STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

CENTRAL ILLINOIS LIGHT COMPANY,	)	
d/b/a Ameren CILCO	)	**ICC Docket No. 06-0070**
	)	
Proposed General Increase For Delivery Services	)	
	)	
	)	
CENTRAL ILLINOIS PUBLIC SERVICES	)	
COMPANY,	)	
d/b/a AmerenCIPS	)	**ICC Docket No. 06-0071**
	)	
Proposed General Increase For Delivery Services	)	
	)	
ILLINOIS POWER COMPANY,	)	
d/b/a AmerenIP	)	**ICC Docket No. 06-0072**
	)	
Proposed General Increase For Delivery Services	)	**(consolidated)**

INITIAL BRIEF OF THE CITIZENS UTILITY BOARD

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TABLE OF CONTENTS

I. Rate Base

- A. Plant Additions
- B. Pro forma Plant Additions
- C. G&I Plant
  - 1. G&I Plant Amortization
  - 2. Plant transfer
  - 3. Functionalization of Plant
- D. Reallocation of Depreciation Reserve
- E. OPEB Liability
  - 1. Unfunded OPEB
  - 2. ADIT Treatment
- F. Cash Working Capital
  - 1. Lead/lag methodology
  - 2. Interest Expense Lead
  - 3. Capitalized Payroll in CWC Requirements
  - 4. Payroll Withholding Taxes
  - 5. Expense levels to which cash working capital factors are applied.

II. Operating Expenses and Revenues

- A. Income Statement
- B. Vegetation Management/Tree Trimming
- C. Injuries and Damages Expense
- D. Rate Case Expense
  - 1. Delivery Services
  - 2. Post-2006 Basic Generation Services

3. Depreciation Study

E. A&G Expenses

1. Incentive Compensation

2. Pension and OPEB Expense

3. Major Medical

4. Other A&G

F. Effect of Ameren Ownership on IP Expenses

III. **Rate of Return……....3**

A. **Capital Structure……3**

1. Capital Structure Measurement Period

2. Imputed Capital Structures

3. CILCO $4.64 Preferred Stock Expense

B. Measurement date of Short-term and Variable Interest Rates

C. Cost of Illinois Power TFTNs

D. **Cost of Equity……6**

1. **Rating Agencies……6**

2. **Methodology…….10**

3. Appropriate comparison proxy groups

4. Period of relevant data to be used

5. **Appropriate cost of equity…….……..14**

IV. **Rate Design……...……15**

A. Customer Class Issues

B. **Cost of Service Issues…….……..15**

1. Segregation and accounting for delivery service and generation-related uncollectible expenses

2. Development of Meter Costs v. Customer Costs

C. **Inter-Class Allocation Issues…….…….19**

1. **Allocation methodology……..19**

2. Minimum Distribution System Study

D. Rider QF

E. Supply Procurement Adjustment

1. Recovery of supply-related costs

2. Amount of supply-related costs

3. SPA tracking through the Market Value Adjustment Factor

F. Line Extension Refunds

G. **Residential RTP Program……...…….22**

H. Uniform Lighting Rates for AmerenIP

V. Miscellaneous Service Issues

A. Ameren Companies' communications

1. With customers

a. RES review

b. Billing separation

2. Website

3. RES

a. Point of contact

b. Use of EDI framework/automation

c. Documentation of Switching Rules

B. Contracts and Service Agreements

C. Line and Service Extensions

D. Metering Services

E. Vegetation Management/Tree Trimming

VI. Responses to Commissioners' Questions

INTRODUCTION

In the beginning of 2006, Central Illinois Light Company, d/b/a Ameren CILCO ("CILCO"), Central Illinois Public Services Company, d/b/a AmerenCIPS ("CIPS") and Illinois Power Company, d/b/a AmerenIP ("IP")(collectively referred to as the "Ameren Utilities" or "Ameren") filed these consolidated cases under Section 16-108 of the Public Utilities Act ("Act" or "PUA"). Section 16-108 establishes a process for the development and approval of delivery services tariffs ("DSTs") post restructuring. The Ameren Utilities therefore initiated these proceedings, *inter alia*, to establish the terms and rates that their residential ratepayers will be charged for delivery services beginning in 2007.

As pointed out in more detail below, rates paid by the Ameren Utilities residential customers for delivery services must be "just and reasonable." 220 ILCS § §5/9-101& 5/16-108. The Ameren Utilities have failed to meet their burden of proof to demonstrate the justness and reasonableness of their proposed rates and should not be allowed to recover overstated and unsupported costs. There are a number of areas in which they have overstated their rate base, capital structure, rate of return and other expenses in the revenue requirement.

