multi-family buildings. This distinction reflects the fact that, as ComEd's cost of service studies confirmed, distribution costs are lower for multi-family customers than for single-family customers. CUB-CCSAO-City Ex. 4.0 (corrected) at 40, L. 1211-12. As CUB-CCSAO-City witness Edward Bodmer testified in ComEd's last rate case (Docket 01-0423), the reason is "intuitively obvious, and well recognized in the electric utility industry": density affects the length or size (and cost) of distribution facilities installed to serve a particular area. CUB-CCSAO-City Ex. 4.01 at 72, L. 1413-15.

ComEd has, however, done an about-face in this case, claiming that its ECOSS shows there is no meaningful cost difference in serving multi-family and single-family residential customers. *See* ComEd Ex. 9.0 (Corrected) at 36, L. 765-69. But as Mr. Bodmer testified, the only reason ComEd can maintain that the costs of serving single-family versus multi-family customers do not differ significantly "is the crude manner in which costs are now allocated in the embedded cost study." CUB-CCSAO-City Ex. 4.0 (Revised) at 40, L. 1212-14. In particular, as was the case in Docket 01-0423, ComEd's ECOSS does not classify distribution costs according to population density. *See* CUB-CCSAO-City Ex. 4.01 at 72, L. 1401-02. In Docket No. 01-0423, Mr. Bodmer explained that:

> [t]he significant issue involving population density is within the residential class. There, most customers use overhead wire, meaning it is likely that customers in areas with higher population density will have lower costs than customers in areas with lower population density. This is simply due to the fact that less wire is required to serve the customers.

CUB-CCSAO-City Ex. 4.01 at 74, L. 1439-43. Mr. Bodmer added that ComEd should

> adjust the allocation factor for distribution cost in the same way that it should adjust the allocation factors for services and other items -- on the basis of the relative cost of serving representative actual customers. This adjustment should be developed from accurate actual data on the miles of distribution lines and the actual cost of serving different density areas.

Id. at 74, L. 1450-54. Because the allocation factors in ComEd's ECOSS in this case are flawed in this same respect, ComEd's claim that the cost of serving single- and multi-family buildings is not significantly different is entitled to no weight. *See* CUB-CCSAO-City Ex. 4.0 (corrected) at 40, L. 1214-15.

Even setting aside these flaws, AG witness Scott Rubin testified that ComEd's own cost of service study shows a 36 percent difference in the cost of serving single-family versus multi-family customers. AG Ex. 1.0 at 15, L. 313-15. Although Mr. Crumrine has characterized this substantial cost difference as insufficient to warrant maintaining separate classes for multi-family and single-family customers, he has not identified how large a cost difference is required in his view before customers should be moved to separate classes. Thus, ComEd's proposal to restructure the residential class is unsupported and unreasonable, particularly in light of Mr. Rubin's testimony demonstrating that consolidating single- and multi-family customers onto a single rate would have an "enormous impact on low-use, multi-family customers." *Id.* at 16, L. 329-30.

Indeed, the impact on low-use, multi-family customers alone warrants rejecting ComEd's rate design proposal. Mr. Rubin testified that eliminating the distinction between multi-family and single-family customers would produce extraordinarily high rate increases for many multi-family customers. Mr. Rubin submitted a bill impact analysis showing that depending on the energy prices resulting from the auction ComEd plans to use to procure electricity in the post-transition era, bills for customers in multi-family buildings who use between 51 and 100 KWH per month would increase by 55 to 70 percent, while bills for multi-family building customers who use less than 50 KWH per month would increase ***by 115 to 125 percent***. *Id.* at 12, L. 256-59. Hundreds of thousands of low-use, predominantly non-space heating customers in multi-family buildings would thus face prodigious increases in their electric bills as a result of being moved to a consolidated rate with single-family customers. *Id.* at 12-13, L. 259-64.

