STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

CENTRAL ILLINOIS LIGHT COMPANY d/b/a AmerenCILCO	: : :	 No. 06-0070
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY d/b/a AmerenCIPS	: : :	 No. 06-0071
ILLINOIS POWER COMPANY d/b/a AmerenIP	: : :	 No. 06-0072
Proposed general increase for delivery services (Tariffs filed December 27, 2005).	: :	(Consolidated)

REPLY BRIEF OF THE ILLINOIS INDUSTRIAL ENERGY CONSUMERS

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INTRODUCTION

The Illinois Industrial Energy Consumers ("IIEC") present this Reply Brief in response to certain issues raised and arguments made by Central Illinois Public Service Company d/b/a Ameren CIPS ("CIPS"), Central Illinois Light Company d/b/a AmerenCILCO ("CILCO") and Illinois Power Company d/b/a AmerenIP ("IP"), collectively (the "Ameren Companies"); the Illinois Commerce Commission Staff ("Staff"), Citizens Utility Board ("CUB"), and the Kroger Co. ("Kroger") in their Initial Briefs in this proceeding. IIEC also references the Initial Briefs of the Illinois Attorney General ("AG") and the Cities of Champaign, et al., (the "Cities"). IIEC's failure to respond to a brief or argument of any party should not be considered as acceptance of or agreement with that Brief or argument unless specifically stated otherwise herein.

I. Rate Base

D. G & I Plant

The Ameren Companies address IIEC's position on the appropriate level of general and intangible ("G & I") plant to be reflected in the their rate bases in this proceeding. (Ameren Init.Br. at 16). The Ameren Companies offer three reasons for rejecting IIEC's position. First, they assert that IIEC relies on test year data from prior Ameren Company rate cases that is outdated. Second, they argue there is no sound basis for the proportionality principle supported by IIEC. (*Id.*) Third, they observe the Commission has rejected the proportionality principle in a recent case. (*Id.*) Each of these reasons is without merit, as discussed below

The Ameren Companies' first reason for rejecting IIEC's position is not persuasive. They rely on the testimony of Ameren Witness Adams. (Adams Ameren Ex. 37.0 at 6). Mr. Adams presented testimony to the effect that CILCO and CIPS had divested themselves of their generation assets after the test year in their most recent rate cases. (*Id.*) He also testified that IP had been acquired by Ameren Corporation since IP's most recent rate case. (*Id.*)

However, Mr. Adams and the Ameren Companies overlook or forget that the most recent rate cases for CILCO, CIPS and IP were "delivery service rate cases." (*See* CILCO, ICC Dkts. 01-0465, 01-0530 and 01-0637 (Cons.) - a petition to the Commission to enter an Order approving delivery service tariffs, including revision to existing rates, riders, terms and conditions applicable to non-residential delivery services and new rates, riders, terms and conditions applicable to residential delivery services; CIPS ICC Dkt. 00-0802 - a request for approval of revisions to delivery service tariffs, and approval of a delivery service implementation plan; IP ICC Dkt. 01-0432 - proposed revisions to delivery service tariff sheets and other sheets.) These cases determined the revenue requirements for the Ameren Companies for delivery service only, not the revenue requirement for a fully integrated utility offering bundled utility service. Therefore, a change in the status of CILCO, ComEd or IP from a fully integrated utility, to a delivery services only company has no bearing on IIEC's use of any test year data from the prior CIPS, CILCO and IP delivery service rate cases. Those data reflected the cost of providing delivery services, not bundled (generation and delivery) services. In this case, the Ameren Companies similarly seek approval of delivery service rates and their associated delivery service revenue requirements. Information and data from prior delivery service rate cases are clearly relevant.[1]

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[1] Indeed the Ameren Companies themselves compare costs approved in past delivery service cases to costs requested in this case in relation to OPEB Expense. (*See*, Ameren Init.Br. at 71)

Furthermore, IIEC did not rely directly on test year data from the prior CIPS, CILCO and IP delivery service rate cases. Instead, it relied on the levels of G&I plant that were determined just and reasonable by the Commission, in the last delivery service rate case, for each Ameren Company. IIEC has pointed out the significant and unexplained increases in G & I plant proposed by each Ameren Company in this case, in comparison to the levels of G & I plant found reasonable in their most recent delivery service rate cases. IIEC has recommended that in the absence of a satisfactory explanation of these increases, which it is the burden of Ameren Companies to provide, the Commission should follow its past practice in determining the appropriate level of G & I plant to be included in rate base in this proceeding, by applying the Commission's principle of proportionality.

The second argument offered by the Ameren Companies for rejecting IIEC's position is that there is not a sound basis for the principle of proportionality. The Ameren Companies are incorrect. The Commission itself has applied the principle of proportionality and was then affirmed on appeal in its application of same, under circumstances similar to those in this case. In *Illinois Power Company*, Dkt. 01-0432, the Commission found that IP had failed to justify a large increase in G&I plant compared to the level approved in IP's most recent rate case and applied the principle of proportionality. (*Illinois Power Company*, ICC Dkt. 01-0432 Order, March 28, 2002 at 17, affirmed *Illinois Power Company v. ICC*, Gen. No. 5-02-0406 (ICC Dkt. No. 01-0432) App. Ct. 5th Dist.). Likewise, the Ameren Companies here have failed to explain the 45.8% increase in G & I plant for CILCO, the 133.3% increase in G & I plant for CIPS and the 53.7% increase in G & I plant for IP. (*See* Chalfant IIEC Ex. 2.0 at 2:34-38). Thus, IIEC's position is based upon the principle developed and used by the Commission in similar circumstances in the last IP case, which was affirmed on appeal. IIEC believes that the Commission's principle of proportionality is in fact sound, and should be applied in this case.