Among other things, the Ameren Utilities have asked for a rate of return on equity capital of over 11%. This rate of return was admittedly inflated by Ameren's expert witness, Ms. McShane, from her initial calculations of about 8.8%. Ms. McShane's initial rate of return calculations using accepted methodologies yielded rates closer to Cub's proposed 8% return, rather than the Company's desired 11% rate of return on equity.

In addition, the Ameren Utilities have inflated their capital structure, proposing capital structures for the three utilities that range from 47 to 55 percent. If allowed to collect on these inflated rates of return and capital structures, the Ameren Utilities would unlawfully be

overcharging their customers.

The Citizens Utility Board ("CUB") has proposed rates of return of 8% on equity capital and capital structures of between 32 to 44 percent equity. CUB's proposals leads to rates that are "just and reasonable" while giving the Ameren Utilities a sufficient return on their investment. Therefore, CUB's proposals should be adopted by the Commission.

In addition to Ameren's inflated rates of return and capital structure, the companies continue to use the "Peak Demand" methodology in allocating distribution demand costs among customer classifications. As explained below, the application of this methodology leads to higher allocation of distribution demand costs to residential customers, thereby increasing their rates.

Legal Standards and Ratemaking Principles

In its determinations in the present proceeding, the Commission must follow several governing legal ratemaking principles. The first, and most important, principle 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. *Id. See also United Cities Gas Co. v. Ill. Commerce Comm'n*, 163 Ill.2d 1, 23-24 (1994). Second, utilities are permitted only a "sufficient return on their investment to attract capital in the financial markets at competitive rates." § 5/1-102 (a) (iii). Third, 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).

In *CUB v. ICC*, 276 Ill. App. 3d 730, 737 (1995), the Illinois Court warned: "current

ratepayers should pay for only that [aspect of the business] which produces current benefits." (276 Ill. App. 3d at 741.) Additionally, citing Section 9-230 of the Act, the Court stated:

> [t]he legislature has directed the Commission to protect against the increased cost of capital sought by a utility with such an inflated level of equity. … [T]he Commission should disallow recovery of any cost of capital in excess of that reasonably necessary for the provision of services. If a utility has included excessive equity in its capital structure, it has inflated the rate of return and its capital cost.

Id. at 745-46.

From the foregoing, it is clear that the Commission's mandate in this matter is to determine whether the rates proposed by the Ameren Utilities are just and reasonable and the rate of return is "sufficient to attract investors". The burden to prove the justness and reasonableness of the proposed rates and the sufficiency of the return falls squarely upon the Ameren Utilities.

III. Rate of Return

A. Capital Structure

The Commission should reject Ameren's proposed Capital Structures since the proposal is not just and reasonable.

A critical issue here is the appropriate capital structure for the Ameren Utilities for ratemaking purposes. Essentially, the capital structure is the mixture of debt and equity financing that a company uses to finance its operations. Equity is the stake that shareholders have in the business and debt is the money that the company barrows. The mix of debt to equity has an impact on Ameren's revenue requirements. Ameren proposed a higher mix of equity over debt—in the range of 47 to 55 percent equity. The combination of the Ameren Utilities' overstated rate of return and their proposed high percentage of equity over debt creates an unreasonably high overall cost of capital, which in turn, leads to inflated rates for consumers.

The Ameren Utilities have proposed a capital structure in the range of 47 to 55 percent equity. The reason is obvious. The Ameren Utilities' debt service charge (about 6%) is cheaper

than their proposed return on equity (over 11%). The combination of their overstated rates of return and their proposed high percentage of equity over debt creates greater revenue streams, which inures to the benefit of the Ameren Corp. and to the detriment of ratepayers.

In arriving at his opinions about the Ameren Utilities' proposed capital structure, Mr. Bodmer analyzed various issues associated with capital structures, including goodwill, bond-rating targets and whether a hypothetical capital structure is appropriate for establishing capitalization ratios. Cub Ex.1.0, pp. 86-88. He concluded that the capital structure percentages proposed by the Ameren Utilities were not appropriate. *Id.* He determined that the capital structures did not correspond to the rate bases because of goodwill, inter-company notes and other issues. Id. He further explained that the equity injections prior to the rate case did not represent the least cost option from a ratepayer perspective. *Id.*

Mr. Bodmer also concluded that the Ameren Utilities' low level of business risk allows the company to maintain a relatively high debt to equity capital percentage. *Id*. at 87 In a book written by two senior credit analysis professionals from Standard and Poor's in 2005, Blaise Ganguin and John Bilardello explain the relationship between business risk and financial leverage as follows:

> Another way of thinking about the relationship between business and financial risks would be to allow more aggressive credit ratios when the business risk is lower. Let's take the case of water utilities: In most cases, both supply and demand are generally fairly predictable, and once pipes are in the ground and maintained properly, the cost of running a water utility is very predictable. Hence cash flow predictability and volatility should be fairly good, allowing a higher level of financial risk.[1]