Messrs Rubin and Bodmer have established that ComEd's proposal to eliminate the distinction between multi-family and single-family ratepayers is not cost justified and would sharply and unreasonably increase rates for low-use, multi-family customers. Accordingly, the Commission should require ComEd to maintain the existing separate classes for multi-family and single-family customers.

b) Non-residential

(1) Railroad Class

(2) Very Large Load Customers

(3) High Voltage Class Rates

(4) Other Classes

2. Relative Class Annual Utilization of Distribution Facilities—*The Commission Should Take Into Account Class Utilization of the Distribution System in Allocating ComEd's Revenue Requirement Among the Rate Classes*

ComEd's proposed class revenue allocation is based solely on the ECOSS, and does not consider rate impacts on particular customer classes. CUB-CCSAO-City Ex. 3.0 at 24-25. As a matter of fairness and equity, the allocation of ComEd's revenue requirement among the rate classes should take into account relative class utilization of the distribution system.

As Mr. Crumrine agreed on cross-examination, rate moderation is a well-established rate design principle. *See* March 30, 2006 Tr. at 2295. And logically, rate mitigation should be applied, not just to ComEd's procurement of power, but to its distribution function as well. CUB-CCSAO-City Ex. 3.0 at 26-27, L. 535-40. As discussed above, to mitigate the impact on residential customers of ComEd's proposed $135.7 million increase in residential distribution rates, the Commission should consider criteria other than just cost of service, including average class utilization of distribution facilities and class risk differentials. *Id.* at 29, L. 589-96. Adopting a reduced rate increase of $45.2 million -- $90.5 million less than ComEd's proposed increase -- based on Mr. Ruback's adjusted P&A cost of service study would appropriately reflect these key non-cost criteria. *Id.* at 30-31, L. 627-30.

Additionally, ComEd's insistence that inter-class revenue requirements be based entirely on cost ignores the limitations of cost of service studies. *Id.* at 25, L. 509-13. Indeed, ComEd witness Alan Heintz admitted under cross-examination that developing distribution demand allocators in cost of service studies is not an exact science, and accordingly requires some judgment. March 27, 2006 Tr. at 1545. As Mr. Ruback testified, numerous methodologies with the potential for widely varying results can reasonably be used in conducting cost of service studies. For example, measurements of demand used in developing allocation factors are the product of load research, which, as Mr. Ruback explained, is not unassailable. CUB-CCSAO-City Ex. 3.0 at 26, L. 514-18.

In addition, ComEd's slavish adherence to the ECOSS in setting class revenue requirements is inappropriate given that this proceeding concerns retail distribution rates for a monopoly service. *Id.* at 25, L. 501-02. As Mr. Ruback explained, basing revenue requirements on the system average rate of return is proper in determining wholesale and jurisdictional revenue requirements, which do not implicate rate impacts on particular classes, but not in establishing inter-class retail distribution revenue requirements. Doing otherwise would strip the Commission of its discretion to mitigate customer impacts in setting class revenue requirements. *Id.* at 25, L. 502-07.

The Commission should ensure that the allocation of ComEd's revenue requirement among customer classes is fair and avoids rate shock. To do this, class revenue requirements must be based on criteria other than just cost, including relative class utilization of the distribution system.

3. Environmental Cost Rate Redesign
4. Rider ECR
5. Rider AC7
6. Rider CLR7

7. Elimination of Riders ISS, 26, 27, 30, 32
8. Elimination of Rider 25
9. Rider DE
10. Rider NS
    a) Reserved Capacity Charge
    b) Standard Service Construction Costs
    c) Effect on Existing Contracts
    d) Rider NS and Elimination of Rider 8
11. Rider POG
12. Rider GCB7
13. Rider QSW
14. Rider TSS
15. Rider TAX
16. Rider ML
17. Rider RESALE
    a) Issues That Have Been Resolved
    b) Unresolved Issues
18. Rate RDS (CTA)
19. Rate BES-RR
20. General Terms and Conditions
21. Demand Charge
22. Proposed Change in Definition of Maximum kW Delivered
23. Single Monthly Peak Vs. Average of 3 Peaks for Municipal Pumping
24. Municipal Pumping Class in Demand-based Categories
25. Credit for CTA's Own Transformation and Distribution
26. Supply Administration Charge

27. Real Time Pricing Meters and Energy Smart Pricing Plan[6]

CUB and the City have proposed a program to expand existing residential real time pricing ("RTP") programs for up to 70,000 customers over three years. Currently there is an RTP pilot in ComEd's service territory with approximately 1,300 participants. CUB/City's proposal would expand the program incrementally from 15,000 customers in year one to 70,000 customers over three years. Additionally, CUB/City's proposal spreads the costs of the program over the entire residential customer base. CUB and the City believe that this program would reduce barriers to RTP participation and would provide valuable reliability benefits to the overall electrical system.