The third reason offered by the Ameren Companies for rejection of IIEC's position is that a proposal made by IIEC in the ComEd case, to establish the appropriate increase in general and intangible plant costs in proportion to the percentage increase in distribution plant costs, was rejected. (*Commonwealth Edison Company*, Dkt. 05-0597, Order July 26, 2006 at 27). Rejection of IIEC's position in the ComEd case is not binding upon the Commission in this case. As noted in the quotation the Ameren Companies rely upon from the Commonwealth Edison Order, the Commission's decision in that case was based upon the record in that case. The Commission's decision here must be based on the record in this case. The record here clearly supports IIEC's position. The Ameren Companies have failed to provide a satisfactory explanation of the significant increase in G & I plant from one delivery service case to another. Under such circumstances, the Commission has adopted the proportionality principle. Its adoption of that principle is based on the relationship it found between general and intangible plant costs and distribution plant costs. Therefore, IIEC's proposal to apply the proportionality principle should be adopted.

Finally, contrary to the Ameren Companies' suggestion the Commission need not conclude G&I plant assets are (i) being used to support non-regulated generation businesses or (ii) not being used in support of the Ameren Companies delivery service business. The Commission need only conclude that the increases in G & I plant for these Companies, which are substantial, were not adequately explained or supported. Under such circumstances, the Ameren Companies have not met their burden of proof and the Commission may apply the principle of proportionality.

II. Operating Expenses and Revenues

E. A&G Expense

The Ameren Companies oppose IIEC's recommendation to set the authorized level of A&G expense (overhead) for the Ameren Companies at an amount equal to the proportionate increase in the cost of the activity the overhead supports -- O&M (other than A&G). (Ameren Init.Br. at 60 - 64). They argue that IIEC relied on a generalized view of A&G instead of particular A&G expenses and acknowledged no specific evidence. (*Id.* at 60-61)

IIEC witnesses in this case noted that the Ameren Companies' testimony; in support of their A&G expenses was flawed, because it focused the Commission on line items of requested A&G costs, without providing perspective on the magnitude of the overall proposed increase in A&G expenses. IIEC testimony suggested that the Ameren Companies had not adequately supported the lines items of their requested A&G expenses. Nor did the Ameren Companies adequately explain the tremendous disparity between the massive increase in proposed A&G expense (368% for IP, 394% for CILCO, 63.8% for CIPS) relative to the much more modest increase in direct O&M costs (11.7% for IP, 33.2% for CILCO and 7.8% for CIPS). IIEC presented testimony that there was sufficient correlation between the incurrence of distribution O&M and A&G costs to justify IIEC's recommended A&G expense levels. IIEC also presented testimony to the effect that to protect against the subsidization of unregulated businesses by the Ameren Companies the Commission should implement the approach approved in IP Docket 01-0432 and relate the growth in A&G expense of the Ameren Companies, to the rate of growth in distribution O&M costs (other than A&G). (Chalfant, IIEC Ex. 2.0 at 3-12:54-228 and IIEC Ex. 5.0 at 10-16:198-330).

The Ameren Companies argue that there is no basis for the relationship between A&G and O&M expense (other than A&G). However, IIEC Witness Chalfant testified that it is appropriate to assume a correlation between the two. (Chalfant, IIEC Ex. 5.0 at 12:233-234). As Mr. Chalfant explained, utilities incur A&G expense to support direct utility operations, such as distribution operations. (*Id.* at 12:234-235). He suggested that but for the investment in the underlying physical assets, such as distribution plant, utilities would not need the accountants, managers and information technology employees whose salaries contribute to overhead costs. He also suggested that but for the presence of employees needed to operate and maintain those assets, a utility would not incur the medical and pension costs that are treated as overhead costs. (*Id.* at 12:235-240). Mr. Chalfant noted that cost drivers that impact direct O&M costs, such as growth in system load or increase in the number of customers also have a positive correlation with increases in A&G expense. (*Id.* at 12:241-243). Mr. Chalfant also observed that a perfect correlation between all the cost drivers for direct O&M and A&G costs was not necessary in order to adopt IIEC's recommendation on the appropriate level of A&G expense in this case. He concluded there is sufficient correlation between these two items of cost to justify the use of the growth in O&M (other than A&G) as a measure of the reasonableness of the increase in A&G expense proposed by the Ameren Companies in this case. (*Id.* 13:250-257).

Thus, IIEC has provided a foundation in the record for the relationship between A&G and O&M (other than A&G). The correlation between A&G and O&M (other than A&G) cost drivers may not be perfect in each and every instance. However, in this case the Ameren Companies have failed to explain why the rates of growth in these two cost categories should so dramatically diverge under their proposals. Therefore, IIEC's proposal to increase A&G in proportion to the increase in O&M (other than A&G) should be adopted.

Furthermore, contrary to the Ameren Companies' implication, IIEC evidence did respond to Ameren's suggestions that A&G expense for the distribution companies has risen relative to other operations such as the generation operations of their affiliates, because of increases in security, legal and regulatory expense. IIEC presented testimony to the effect that it was more likely that increases in security costs would impact unregulated generation operations of the Ameren Companies' affiliates than the operations of the Ameren Companies themselves because large generation plants were more likely targets of sabotage than local distribution feeders. (*Id.* at 13-14:271-277). IIEC witnesses also noted that generation operations face increasingly stringent and complex plant emission standards in comparison to those faced by the Ameren companies, which are now essentially wires only companies. (*Id.* at 14:278-285).

In response to the arguments of Ameren Companies that they have provided all the necessary support for their proposed A&G costs, IIEC witness Chalfant testified that Ameren's direct testimony provided very little more than a summary of procedures employed to allocate A&G costs as support for the proposed A&G cost recovery levels in this case. (*Id.* at 14:292-295). He further noted that the Ameren Companies' witness description of the A&G expense, other than pension benefit costs, was limited to a one page summary of cost data, presented in its rebuttal testimony, for a six month period that did not conform to the test year in this case. (*Id.* at 14-15:297-301).

The Ameren Companies also argue that their allocation methodology supports the level of A&G expense requested in this case. (Ameren Init. Br. at 62). However, the allocation they describe does not account for all the expenses they request. IIEC evidence showed that the General Services Agreement (GSA) which forms the basis for the proposed allocation, does not specify precise cost allocators for many of the cost categories that are the subject of the Ameren Companies' A&G expenses in this case. (*Id.* at 15:304-312).