Id. at 87-88

Post-2006, the Ameren Utilities' financial risk would be quite analogous to the water utility in the above quote and would be able to operate with high debt leverage. In Mr. Bodmer's

opinion, the ICC should encourage distribution companies to take advantage of high debt capacity given their very low business risk. *Id.* at 88. Mr. Bodmer therefore concludes that the Ameren Utilities' proposals do not lead to "just and reasonable" rates for consumers. *Id.*

After concluding that the Ameren Utilities' proposed capital structures were inequitable to ratepayers, Mr. Bodmer computed an appropriate equity ratio for each company. *Id*. pp. 88-91. He used financial ratio guidelines published by Standard and Poor's for BBB rated companies and then derived a hypothetical capital structure through construction of prospective ratios using the recommended return on equity and the capital structure. *Id*. He applied the approach using a return on equity of 8% and each company's financial statements. In this analysis the finds from operations the ("FFO")/Interest coverage and the FFO/Debt coverage remain in the BBB range for each of the companies.

Commission Staff witness, Ms. Kight, in the ComEd DST case, No. 05-0597, also recommended this BBB range. CUB Ex.3.0 at 10-11. Ms. Kight explained that, "A credit rating of BBB indicates an adequate capacity to meet financial commitments. A debt issuer with a BBB credit rating has access to debt capital under most, if not all, financial market conditions while taking greater advantage of the tax-deductibility of debt interest than capital structures that support higher credit ratings." *Id* at 10.

Mr. Bodmer concluded that the most appropriate capital structures are:

CIPS Capital Structure

	Proportion
Short-Term Debt	0.49%
Long-Term Debt	67.16%
Preferred Stock	4.73%
Common Stock	27.63%
Total	100.00%

[1] Ganguin, B. and Bilardello, J., 2005, Fundamentals of Corporate Credit Analysis, McGraw-Hill Books, p. 277.

CILCO Capital Structure

	Proportion
Short-Term Debt	20.04%
Long-Term Debt	36.86%
Preferred Stock	8.66%
Common Stock	34.44%
Total	100.00%

IP Capital Structure

	Proportion
Short-Term Debt	0.00%
Transitional Funding Trust	15.41%
Long-Term Debt	41.07%
Preferred Stock	2.06%
Common Stock	41.46%
Total	100.00%

See CUB Ex. 3.0, p. 3 (revised July 20, 2006).

D. Cost of Equity

1. Rating Agencies

The Commission should reject Ameren's proposed Cost of Equity since the proposal is not just and reasonable.

The ***cost of equity capital*** is the minimum rate of return that investors in a stock with similar risks to the Ameren Utilities would require to make an investment in that stock. Cub Ex. 1, p. 9 Unlike the cost of debt capital, the cost of equity capital cannot be directly observed in loan agreements or bond prospectuses. Id. Instead, the cost of equity capital is usually determined indirectly through applying an analytical model to stock market data. *Id.*

As Mr. Bodmer explained, setting the return on the original investment made by a company equal to the cost of capital is a long standing principle of regulation. *Id.* at 10-13. This principle ensures that regulated companies can raise money for additional investments. *Id.* If the return is set below the cost of capital, then the companies will have trouble financing new

investment at reasonable rates. *Id.* On the other hand, if the return on equity is above the cost of capital, then an uneconomic and unfair wealth transfer from ratepayers to investors is occurring. *Id.*

As Mr. Bodmer also explained, the problem with setting the return on equity is that, unlike other components of the revenue requirement, one cannot directly observe the cost of equity component. *Id.* This implies that, before the fact, it is not possible to determine if the calculated return on equity indeed corresponds to the actual cost of equity capital. *Id.* However, after the fact, if prices are set according to the traditional principle of using incremental market based capital costs to determine the appropriate return on the firm's original investment, then the market capital of the firm should be about equal to the original investment, or book value. This means that observed market to book ratios of about 1.0 provide evidence that companies are earning their cost of capital.

As Mr. Bodmer further explained, the main implication that market to book ratios are above 1.0 for regulated utility companies is not complicated. *Id.* at 10-12. Market to book ratios are above 1.0 when companies earn a return on their original investment that exceeds their cost of equity capital. In the case of the Ameren companies' parent Ameren Corp., the company's market capitalization divided by the equity investment (excluding goodwill) yields a market to book ratio of 1.95. *Id.* This indicates that without any rate increases, the holding company is already earning more than its cost of equity capital. This situation arises because returns granted by regulatory commissions remain at levels that clearly exceed market-based cost of capital calculations. Market to book ratios of above 1.0 in the past decade reveal that utility companies have consistently earned more than their cost of capital. *Id.* This amounts to a wealth transfer from ratepayers to investors.