[6] This argument is presented by CUB and the City only. CCSAO believes this important issue should be the subject of a separate proceeding by the Commission.

Staff generally supports RTP, but proposes another small pilot limited to 2,000 customers before expanding to the size program CUB and the City support. As explained below, CUB and the City believe that while questions regarding total net benefits cannot be specifically answered at this time, the available evidence supports moving forward as CUB-City propose.

Real Time Pricing is an alternative rate structure that allows customers the opportunity to reduce their electricity expenditures by responding to prices as they occur. CUB-City Ex. 1.0 at 6, L. 103-09. Customers receive price signals regarding peak prices from the utility a day in advance and can adjust their electricity usage accordingly. In addition to reducing electricity bills for RTP participants, customer response to high prices benefits the entire system by reducing demand and decreasing the strain placed on the electricity grid during periods of high demand. Staff Ex. 20.0 at 6, L. 131-37.

The price of electricity can vary significantly throughout the daytime hours, especially during periods of high demand. In fact, over the span of just a few hours prices may increase by as much as a hundred-fold. CUB-City Ex. 1.02 at ES-1. Historically, consumers have been insulated from these price swings because they pay flat rates for electricity. These rates do not vary as the underlying price of electricity changes. CUB-City Ex. 1.0 at 6 L. 103-05. As a result, consumers do not see the price of the electricity that they actually use. This lack of a transparent price signal causes customers to over-consume when electricity is scarce and prices are high, and under-consume when electricity is abundant, and prices are low. Such behavior strains the electricity grid and results in increased costs for consumers. Commissioner Cross Ex. 1.0 at 69-73.

For customers to participate in RTP plans, ComEd must install meters with interval demand register (“IDR meters”) that can record customer usage based upon when it occurs. The cost of these meters is significantly greater than the cost of ComEd's standard meters for residential customers. CUB-City Ex. 1.0 at 8, L. 145-50. In direct testimony, Christopher C. Thomas, CUB's Director of Policy, proposed that the Commission take action to spread the cost of RTP metering, across all residential customers to reduce financial barriers to participation. CUB-City Ex. 1.0 at12-13, L. 236-49. If the costs are not spread across the class, then the price of the meter will make participation prohibitive. CUB-City Ex. 1.0 at 8 L. 149-59.

Staff has questioned customer responsiveness to price and has proposed that more detailed study is necessary to fully address this question. Staff Ex. 20.0 at 7 L. 149-57, Ex. 22.0 at 21 L. 470-71. CUB and the City disagree. The record indicates that customers do respond to prices. The Center for Neighborhood Technology's Community Energy Cooperative ("CEC") Energy Smart Pricing Plan ("ESPP") is a pilot residential RTP program sponsored by ComEd and the Illinois Department of Commerce and Economic Opportunity ("DCEO"). The results of the ESPP demonstrate that:

a. Customers respond to price notifications;
b. Participants consume less electricity during high priced periods - indicating that they respond to price signals; and
c. Customers are more aware of energy usage, as survey responses indicate.

CUB-City Ex. 1.02 at ES-7; Ex. 4.0 at 16-17 L. 355-62; Ex. 4.01 at S-5.