Thus, the Ameren Companies have not met their burden of proof to justify the enormous increases in A&G expense (394% for CILCO, 368% for IP and 63.8% for CIPS) requested in this proceeding (Chalfant, IIEC Ex. 2.0 at 11-12:199-207). In the absence of such justification, IIEC has presented evidence affirming the correlation between the growth in O&M (other than A&G) and the growth in A&G. IIEC has demonstrated that the Commission has adopted the alternative approach IIEC proposes in past cases where the utility has failed to demonstrate the reasonableness of increases in overhead that outpace increases in the activity the overhead supports.. Therefore, IIEC's recommendation to increase A&G expense in proportion to the level of increase authorized for O&M (other than A&G) is reasonable and should be adopted in this proceeding.

F. Effect of Ameren Ownership on Illinois Power Expenses

Only IIEC's recommendation for a measured amortization of the IP merger cost regulatory asset is consistent with Ameren's and IP's commitment, made to the Commission and consumer representatives in its merger case, to protect IP ratepayers. In the context of its discussion of AmerenIP's Ameren Services ("AMS") cost allocations, the AG expresses its agreement with IIEC's position that IP's recovery of incremental merger costs was meant to be balanced by achieved merger savings. (AG Init. Br. at 18-22). The settlement agreement among parties in Ameren Corporation's merger proceeding and the findings and conditions of the Commission's merger order were premised on that balance. (*See* AG Init. Br. at 20; IIEC Init. Br. at 15-16 (and the primary sources cited therein)). The implementation of those mandates requires nothing less.

As the AG states:

> The Commission relied on this MoA for its finding that the proposed reorganization was not likely to result in any adverse rate impact on customers. Therefore, it is critical that the balance between benefits and costs underlying the MoA not be upset. (AG Init. Br. at 19-20).[2]

Staff does not take a position on appropriate amortization cost recovery respecting IP's merger cost regulatory asset. (*See* Staff Init. Br. at 72). The Ameren Companies do not address the topic at all in their initial brief. (*See* Ameren Init. Br. at 74). The Commission should preserve the integrity of its merger order and adjust IP's recovery of merger asset amortization costs to match achieved merger savings. The Commission should allow recovery of only $3,883,000 in test year amortization costs for IP.

III. Rate of Return

B. Capital Structure

The briefs of the parties in this case do not endorse the capital structure proposed by Ameren Companies for IP. IIEC opposes IP's proposed capital structure because of its excessive equity component. IIEC has recommended the adoption of a reasonable capital structure for the company.

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[2] The AG includes an additional element in its criticism of IP's efforts to gain cost recoveries in excess of achieved savings. The AG asserts that at the time of its merger case IP and the Ameren Corporation knew of -- but did not disclose -- certain expected expenses that could have affected the Commission's determination that adverse rate impacts from the merger were unlikely. Therefore, the AG argues, IP should not be allowed to use such known (but undisclosed) expenses to increase its revenue requirement, adversely affecting ratepayers. (AG Init. Br. at 21).

(*See* IIEC Init. Br. at 17-23). CUB opposes the proposed capital structures for the Ameren Companies, including IP, citing several sources of excess equity. (CUB Init. Br. at 3-4). The Cities accept the Ameren Companies' proposal for IP only conditionally, deeming the equity ratio excessive if the approved return on equity exceeds 9.46%. (Cities Init. Br. at 2-3). The only unqualified support for the Ameren Companies' proposed IP capital structure comes from Staff. But, that support rests on an erroneous interpretation and application of the law by Staff's cost of capital experts. (*See* Staff Init. Br. at 83).

CUB identifies a list of actions by the Ameren Companies (including the treatment of goodwill, inter-company notes, and a pre-rate case equity injection) that CUB argues improperly inflate the proposed capital structures and compromises the correspondence with their regulated rate bases. (CUB Init. Br. at 4). CUB's expert Edward Bodmer compares the post-2006 riskiness of IP and the other Ameren utilities to that of a water utility. (*Id*. at 4) CUB notes utilities' strong economic incentive to include more (expensive) equity and less (cheaper) debt in their capital structures. (CUB Init. Br. at 3-4). CUB's Mr. Bodmer argues that the Commission should encourage utilities to take advantage of that lower risk to use greater quantities of lower-cost debt instead of the proposed levels of equity capital, and he proposes a 41.6% equity ratio for IP. (*Id*. at 4-5 and 6). He assessed the reasonableness of his recommended equity ratio for IP (combined with his 8% cost of equity recommendation) using criteria of credit rating agencies, which he asserts yield credit ratings that satisfy the Commission's investment grade requirement. (*Id*. at 5).

CUB's evidence, described above, bolsters the validity of IIEC's conclusion that IIEC's capital structure and cost of equity recommendations will produce the required investment grade rating for IP. Using the recommendations of IIEC's expert, Michael Gorman, that the Commission adopt a similar equity ratio and a higher (10.0%) cost of equity gives even greater assurance of a credit rating satisfying Commission standards. Mr. Gorman's evaluation found that his recommendations are consistent with the relevant (investment grade) ratings agency financial ratio criteria for IP. (Gorman IIEC Corr. Ex. 3.0 at 13-14:262-290, 32:681-33:701).

The Cities accept the Ameren Companies' proposed capital structure for IP, but only conditionally. The Cities' expert Richard Cuthbert concluded that if the authorized return on common equity exceeds the 9.46% he recommends, the equity ratio and cost of equity combine to produce excessive returns. (Cities Init. Br. at 2-3). The Cities view Mr. Cuthbert's recommended cost of equity as "a cap, not a floor." (*Id*. at 11). Accordingly, he recommended that if the approved equity return is higher, the utility's capital structure should be adjusted to be more in line with the median of his proxy group and the "broader electric industry." (Cities Init. Br. at 47). Such an adjustment also would bring his recommendation more in line with that of IIEC's Mr. Gorman. An adjustment is further supported by Mr. Gorman's testimony that IP's purchased power financial risk will be comparable to that of the other Ameren Companies because the procurement and cost recovery mechanisms will be identical for all the Ameren Companies. Thus, IP's capital structure should be close to that of the other Ameren Companies.