Utilities also often refer to previous rate cases to "justify" the rates they seek in the present. IP was granted a return on equity of 10.80% in August 1999 and CILCO was granted a return of 10.52% in the same month. *Id.* at 13-15. The last delivery rate case for CIPS resulted in a settled return on equity of 11.25%. While the requested return on equity of 11% when compared to the earlier returns granted by the ICC may appear reasonable, changes in the federal tax law, in interest rates, in the requested capital structure and in the Ameren Utilities' present risk demonstrate that they are in fact requesting a much higher return than that granted in previous cases. *Id.*

Among other things, changes in the tax law have lowered the Ameren Utilities' pre-tax cost of equity. *Id.* pp. 15-17. The marginal income tax rate now is 33% versus 36% in 2001. The tax rate on dividends is now 15% versus 33% prior to May 2003. The long-term capital tax rate is now 15% versus 20% prior to May 2003.

In its rate orders, the ICC grants utility companies a pre-tax return on equity rather than an after-tax return. *Id.* at 15-17. Investors, however, are ultimately interested in the amount of money that goes into their pockets after they pay taxes. Significant reductions in the income tax on dividends and capital gains paid by investors as a result of the Bush Administration tax law changes in 2001 and 2003 have affected the pre-tax return required by investors. These tax reductions mean that if the ICC grants the same pre-tax return to the Ameren Utilities or other utility companies, it is in fact allowing investors to realize a greater after-tax rate of return.

Interest rates have also declined significantly since the earlier rate cases for the Ameren Utilities, which should lower the rate of return here. *Id.* at 17. For example, the yield on a ten year U.S. Treasury Bond has declined steadily from about 8.7% to 4.8% from 1990 to 2006.

In addition, given the ICC order from the Ameren Utilities' auction case, the companies will have less business risk than they had in the past as integrated electric utility companies owning power plants and during the transition period. Under the auction tariffs, every dollar spent by the utilities for power is passed on directly to ratepayers. This means that the Ameren Utilities will have virtually no commodity risk associated with uncertain volumes, supplier credit or even variation in supply prices.

Likewise, relative to being an integrated utility company, the Ameren Utilities will receive a greater proportion of their operating income from residential customers. Residential revenues have less variation related to overall economic activity than revenues collected from other customer groups. For example, during a recession, residential revenues do not typically decline as much as industrial revenues. The risk experienced by the Ameren Utilities, coupled with the overall cost of capital in the economy, determines the cost of equity capital. *Id.* at 22.

Finally, the Ameren Utilities' corporate structure demonstrates the significant merger activity that has occurred since 1997. Reports from some of the merger transactions in the industry enable the Commission to take advantage of direct evidence of investor expectations rather than judgments derived from theoretical computations such as the CAPM or the DCF model. *Id.* at 20-21.

Part of the mandate of investment banks in making fairness opinions is coming up with valuations of the utility companies involved in the merger. Id. In the process of making their valuations, the investment banks discount cash flows at a cost of capital that reflects required investor returns, which, in turn, requires a cost of equity hurdle rate. *Id.* Investment Bank valuation must be unbiased in order to correctly value companies. If the valuations made by investment banks are not biased, then the equity cost of capital figures that underlie the valuation

are presumably also unbiased. The cost of equity capital used by investment banks to discount future cash flows is the opportunity cost that measures required returns for investments of similar risk. *Id.* This is the same measure the ICC should establish in this proceeding.

In the ComEd delivery service rate case, a letter from Lehman Brothers was introduced. *Id.* at 21. The letter was generated as part of the multi-billion dollar merger between Exelon and PSE & G first proposed in 2004. This letter explicitly stated, **"[F]rom a practical matter, regulatory authorized ROEs are typically 300 or more basis points more than the discount rates used in investment bank fairness opinions."** *Id.* CUB suggests that the judgment of bankers, who are more closely attuned to investor expectations, should be substituted for the judgment of consultants hired by utility companies.

All of the above factors and information mean that rates of return should be lower than what has been granted in previous rate cases. This information and facts also are important when exercising the discretionary decisions made when using two commonly used formulas in calculating the cost of capital--the Dividend Discount Method ("DCF") and the Capital Asset Pricing Model ("CAPM").

2. Methodology

The Commission should reject Ameren's proposed cost of capital methodology since it is not just and reasonable

When using either the DCF or CAPM, discretion enters into the calculation. Ms. McShane states that determining a rate of return is not a "precise science." McShane Test. July 24, 2006 at 196-197, 243-244. Unlike the cost of debt, a rate of return is not a published number in the market. *Id.* With the DCF, one of the discretionary decisions is what growth rate should be used. With the CAPM, the decision is what betas and risk premiums--which measure the degree of investment risk for the company-- should be used. *Id.*

In either case, the growth rate, betas and risk premiums try to reflect whether a "typical" investor believes he/she is making a risky or conservative investment in a business. If the risk is considered high, the investor will look for a higher rate of return to justify his taking the chance. Conversely, if the risk is considered low to moderate, he will be satisfied with a lower rate of return because of his belief that the investment will yield lower, but constant returns.