Staff has recommended that more detailed analysis of net system benefits, or the benefits all customers receive from individual customer response to prices, is needed before CUB-City's proposal can be implemented. Staff Ex. 20.0 at 6-7, L. 144-47. CUB and the City share Staff's concerns about net system benefits but disagree that they must be precisely calculated in the instant proceeding. The Department of Energy ("DOE") and International Energy Agency

("IEA") reports, Commissioners' Cross Exhibits 1 and 2, describe the potential benefits of RTP and indicate that precise valuation of these benefits remains a challenging task. The IEA report is the first attempt to craft a consistent methodology for modeling system-wide net benefits. The DOE report was unable to estimate nationwide net benefits because of the inconsistent methodologies used by the past research in the U.S. However, while exact quantification remains difficult, both of these studies indicate that benefits do exist. Based on this accumulated research, and the testimony supporting the potential benefits for Illinois consumers, there is enough evidence supporting CUB-City's proposal to move forward with implementation. CUB-City Ex. 4.0 at 17, L. 362-71. CUB-City's proposed program will provide customers immediate benefits, both to individual users and system wide, and provide experience and data for a more complete and precise analysis of projected benefits in Illinois. ComEd Ex 46.0 at 19, L. 395-97.

When the parties first filed testimony in this proceeding, there was substantial disagreement over the actual per-meter costs that the utility should be allowed to recover. Since the filing of testimony, however, CUB, the City, and ComEd have reached an agreement regarding the cost and useful life of the IDR meters necessary for RTP. CUB-City Ex. 4.0 at 5, L. 78-86; ComEd Ex. 46.0 at 31, L. 633-35.

While CUB-City and ComEd have agreed on the cost and useful life of IDR meters, there are two other remaining issues. The first issue is the appropriate cost of capital used to set ComEd's rates. This cost of capital affects the calculation of meter lease rates contained in Rider ML. In turn, these meter lease rates affect the program implementation costs necessary to implement CUB-City's proposal. The issues surrounding capital costs are fully addressed in the cost of capital section of this brief. The Commission's decision on this issue will affect the calculation of the meter lease charges in Rider ML. CUB-City Ex. 4.0 at 5-6L. 9499.

The second issue of disagreement is ComEd's inclusion of inflation in meter exchange labor rates. ComEd has included inflation to increase costs without also recognizing that cost reductions from efficiency gains likely will occur in the future. This is inappropriate because ComEd's cost will inevitably decline as the Company gains more experience with residential IDR metering and becomes more efficient. These efficiencies should be recognized by removing inflation from the cost of performing meter exchanges. CUB-City Ex. 2.0 at 14 L. 313-23.

If the Commission adopts CUB-City's proposals on these two issues, the monthly customer charges will be lower than ComEd has proposed. ComEd proposes a monthly customer charge of $0.09 for the administrator's low estimate of 30,000 participants, and a monthly customer charge of $0.16 for the administrator's high estimate of 70,000 participants. ComEd Ex. 46.1. As shown in CUB-City Exs. 4.03 and 4.04, the appropriate customer charges should be $0.086 and $0.148 respectively. These proposed charges for CUB-City proposal ensures that ComEd has an opportunity to recover its costs. CUB and the City believe that dealing with this issue in the current rate case is the clearest method for implementing CUB-City's proposal and ensuring cost recovery for the utility. CUB-City Ex. 4.0 at 17 L. 372-75. In fact, even though the exact rates have been a topic of disagreement, the utility supports the CUB-City proposal. ComEd Ex. 23.0 at 42-43 L. 912-24.

Staff's proposal to conduct a load research program before expanding the CUB-City recommended residential RTP program is unnecessary. Staff Exs. 20.0 at 7 L. 149-57; 22 at 26 L. 575-78. Customer behavior under the existing ESPP has been extensively researched, and the proposed budget for the expanded program includes an allocation for load research and program evaluation. ComEd Ex. 23.2. The Current administrator has indicated a willingness to work with Staff to develop acceptable load research programs as the program develops. CUB-City Ex. 4.0 at 12, L. 256-61.

CUB and the City are concerned that Staff's proposed research plan is too small in scale and too short in duration to achieve the benefits that Staff desires. Without a significant real time pricing program in place, it will be very difficult, if not impossible, to create a more precise analysis of net benefits in Illinois. The previous ESPP research shows that customers do respond to price signals, and a larger program should demonstrate the extent to which this response can be achieved on a larger scale for a longer time. CUB-City Ex. 4.0 at 13, L. 264-71.