The Ameren Companies' sole supporter on IP's capital structure is the Commission Staff. Staff argues that an imputed capital structure should be used only if a utility's actual capital structure is inappropriate. (Staff Init. Br. at 83). Staff's apparent standard for rejecting a utility's actual capital structure – a clear demonstration of its unreasonableness by non-utility parties – is not consistent with the Public Utilities Act's statutory assignment of the burden of proof.[3] (*See* 220 ILCS 5/9-201(c)). Staff cites only the testimony of Mr. Pregozen (Pregozen, Staff Ex. 5.0 at 4-6) for the proposition that the Commission should not impute a capital structure unless the actual structure of the utility is shown to be inappropriate. Staff provides no other citation or support for that position.

In contrast to Staff's position, the Act specifically provides that "the burden of proof to establish the justness and reasonableness of the proposed rates or other charges . . . in whole and in part, shall be upon the utility." 220 ILCS 5/9-201(c)). Staff's implicit imposition of inconsistent requirements on opponents of the utility's proposals has the effect of modifying the statutory burden of proof by giving the utility's actual capital structure an unwarranted presumption of reasonableness. In other words, Staff's position unlawfully shifts the burden of proof and relieves the utility of the burden of making the evidentiary showing required by the Act. Thus, Staff's tainted support for the Ameren Companies' proposed capital structures cannot be the basis for a Commission decision on this issue. (220 ILCS 5/10-201(e)(iv)C).

Moreover, Mr. Pregozen's testimony does not, in fact, support Staff's erroneous standard. It merely states his subjective determinations that the IP structure is reasonable (when combined with Staff's revenue requirement) and not to recommend a change "at this time" as to the other utilities. (Pregozen Staff Ex. 5.0 at 32:554-566).

As to Staff's conclusion that the IP capital structure is reasonable, the evidence shows

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[3] The evidence of record satisfies even this erroneous standard, since IIEC's Mr. Gorman demonstrated the unreasonableness of the proposed capital structure in his testimony. (*See* Gorman, IIEC Corr. Ex. 3.0 at 7-13:127-259; Gorman, IIEC Ex. 6.0 at 9-10:189-203)

otherwise. As explained in detail in IIEC's testimony and initial brief, the record evidence shows that IP's proposed capital structure is, in fact, not reasonable. IP's inclusion of the specialized Transitional Funding Notes debt in its proposed capital structure, which IP offers as both a corporate and a ratemaking capital structure, (a) is inconsistent with the actual evaluation of IP's corporate capital structure by credit rating agencies and (b) obscures the excessive level of equity in its ratemaking capital structure. (*See* IIEC Init. Br. at 17-23; Gorman IIEC Corr. Ex. 3.0 at 7:127-15:289).

The arguments of the Ameren Companies themselves are founded on the premise that the current credit ratings of IP and other Ameren utilities should not be degraded, even where they are above investment grade.[4] (Ameren Init. Br. at 77-78). IIEC's recommended capital structure for IP and its cost of equity recommendation for all the Ameren Illinois utilities, while distinct from those proposed by the Ameren Companies, are consistent with a strong "A" rating for IP, using S&P's financial ratio criteria. (Gorman IIEC Corr. Ex. 3.0 at 32:679-34:740).

Finally, the Ameren Companies address the effect of their relationship with other Ameren affiliates on utility capital needs. The Ameren Companies agree with IIEC's Mr. Gorman that "AmerenIP's permanent capital cannot finance the operations of its affiliates and vice versa." (*Id*. at 82). However, the Ameren Companies emphasize that "although Ameren's Illinois utilities are exposed to a number of similar business risks, they are and remain separate legal entities with separate operations, separate cash flow profiles and separate debt and preferred stock obligations. Their

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[4] Staff projects the Ameren Companies' credit ratings as being as high as AA or A+ using a cost of equity similar to IIEC's and their current capital structures. (Pregozen Staff Ex. 5.0 at 32:554-557).

respective capital structures reflect these factors and related ratings effects." (*Id*.).

Mr. Gorman did respect the separateness of the Ameren Companies. In fact, he has proposed a change in capital structure for only one utility – IP, the one with an anomalously high equity ratio. Mr. Gorman did not close his eyes to the apparent effect on IP ratepayers of the relationships among Ameren affiliates. Mr. Gorman conformed his recommendation to remedy the support the utility's affiliates would receive from the high equity utility capital structure proposed for IP. (*See* IIEC Init. Br. at 23; Gorman, IIEC Ex. 6.0 at15:337-339). As pointed out in IIEC's Initial Brief, by expressly prohibiting recovery of affiliate costs through utility rates, the Act requires the adjustments Mr. Gorman recommends. (IIEC Init. Br. at 22-23). Curiously, the Ameren Companies argue that "Mr. Gorman's recommendation is at odds with a fundamental cost of service ratemaking principal (*sic*) of ignoring the costs and effects of affiliates as part of setting rates for a given utility." (Ameren Init. Br. at 82). The Ameren Companies have it backwards. Mr. Gorman's recommendation accounts for the effect of affiliate relationships on IP's capital structure; the Ameren Companies' proposal does not. And, using Standard & Poor's ("S&P") financial ratios, Mr. Gorman concluded that his proposed capital structure for IP would preserve its current bond rating. Ameren did not respond to this testimony, and it stands unrefuted.