As discussed in the section above, Mr. Bodmer explained why the business risk of the Ameren Utilities should be considered lower due to the changes in the nature of the companies and financial markets over the years. Interest rates are lower than in previous years, income and capital tax rates have gone down and CILCO, CIPS and IP are now essentially, if not entirely, distribution and transmission electricity utility companies. The elimination of the companies' generating and selling power has reduced a large part of their prior business risk.

He also pointed out that over the years, market to book ratios for companies like the Ameren Utilities have exceeded one to one, which means that rate of returns on cost of capital have historically been too high. CUB Ex. 1.0, at 10-12. This, in turn means, that an inequitable transfer of money has occurred away from ratepayers to the utilities.

In applying these factors, Mr. Bodmer used a sample of companies with similar risks in selecting growth rates, betas and risk premiums for calculating the rate of return on the equity capital. *Id.* at 27-39 and 49-62. Mr. Bodmer found that under an appropriate DCF analysis, CILCO's, CIPS' and IP's cost of equity is 7.93% and with an appropriate CAPM analysis, no greater than 8%. *Id.* at 26 and 50. He concluded that this return will be perceived by the investment community as a strong return given the nature of the utilities' businesses, and yet be fair and equitable to ratepayers. *Id.* In other words, the rates derived from such returns are "just and reasonable" and the companies will receive a "sufficient return on investment."

Mr. Bodmer also analyzed the Ameren Utilities' expert witness Ms. McShane's rate of return calculations and found many critical errors. *Id.* at 40-47 and 69-74. Ms. McShane opines that the rate of return here should be over 11%. However, her analysis is flawed. Among other errors, she used sell-side analyst growth rates that historically overstate returns, she distorted dividend payout ratios, and her choice of sample companies was flawed. Id. She then exacerbated her errors by "inflating upwards" by about 300 basis points the initial rate of returns derived from her calculations. CILCO Ex. 3.0, at 25- 33; July 24, 2006 Tr. at 197- 214 and 256-257. While she looked at so-called factors to justify the bump up, she considered no factors that might have led to a decrease in her rate of return calculations. July 24, 2006 Tr. at 214-215.

Nevertheless, Ms. McShane, in one respect, actually confirms in her testimony that Mr. Bodmer's rate of returns are correct. Ms. McShane used growth rates derived from many sources but also included rates from International Brokers Estimation System ("IBES"). Id pp. 256-257 Mr. Bodmer also used growth rates from IBES believing that they best approximated the business risks associated with the Ameren Utilities. When Ms. McShane used the IBES rates for her DCF calculation, she came up with a rate of return of 8.8%; Mr. Bodmer's rate of return using IBES data was 7.95%. Of course, Ms. McShane then jacked her rate up later, as she has admitted. However, even by their own expert's admission, the Ameren Utilities' unaltered rate of return is 8.8% versus the over 11% they are seeking.

Moreover, in an unusual, startling moment of candor, the Ameren Utilities admitted through their counsel that their requested rates of returns are always too high and rejected by the Commission. July 24, 2006 Tr. at 342-346. Ameren's counsel asked Mr. Bodmer the following questions with the following factual predicates:

> Q. Now, when the ICC set CILCO's current DST rates, it rejected the utility's proposed ROE, didn't it?

A. In which case, sir, are you referring to?

Q. In the last CILCO DST electric case?

A. I am sure it did, yes.

Q. And when the Commission set CILCO's current gas rates, it also rejected the Company's proposal and accepted Staff's, is that right?

A. I am not familiar with that case, but I certainly would expect that to happen, yes.

Q. And when CILCO's bundled electric rates were set in 1982, the Commission again rejected the utility’s ROE proposal, is that right?

A. In 1982 I would assume that is correct. I haven't reviewed that order, or at least recently.

Q. When the Commission set CIPS' gas rates a few years ago, it rejected the Company's proposal and accepted Staff's, is that right?

A. I am sorry, what was the date on that?

Q. I believe it was 2003.

A. Okay. I would accept that. In the 1982 case and the 1992 case, are you telling me that in both cases they accepted the Staff proposal?

Q. Yes.

A. In the 1982 case?

Q. Well, right now I am asking you if they rejected the Company's proposal.

A. Well, I assume they did, yes.

Q. When CIPS' current DST rates were set, the Company and the Staff reached a settlement that used the Staff's number, isn't that right?