The Commission should act now to expand residential real time pricing programs. Delaying implementation of CUB-City's proposal or initiating a separate proceeding would raise a host of cost recovery issues, including single-issue ratemaking. This is unnecessary given that the CUB-City proposal produces important benefits for both participants and non-participants. CUB and the City are very mindful of the costs that this program will impose on all customers. At the proposed level, customers' annual electricity bills will increase by $1.80. CUB and the City believe that this rate increase would provide data and experience that is crucial to the future of Illinois consumers in restructured energy markets, and valuable rate options for residential end users, and would be a wise investment in the future reliability of the overall electricity system. CUB-City Ex. 4.0 at 17-18, L. 377-86.

28. Distribution Loss Factors
29. Replacement of Rider 28 with Rider LGC
30. Other

IV. CUSTOMER CHOICE AND RETAIL SUPPLIER ISSUES

A. Clarification of Tariffs for Post-transition Period
B. General Account Agency
C. Electronic Data Interchange
D. Data Exchange for PowerPath
E. Improved Electronic Communication with Customers/RESs

F. Utility Consolidated Billing with Purchase of Receivables
G. Other

V. STAFF REPORTS ON COMED'S PERFORMANCE

A. Tree Trimming
B. Reliability Performance
C. Electric Metering

VI. RESPONSE TO COMMISSIONER QUESTIONS RELATING TO DEMAND RESPONSE[7]

At the hearing there appeared to be almost no substantive disagreement in response to the questions posed by Commissioners Ford and Lieberman. The few disagreements that exist have been covered in response to III. H. 27. (Real Time Pricing Meters and Energy Smart Pricing Plan) above. CUB and the City reserve the right to respond to issues raised in the briefs of the other parties.

VII. OTHER ISSUES

VIII. TABLE OF PROPOSED ADJUSTMENTS

IX. ACRONYMS AND TERMS

CONCLUSION

For the reasons discussed herein, CUB-CCSAO-City respect fully request that the Commission reject ComEd's rate increase as proposed. Instead, the utilitiy's proposal should be modified as set forth in this brief.

[7] The Cook County State's Attorney's Office did not file any testimony in response to the Commissioners' questions on demand response. Ultimately, this important issue should be the subject of a Commission proceeding.

Respectfully submitted,

CITIZENS UTILITY BOARD,

April 25, 2006

By: ______________________________

JULIE SODERNA

CITIZENS UTILITY BOARD

Julie Soderna
Melville Nickerson
Citizens Utility Board
208 S. LaSalle, Suite 1760
Chicago, IL 60604
(312) 263-4282
(312) 263-4329 fax
jsoderna@citizensutilityboard.org
mnickerson@citizensutilityboard.org

Respectfully submitted,

April 25, 2006

RICHARD A. DEVINE,
STATE'S ATTORNEY OF COOK COUNTY

MARIE D. SPICUZZA
Assistant State's Attorney

RICHARD A. DEVINE
STATE'S ATTORNEY OF COOK COUNTY

Mark N. Pera
Supervisor, Environment and Energy Division
Marie D. Spicuzza
Deputy Supervisor, Environment and Energy Division
Allan Goldenberg
Assistant State's Attorneys

Cook County State's Attorney's Office
69 West Washington, Suite 3130
Chicago, Illinois 60602
312-603-8600
312-603-9835 (fax)
mpera@cookcountygov.com
mspicuz@cookcountygov.com
agolden@cookcountygov.com

Respectfully submitted,

April 25, 2006

MARA S. GEORGES
CORPORATION COUNSEL
CITY OF CHICAGO,

By: ____

RONALD JOLLY
Senior Counsel

MARA S. GEORGES
CORPORATION COUNSEL

Ronald D. Jolly
Senior Counsel
J. Mark Powell
Assistant Corporation Counsel
City of Chicago
30 N. LaSalle St., Suite 900
Chicago, Illinois 60602
312-744-6929
rjolly@cityofchicago.org
mark.powell@cityofchicago.org