E. Cost of Equity

As IIEC explained in its Initial Brief, Mr. Gorman's cost of equity recommendation defines the mainstream of the range of estimates presented in this case. (IIEC Init. Br. at 36). His analysis and recommendation have earned the support of a party (Wal-Mart) that did not present testimony on this issue. "Wal-Mart generally supports the rate of return analysis supported by IIEC witness

Gorman . . .. Wal-Mart's concern regarding rate of return centers primarily on the return on common equity and the appropriate capital structure. Accordingly, Wal-Mart concurs with the IIEC's analysis regarding the proper rate of return."[5] (Wal-Mart Init. Br. at 6-7 (footnote omitted).

With respect to the Ameren Companies' proposed cost of equity -- which exceeds all other recommendations by at least 90 basis points -- there is a consensus among parties addressing cost of capital issues that the Ameren Companies' proposal is not appropriate. (*See* discussion and citations *infra*). There is a similar consensus among the cost of capital experts in this case that Ameren Companies witness Kathleen McShane's cost of equity estimation analyses are technically flawed, upwardly biased, and inappropriate for adoption by the Commission. (*Id.*) Each of the cost of equity experts in this case has independently identified errors in Ms. McShane's analyses. Together, those criticisms, many of them identifying the same errors, describe flaws that invalidate her results.

All parties recognize that the cost of equity is not an observable datum, requiring both the use of analytical models and the exercise of expert judgment.[6] (*See, e.g.*, CUB Init. Br. at 7; Staff Init. Br. at 97; Ameren Init. Br. at 95). The application of judgment is manifested in the adjustments made by the experts to their model results to account for special circumstances bearing on a particular cost of equity estimates and for known model deficiencies. (*See, e.g.*, Staff Init. Br. at 97; McShane, Tr. 193:21-194:4, 194:10). Ms. McShane errs on both counts.

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[5] Wal-Mart also expressly supports IIEC's analysis with respect to the Rate of Return sub-topics Mr. Gorman addressed in his analysis. (Wal-Mart Init. Br. at 7-8).

[6] CUB also contends that one cannot determine before the fact whether estimates developed from analytical models correspond with the actual market cost of equity and that such estimates should be examined after the fact through the lens of market-to-book ratios. (CUB Init. Br. at 7).

Ms. McShane's flawed analyses begin with a view of the environment in which the Ameren Companies operate that is decidedly different from the prevailing perspective. Other experts see the recently approved auction process, which shifts all commodity risk from the Ameren Companies to suppliers or ratepayers, as reducing the utilities' riskiness, and cost of equity. Ms. McShane opposes recognition of that reality. (*See, e.g.*, CUB Init. Br. at 9; Cities Init. Br. at 4; IIEC Init. Br. at 24; *contrast* Ameren Init. Br. at 116). The Ameren Companies deny the risk reduction effect of their move from a multi-year purchased power commitment to an auction procurement arrangement that relieves them of commodity risk. (*Compare* Cities Init. Br. at 4 and Ameren Init Br. at 116).

Other experts recognized in their analyses that recent, significant changes in certain economic factors have directly affected the cost of capital in ways inadequately reflected in the Ameren Companies' proposals. For instance, IIEC, the Cities, and CUB point out the effect of lower interest rates and reduced tax rates on the cost of equity. For example:

> Authorized returns are pre-tax, but because of tax law, risk reduction and other changes since each Ameren Company's last case, granting a return similar to previous returns would actually give investors a greater return. (CUB Init. Br. at 8; *see also* Cities Init. Br. at 5).

According to Mr. Cuthbert, "[b]ecause the reduction in taxation on dividends for individuals enhances their after-tax returns, it reduces their pre-tax required rates of return in comparison to other investment opportunities." (Cities Init. Br. at 5, *citing* Cities Ex. 1 at 17:11-13). The Cities also join IIEC in recognizing the effect of the "observed trend of declining interest rates for financial instruments" on the cost of equity. (Cities Init. Br. at 5, 9; Gorman, IIEC Corr. Ex. 3.0 at 46:1005-1007).

The rejection of Ms. McShane's proposed post-analysis upward adjustments is unanimous. In its Initial Brief, IIEC exposed the fallacy of those adjustments in detail. (IIEC Init. Br. at 28-33). CUB criticizes Ms. McShane for preserving the market premium resulting from earning above the actual cost of equity, as indicated by Ameren Companies' market-to-book ratios that are far above 1.0. CUB argues that Ameren Companies' proposed rate of return on common equity, of over 11%, was inflated by the adjustments the Ameren Companies' expert witness, Ms. McShane, added to her initial cost of equity estimations of about 8.8% which she developed using accepted methodologies. (CUB Init. Br. at 1, 12). Staff points out that her adjustments have been rejected previously by the Commission. (Staff Init. Br. at 111 (*citing* various Ameren Companies case decisions)). Staff also noted that Ms. McShane's adjustments "are based on the flawed argument that a market-derived required rate of return does not produce a 'fair' return when applied to a book value rate base if the market to book value ratio differs from one." (*Id*.) Staff contends that her argument "fatally equates secondary investing (i.e., the purchase of existing shares of stock from other investors) with primary investing (i.e., the purchase of new shares of stock directly from the company or the retention of earnings for reinvestment)." (*Id*.) The Cities concluded with respect to Ms. McShane's proposed financial flexibility and premium preservation adjustments that "[t]here is inadequate support for either adjustment and the adjustments should be rejected." (Cities Init. Br at 9).

Staff's Initial Brief also observes that the mechanisms by which Ms. McShane proposes to adjust her proposed cost of equity (basing equity returns on market indicators and applying authorized returns to book value) are long-standing and well known to a workably efficient market that already responds to such information. (Staff Init. Br. at 114; McShane, Tr. 217:7-17, Tr. 218:16-220:5).

IIEC's initial brief explained that artificially boosting returns to compensate for rate setting procedures well known in the investment community and already reflected in market requirements would simply amount to double recovery for investors. (IIEC Init. Br. at 31-32).