A. I think that's correct.

Q. And the Commission approved that, correct?

A. I would assume that they did.

Q. And when IP's DST rates were set, the Commission rejected the Company's proposal and accepted the Staff's, right?

A. All right.

July 24, 2006 Tr at 343-345. Obviously, Ms. McShane followed the Utilities' standard practice of aiming high when she inflated her initial rate of return. Had Ms. McShane not purposely shot high by improperly inflating her DCF-IBES calculation, the 8.8% rate of return she derived certainly is a more honest calculation by the Ameren Utilities of what their rate of return on equity capital should be here.

In sum, Mr. Bodmer's proposed rate of return of about 8% and Ms. McShane's uninflated DCF-IBES calculation of 8.8% reveals that a rate of return on equity capital of around 8% would result in rates "just and reasonable" to ratepayers while assuring the Ameren Utilities a "sufficient return on investment."

5. Appropriate cost of equity

The Commission should reject Ameren's cost of equity since the Company's proposal is not just and reasonable.

Based on the record and the reasons discussed above, the Commission should adopt CUB's cost of equity:

CIPS Capital Structure and Rate of Return			
	Proportion	Cost of Capital	Weighted Cost
Short-Term Debt	0.49%	4.80%	0.02%
Long-Term Debt	67.16%	6.21%	4.17%
Preferred Stock	4.73%	5.02%	0.24%
Common Stock	27.63%	8.00%	2.21%
Total	100.00%		6.64%

CILCO Capital Structure and Rate of Return			
	Proportion	Cost of Capital	Weighted Cost
Short-Term Debt	20.04%	4.80%	0.96%

Long-Term Debt	36.86%	7.01%	2.58%
Preferred Stock	8.66%	5.26%	0.46%
Common Stock	34.44%	8.00%	2.76%
Total	100.00%		6.76%

IP Capital Structure and Rate of Return			
	Proportion	Cost of Capital	Weighted Cost
Short-Term Debt	0.00%	4.80%	0.00%
Transitional Funding Trust	15.41%	5.97%	0.92%
Long-Term Debt	41.07%	6.74%	2.77%
Preferred Stock	2.06%	5.01%	0.10%
Common Stock	41.46%	8.00%	3.32%
Total	100.00%		7.11%

See CUB Ex. 3.0, p. 3 (revised July 20, 2006)

IV. Rate Design

B. Cost of Service Issues

The Average and Peak method of dividing distribution demand cost correctly acknowledges that Ameren's system is designed to meet its customers' peak demands and year-round service needs.

An essential part of any delivery service rate proceeding is the cost of service study. The cost of service study analyzes a utility's cost to deliver service to individual customers or customer classes via the utility's distribution system. Once a utility determines its cost of service or revenue requirement the cost of service study is used to divide a utility's distribution cost between the residential, commercial and industrial customer classes. Since numerous customers share a utility company's distribution system the costs incurred by each class are not easily assigned. The cost of service study seeks to divide the cost of service based on a specific set of criteria.

Ameren insists the Commission adopt the non-coincidental peak demand method that divides distribution demand costs based on each customer classes' one-time maximum demand.

However, this ignores the fact that Ameren's distribution system serves customers on a year-round basis. It is important to understand that each customer classes' one-time maximum demand or non-coincidental peak demand occurs for only one hour out of the 8,760 hours within a calendar year. Dividing cost based on the non-coincidental peak demand assumes that Ameren's entire system was designed to meet one hour of maximum demand. This is clearly contrary to how customers actually use Ameren's distribution system. Customers depend on the distribution system to meet their demands every day, not just when they are using the most electricity. Although Ameren fails to account for this fundamental principle in its cost of service study, Ameren Witness Mr. Difani admitted this point during cross-examination when he testified as follows:

> Q. An Electric system is also valuable to its customers if the customers can rely upon the system to deliver demand throughout the calendar year, correct?
>
> A. I think it is valuable to customers to deliver energy, power, throughout the year, yes.

July 24, 2006 Tr. at 298

> Q. Would it also be fair to say that customer demand occurs not only during the one hour of non-coincidental peak demand but also during the other 8,759 hours during a particular calendar year, correct?
>
> A. Yes.

Id. at 299.

CUB Witness Mr. Thomas testified that the Commission rejected similar arguments in a recent Nicor delivery service rate proceeding when the Commission concluded: "a utility cannot justify its transmission and distribution investment on demands for a single day." CUB Ex. 4.0 at 4, L. 81-95. *See also Final Order in Docket No. 04-0770 page 102.* In response to Commission's position on this issue, Ameren Witness Mr. Difani argued that Ameren's electric

distribution system is distinct from a natural gas transmission system since gas can be stored and electricity is considered to be 'on demand'. Ameren Ex. 40.0 at 5, L. 107-111. Mr. Difani also argued that the two utilities are distinct because under the Average and Peak Method the non-coincidental peak demand for gas is measured in terms of a one-day peak demand whereas electricity is measured in terms of one-hour peak demand.