Defending Ms. McShane's proposed adjustments, the Ameren Companies continue to argue that the Commission should approve returns that maintain the Ameren Companies' market-to-book ratios, and the earnings above their cost of equity that raised their market-to-book ratios above 1.0. (Ameren Init. Br. at 93). Indeed, the Ameren Companies have a history of proposing returns that exceed the actual cost of equity, as determined by the Commission. (Bodmer, Tr. 343-345; CUB Init. Br. at 12-13). The result of accepting the Ameren Companies' argument would mean a continuous, escalating spiral of ever higher returns, driven by (a) adjustments to preserve the premiums from past excess earnings and (b) an inability ever to correct excess returns out of concern that the ardor of credit agencies or investors might cool. (*See* Staff Init. Br. at 112-113).

Other parties also recognized in their briefs the technical flaws that beset Ms. McShane's basic cost of equity analyses. To the considerable extent that the Ameren Companies merely repeat the substance of Ms. McShane's testimony, the evidence and arguments presented are addressed in the initial briefs of IIEC and other parties. (*See e.g.,* IIEC Init. Br at 33-36). Errors in Ms. McShane's analyses identified by more than one expert include:

- Her use of excessive dividend growth rates in her DCF analysis (IIEC Init. Br. at 33-34; Staff Init. Br. at 101-105);

- Her use of a comparable earnings analysis, which should be rejected as the Commission has done in recent gas cases. (Staff Initial Brief at 121-122) ("The Order in Docket Nos. 03-0676/03-0677 Cons. states 'The Commission finds, as it has in prior dockets, that the comparable earning approach has little value because it constitutes an accounting-return based approach rather than a market-based methodology, and fails to reflect the investor-required rate of return.' (Order, Docket Nos. 03-0676/03-0677 Cons., p. 40 (October 6, 2004))" (*Id.* At 122); (*See also* Cities Init. Br. at 10);

- Her use of a flawed choice of samples (CUB Init. Br. at 12; Cities Init. Br. at 7);

- Her use of adjusted historical risk-free interest rates instead of current projections that reflect today's low capital costs (Gorman, IIEC Corr. Ex. 3.0 at 43:921; Cities Init. Br. at 8);

- Her use of growth rates that exceed maximum sustainable levels instead of analysts' forecasts that take account of historical growth, changed economic factors, and investor expectations (Staff Init. Br. at 105; Gorman IIEC Corr. Ex. 3.0 at 39:823-830); and

- Her misuse of historical and forecast inputs (Gorman, IIEC Corr. Ex. 3.0 46:1002, Staff Init. Br. at 105).

IV. Rate Design

B. Customer Class Issues

1. Response to Staff

In its discussion of customer class issues, Staff, for the first time in this proceeding, objects to the Ameren Companies' revenue allocation and makes a recommendation that DS-4[7] rates be increased to subsidize service to DS-1 customers and to reduce rates proposed by Ameren Companies for DS-2 and DS-3 customers. (Staff Init.Br. at 134-140).[8] Specifically Staff argues that any rate

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[7]The DS-4 customer class consists of customers with demands of 1 MW or more. (Jones, Ameren Ex. 10.0 at 17:376-377).

[8] Staff actually accepts the Ameren Companies' revenue allocation with a single modification to the allocation to the DS-2 class elsewhere in its Brief. (*See* Staff Init. Br. at 141). Staff fails to reconcile these contradictory positions.

relief provided to DS-1 customers should be accomplished through increases to lower-price delivery service rates for other customer groups. It reasons that the DS-4 class is better able to absorb the contribution than DS-2 or DS-3 because the DS-4 class:

(i) is the largest class in terms of kWh;

(ii) has the lowest cost per kWh; and

(iii) has more opportunities to offset increases with economical beneficial options in the alternative power supply market than other groups. (Staff Init. Br. at 139)

Staff's recommendation should be rejected for several reasons.

First, the recommendation was never specifically made by any Staff witness in testimony. The closest any Staff witness came to making any such recommendation is in the rebuttal testimony of Staff witness Luth where he posits that "(w)hen evaluating whether to consider caps on increases for some rate classes, the amount of increase should also be reviewed."At no point did Mr. Luth actually recommend introduction of the cross subsidy now proposed in this portion of the Staff Brief. (*See* Luth Staff Exs 8.0 and 19.0)

Second, not only was the recommendation never specifically made, it directly contradicts the position taken by Staff's own cost of service witness Ms. Harden. (*See* Harden Staff Ex. 7.0 at 6-8:116-164 – supporting the revenue allocation for IP and CIPS and the revenue allocation for CILCO with modification to allocation to the DS-2 and DS-3 rate classes only, s*ee* also Harden Staff Ex. 18:0 at 2-5:31-90). It also contradicts the position taken by the Staff in support of the Ameren Companies' interclass revenue allocation in the Revenue Allocation Issues – Allocation Methodology sections of the Staff Initial Brief. (*See* Staff Init. Br. at 141). There the Staff states:

> “Staff only takes issue with the revenue allocation methodology as it is applied to one of the three Ameren companies - Ameren CILCO. Staff proposes that the rates for Ameren CILCO’s DS-2 class increase to 4.51% instead of 13.02% proposed by Ameren CILCO with the remaining revenue requirement added to DS-3 rates. (Harden Dir., ICC Staff Exhibit 7.0, pp. 7-8)" (Id.)

Third, the testimony upon which the Staff’s recommendation is apparently based, (Luth Staff Ex. 19.0) is itself a product of flawed analysis and faulty reasoning. For example, Staff witness Luth apparently assumed for the purpose of his analysis in support of requiring DS-4 customers to subsidize other customer classes that considerably more than 5% of the customers in the large industrial class had moved to delivery service rates/alternative supply. (Luth Tr. 842). Cross- examination of Mr. Luth demonstrated that this was simply not true. Mr. Luth admitted that as of June 30, 2006 only 2.2% of the large commercial and industrial (“C&I”) class for CILCO (one megawatt and over) was on delivery service. He admitted that only 3.6% of the CIPS large industrial customers (one megawatt and over) were on delivery service as of June 30, 2006. (Luth Tr. 849-850). He also admitted that only approximately 5% of large customers (one megawatt and over) on the IP system were taking service from retail electric suppliers as of June, 2006. (Luth Tr. 850-851). Thus, the assumption is without merit and does not support his proposal to create a subsidy for smaller customers funded by large customers.

Mr. Luth’s assumption that a large number of DS-4 customers were on alternative supply was also based on the on percentage of the kWh being furnished, to large customers (including customers in addition to DS-4 customers), by alternative suppliers (37.57% for IP, 16.26% for CIPS and 35% for CILCO). (Luth Staff Ex. 19.0 at 6:114-125). However, as of June 20, 2006 only 11.3% of the kWh for customers one megawatt and over in the large C&I (commercial and industrial) class for IP was on delivery service and only 2.2% of the kWh for customers in the large C&I class one megawatt and over was on delivery service in the CIPS service area, (Luth, Tr. 852-853). Furthermore, Mr. Luth admitted that as of June 30, 2006, 28% of the kWh of the large C&I one megawatt and over class in the CILCO service territory was taking delivery service, but that the 28% represented only 2 out of 90 eligible customers. (Luth, Tr. 853).

Mr. Luth also admitted that his calculation, of the kWh of large customers being served by alternative retail electric suppliers, possibly included more than the DS-4 rate class, which is the rate class that is the focus of Mr. Luth's testimony and the apparent Staff recommendation. (Luth, Tr. 851-852). Thus Mr. Luth's calculation of the kWh of large customers on alternative supply is not only inaccurate and out of date, but may be overstated as it relates to the DS-4 class because it may include kWh of customers from other rate classes.

Mr. Luth's testimony was based not only on faulty analysis, but faulty logic as well. The Staff appears to argue that customers who have access to alternative supply could and should pay more for delivery services than customers who do not, relative to their costs of service. (Luth, Staff Ex. 19.0 at 5-6:101-105 and 7:128-136; Staff Init. Br. at 139). This is contrary to the long established policy of the Commission to encourage the development of the competitive market and to insure that customers of alternative retail electric suppliers are not discriminated against. The position of Staff here is indeed ironic in that it was Staff itself which recommended the Commission follow the advice of the Rates Working Group in the Post-2006 Initiative to:

> . . . continue to employ the cost-based ratemaking approach to the delivery component of bundled rates that it developed and refined in the previous delivery service proceedings." (Final Report of the Illinois Commerce Commission's Post-2006 Initiative at 10).

The Staff also recommended that the Commission

> ". . . determine a common delivery service rate for both bundled and unbundled customers for each utility in the post 2006 era. Those rates will foster competition and streamline the regulatory process." (*Id.)*.

In almost a complete turnaround, the Staff (or some segment thereof) now appears to be recommending the creation of cross subsidies in delivery service rates where none currently exist. (*See* cross of Staff Witness Luth, Tr.844 establishing that current delivery service rates for residential customers in all Illinois utilities are essentially set on cost of service.)

Mr. Luth also implies that customers who consume a large number of kWh can absorb enormous increases in their total bill, which is based on a fixed customer charge, a fixed meter charge and distribution demand charges (Luth Tr. 855) simply because the increase, when calculated on a per kWh, basis represents a smaller increase than the increase per kWh for customers who use substantially less kWh, even though they may actually see substantially smaller percentage increases in their bills than larger customers.[9] This approach defies logic and good regulatory policy. Also, it is without basis, given that Mr. Luth has made no attempt to quantify the relative total delivered cost increases (supply plus delivery) increases to be faced by residential and non-residential customer groups, in order to determine which groups faced the largest increases.

Furthermore, the Staff approach ignores the fundamental fact that the Commission has already

[9]For example, the DS-4 customer class for IP will see a 114.6% increase and the DS-2 class will see a 51.4% increase according to Mr. Luth. (Luth, Staff Ex. 19.0 at 5:90-93).

implemented, in the context of the Ameren Companies' power procurement case, a rate mitigation program for residential (DS-1) customers, as proposed by the Staff itself. (*See Central Illinois Light Company d/b/a Ameren CILCO, et al*, ICC Dkts. 05-0160, 05-0161 and 05-0162(Cons.) Order January 24, 2006 at 244-245). The Commission has carefully crafted said program to insure that other customer classes are not required to subsidize the residential customers. The Staff approach here will render ineffective the Commission's correct attempt to insure that other customers do not subsidize such mitigation programs. Staff's approach assumes, without firm foundation, that large customers with access to alternative supply may be able to save money in their acquisition of power supply from a third party supplier in the future, and that part of the assumed supply savings can now be passed along to other delivery service customers who remain on utility supply service. This discriminatory approach should be rejected by the Commission.

In sum, it appears to be Staff's recommendation that DS-4 customers be required to subsidize DS-1 customers, on the unfirm grounds that a small minority of DS-4 customers (2% to 5%) take alternative supply and might save money in their acquisition of power supply some time in the future. The recommendation is illogical, unfair, founded on faulty analysis and reasoning, is contra to past Commission policy, discriminatory, anticompetitive, contra to the Staff's principal position in this case in support of the Ameren Companies' proposed revenue allocation, and in contradiction of the Commission's Post 2006 report. It should, therefore, be rejected.

2. Response to Kroger

Kroger objects to the creation of inter-class cross subsidies. (Kroger Int. Br. at 6-8). IIEC opposes the creation of inter-class cross subsidies as well. However, Kroger also suggests that if a cross subsidization is authorized, the DS-4 class should be called upon to participate in the subsidization. Thus, Kroger proposes to expand the inter-class cross subsidies when the Commission should be reducing those subsidies. IIEC disagrees with the Kroger proposal. As IIEC witness Stephens demonstrated, Kroger's proposal ". . . would grossly over-collect revenues from the DS-4 class." (Stephens IIEC Ex. 4.0 at 12:222-223). It would over collect revenue from the DS-4 customers in the IP service territory by 31%, in the CIPS service territory by 31% and in the CILCO territory by 40%. (Stephens IIEC Ex. 4.0 at 12:225-229).