The Commission should reject Ameren's argument. Despite Mr. Defani's assertion, the fact remains unchanged that both electric and gas utilities design their systems so that customers can rely on the distribution system to meet their every day demands as well as their non-coincidental peak demands. CUB Ex. 4.0 at 5-6, L. 116-125. Ameren's non-coincidental peak demand method simply ignores the fact that distribution demand costs are also caused by year-round customer demand.

Wal-Mart and the Industrial Energy Consumers agree with Ameren that distribution costs are caused by each customer classes' one-time maximum demand, but argue that distribution cost are driven by connecting customers to the system. This theory obscures the true nature of distribution demand costs since a customer connects to Ameren's system in order to use electricity and Ameren will incur cost based on the customer's demand for electricity. Nevertheless, Wal-Mart and the Industrial Energy Consumers attempt to create a fictional criterion that divides cost based on the number of customers that connect to the system regardless of their demand for electricity.

Wal-Mart and the Illinois Industrial Energy Consumers both support the use of the minimum distribution method to divide distribution demand cost among customer classes, which relies on a combination of peak use and customer connections. Wal-Mart argues that the Commission should adopt the minimum distribution method of dividing costs, whereas the

Illinois Industrial Energy Customers recommend that the Commission order Ameren to recognize a minimum distribution component in its next rate case or make available to the parties the results of a zero intercept analysis for Accounts 364 through 368. Wal-Mart Ex. 1.0 at 17-18 L. 353-404 and IIEC Ex. 2.0 at 22 L. 450-455. Regardless of when Wal-Mart and the Illinois Industrial Consumers propose to implement their cost of service analysis, the minimum distribution method of dividing distribution demand cost is flawed and should be rejected for the reasons stated below.

The minimum distribution method of diving transmission cost is inherently flawed. The minimum distribution method ignores the fact that the distribution demand cost is not only related to the number of customers connected to the system, but also their demand for electrons. Customer costs have already been assigned to customer classes through the embedded cost of service study. Thus, the demand cost should be based on customer demand.

The Commission recognizes this flaw and has consistently rejected the minimum distribution method for dividing cost among customer classes. AG Ex. 4.0 at 6, L. 130-143. For example, in Docket No. 00-0802 the Commission rejected Ameren's recommendation to adopt the minimum distribution method and in doing so the Commission explained: "distribution systems are designed primarily to serve electric demand, and the Commission agrees with Staff that attempts to separate the cost of connecting customers to the electric system from the cost of serving their demand remain problematic. *Id. See also* Docket No. 00-0802, Final Order, at 42.

The Commission should also take a hard look at Wal-Mart's defense of its position. Wal-Mart Witness Mr. Selecky's reliance on the 1992 NARUC Manual to justify the use of the minimum distribution is misplaced. Wal-Mart Ex. No. 1 at 18-181, L. 346-385. The 1992 NARUC Manual actually admits the minimum distribution method may not be an accurate way

to segregate customer and demand related costs. The NARUC Manual warns against the arbitrary assignment of the cost associated with connecting to the system as Wal-Mart Witness Mr. Selecky has done in this case. Wal-Mart Ex. No. 1.0 at 22, L. at 463-467. AG Ex. 4.0 at 3-4, L. 63-72. CUB also notes that in 2000, a NARUC Committee sponsored a paper on rate design entitled *"Charging for Distribution Utility Service: Issues in Rate Design"* that discusses several flaws with minimum distribution method. *Id.* at 4-5, L. 81-123. Consistent with CUB's argument, the paper pointed out that the minimum distribution method fails to draw a clear distinction between the cost to connect to the system and the cost caused by customers demand. *Id.* at 5, L. 99-105. The NARUC sponsored rate design paper also concluded that in the absence of customer demand the transmission system would not exist. *Id.* at 5, L. 109-115.

CUB and Ameren agree that a portion of Ameren's distribution costs is caused by each customer classes' one-time maximum demand. However, CUB requests that the Commission recognize that Ameren's distribution demand cost are also caused by year-round customer demand. Thus, for the reasons set forth the Commission should adopt the Average and Peak Demand method of dividing distribution demand costs among the customer classes since that method divides cost based on each customer classes' maximum demand and year-round use of electricity.

While no method for assigning costs is perfect, CUB submits that the Average and Peak demand method most accurately reflects the cost of serving customers. Thus, the Commission should adopt this methodology.

C. Inter-Class Allocation Issues

(1) Allocation methodology

The Commission should set a lower rate of return for Ameren's residential and government classes since those customers are less risky to serve than the other customer classes.

Rate design or the distribution of inter-class revenue requirements is a question of sound business judgment, as opposed to the strict application of some mathematical formula. *See Illinois Bell Telephone Company v. Commerce Comm'n*, 55 Ill.2d 461, 470 (1973). Rate design requires the use of pragmatic adjustments and the Commission has discretionary authority to design rates that are equitable. *Id.* When designing rates the Commission must balance between setting prices as low as possible for the general public purchasing the service on the one hand, and setting rates sufficient to provide operating expenses, depreciation, reserves and a reasonable rate of return to investors on the fair value of the utility's property on the other hand. *Id. see also Illinois Bell Telephone Co. v. Commerce Comm'n.,* 414 Ill. 275, 286 (1953).

CUB and Ameren agree that the Commission should adopt a method of rate design that mitigates the impact of a rate increase on residential customers. CUB Ex. 2.0 at 4, L 73-86, Ameren Ex. 10.0 at 6, L. 109-115. Both parties recognize that an unmitigated rate increase will have a negative impact on residential customers. CUB Ex. 2.0 at 4, L 73-86, July 27, 2006 Tr. at 883. However, CUB and Ameren part company on the criterion that must be considered when designing residential rates. Ameren insists that the cost of service is based on an equalized rate of return. Ameren Ex. 10.0 at 5, L. 87-90. CUB maintains Ameren's premise is flawed, and requests that the Commission recognize that different customer classes pose different risk of service. CUB maintains that this variable must be accounted for if the residential class is to receive an equitable allocation of service cost.

Ameren's position that the Commission should adopt a rate design based on equal class rates of return assumes that all customer classes present the same level of risk. Ameren's argument ignores the relationship between service risk and higher or lower rates of return. The

more risk a utility incurs by serving a particular customer class the higher the rate of return. The opposite is also true, the less risk a utility incurs by serving a particular customer class the lower the rate of return. In this case, Ameren incurs less risk by serving the residential customers as compared to the larger commercial and industrial customers.

Ameren incurs more risk in serving the larger commercial and industrial customers since those customers are subject to unpredictable changes in the economy that are difficult for Ameren to mitigate. CUB Ex. 4.0 at 13-14, L. 286-294. Ameren incurs less risk by serving the residential customers since the primary risk associated with the residential class is the weather and uncollectibles. CUB Ex. 4.0 at 13, L. 281-286. Ameren minimizes weather related revenue risk through weather-normalized rates. Ameren also takes significant steps to mitigate the risk of uncollectible revenue. CUB Ex. 4.0 at 15, L. 303-307. For example, Ameren proposes to recover class specific uncollectible adjustments that will further minimize the risk of serving residential customers. *Id.* at 310-313.

The residential class is also less risky to serve than the large commercial and industrial class since the residential class has less flexibility in changing their manner of consumption. For example, large commercial and industrial customers are able to take advantage of real time energy prices and can reduce their consumption as prices rise, residential customers cannot make those same adjustments. Large commercial and industrial customers can also relocate portions of their operations to reduce energy costs, residential customers are less likely to relocate just to reduce energy costs. Ameren responds to CUB's analysis by arguing that the Commission never explicitly concluded that the residential class is less risky to serve than the large commercial and industrial class. While this statement is true, the Commission has approved rate design methods that mitigate rate increases for the residential class. Thus Commission should

continue to follow that precedent recognizing that the risk to serve residential customer are less that the risk to serve large commercial and industrial customers. Based on the record, CUB recommends that the Commission limit the residential class increase to 90% of the system average increase.

G. Residential Real Time Pricing Program

The Commission should approve the Residential Real Time Pricing Program proposed by CUB because residential customers, utility companies and the Commission will benefit from the knowledge gained from this energy management program.

The Residential Real Time Pricing ("RTP") Program proposed by CUB represents an excellent opportunity to gain valuable information regarding residential energy management. CUB has proposed expanding the existing Energy Smart Pricing Plan (ESPP) into the Ameren Companies' service territories. Program costs for 20,000 customers over four years will be spread over all residential customers to encourage participation. Such a RTP program will provide decision-makers at all levels with factual data regarding the benefits of the Residential RTP. Based, on the record, CUB and Ameren maintain that all residential customers should benefit from the RTP program. CUB Ex. 2.0 at 4-5, L. 88-114; Ameren Ex. 41.0 at 31-32, L. 642-663. RTP customers will manage their energy usage and limit their demands, which will reduce their peak usage. *Id.* In the alternative, CUB agrees with Ameren that the Commission can view the RTP as a "pilot," and not a program intended to be in compliance with the new RTP law, 220 ILCS 5/16-107. Ameren Ex. 41.0 at 32, L. 654-663.

CONCLUSION

For the reasons discussed herein, CUB respectfully requests that the Commission reject the Ameren Utilities' rate increase as proposed. Instead, the Ameren Utilities' proposal should be modified as set forth in this brief.

Respectfully submitted,

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