Staff witness Harden found the Ameren revenue allocation method, which moved, the DS-2 class to more than 10% above its allocated cost responsibility, is unreasonable. (Harden Staff Ex. 18.0 at 4:79-84). Clearly, the Kroger recommendation is unreasonable since it would increase DS-4 customers more than 30% above their allocated cost of service. This is more than three times the level staff witness Harden found objectionable for other rate classes.

Furthermore, the Kroger approach would result in a delivery service rate increase of as much as 415% for some DS-4 customers. (Jones, Ameren Ex. 20.0 at 7:145-147). According to Mr. Jones, "including the DS-4 group in the DS-1, DS-2, and DS-3 revenue allocation would result in delivery service rates for DS-4 customers that no longer resemble cost based rates." (*Id.* at 7:147-149). IIEC agrees with Mr. Jones and recommends rejection of the Kroger proposal to include DS-4 customers in the DS-1, DS-2, and DS-3 revenue allocation.

However, IIEC notes that it is the creation of the inter-class rate subsidies, where they do not presently exist, that is the fundamental problem and the apparent source of Kroger's objection. (Kroger Init. Br. at 6). By allowing the creation of these inter-class subsidies in this case, the

Commission would be creating an endless debate on the movement of delivery service rates to cost of service, the creation of inter-class subsidies, and the existence of inter-class subsidies for favored rate classes in all future delivery service cases for the Ameren Companies.

The Commission has been able to wring these subsidies out of delivery service rates. (Stephens, IIEC Ex. 1.0 at 12:239-243). The Commission has refused to create cross subsidies in other delivery service rate cases. (*See Commonwealth Edison Company*, ICC Dkt. No. 05-0597, Order, July 26, 2006 at 172 and 176, where the Commission accepted ComEd proposed revenue allocation which eliminated inter-class subsidies; *Central Illinois Public Service Company*, ICC Dkt. 00-0802, Order, December 11, 2001 at 51 - approving Rider ISS - Interim Supply Service for CIPS and concluding it was inappropriate to intentionally develop rates with cross subsidies.) It has adopted a policy of basing delivery service rates on cost of service as part of its policy on the creation of, and the enhancement of competitive retail markets. It should maintain that policy in this case as it has in every delivery service case to come before the Commission since the passage of the Electric Service Customer Choice and Rate Relief Law of 1997. At a minimum, the Commission most certainly should not expand any proposed cross subsidies to include DS-4 customers.

Kroger essentially proposes to combine the DS-3 and DS-4 classes in this case by having common distribution charges for DS-3 and DS-4 customers. (Kroger Init. Br. at 2). However, as IP witness Jones testified this would cause DS-4 rates to rise to unacceptable levels above cost of service. As noted above, DS-4 rates would be 31% to 40% above cost of service for each of the Ameren Companies.

Kroger also argues that maintenance of separate charges for DS-3 and DS-4 classes will provide incentives for certain DS-3 customers to qualify for DS-4 service. Ameren Companies' witness Jones responded to this argument indicating that qualifying for DS-4 service will not necessarily guarantee benefits for DS-3 customers. (*See* Jones Ameren Ex. 41.0 at 4-5:76-106). Mr. Jones noted that the Kroger witness had not considered the "availability" or "delivery service rate reassignment" provisions of DS-3 and DS-4 in arriving at his conclusions. These provisions make it difficult for customers to artificially increase demands to become eligible for a different rate and obtain economic benefit from doing so.

Furthermore, the Kroger argument ignores the fact that it is the Ameren Companies, not customers, who would be penalized if DS-3 customers artificially increase their demand to qualify for DS-4, because the Ameren Companies would under-recover their revenue requirement under such circumstances. However, it is the Ameren Companies that have actually proposed the different rates for DS-3 and DS-4 customers. If the Ameren Companies are not concerned about the possibility that DS-3 customers may artificially increase their demands to qualify for DS-4 service, the Commission should not be concerned.

Finally, many of the Kroger concerns about the difference between DS-3 and DS-4 rates were mitigated by the Ameren Companies' changes to their ECOSS. (Jones, Ameren Ex. 20.0 at 6:124-133).

C. Cost of Service Issue

The Citizens Utility Board proposes to use the average and peak ("A&P") method to allocate distribution demand costs among the customer classes for the purposes of the embedded cost of service study ("ECOSS"). (CUB Init. Br. at 19). Ameren Companies support the use of the non-coincident peak method (NCP) for allocation of these costs, a method that has been consistently approved by the Commission in electric delivery service rate cases in the past, including the recently completed ComEd delivery service case. (ComEd ICC Dkt. 05-0597, Order, July 26, 2006 at 172). The Commission should decline the use of the A&P method in this case as well.

The A&P method is based upon the false premise that the distribution system is designed to match a customer's annual usage rather than the customer's peak demands. The weight of the credible evidence in this case clearly demonstrates otherwise. Staff, IIEC and the Ameren Companies have either explicitly or implicitly recognized that CUB's premise is simply not the case. (*See* Ameren Init. Br. at 124-125; IIEC Init. Br. at 40; and Staff Init. Br. at 129 - accepting the Ameren Companies' ECOSS and the allocation methods and factors contained therein.)

CUB, on the other hand, argues that the distribution system is designed to meet "every day demands" not only customers' non-coincident peak demands. (CUB Init. Br. at 17). CUB's arguments simply ignore the fact that unless the system is designed to meet the customers' peak non-coincident demands, it will not be capable of meeting their other demands each and every day.

CUB's argument that the Commission has accepted the use of the A&P method in gas distribution cases in Illinois (CUB Init. Br. at 16) is not persuasive here and was not ultimately persuasive with the Commission in the recently completed ComEd delivery service case, where CUB made similar arguments. (*See Commonwealth Edison Company*, ICC Dkt. 05-0597, Order, July 26, 2006 at 168 and 172). Also, as the Ameren Companies correctly noted in their Initial Brief, there are substantial differences between a gas utility and electric utility. (Ameren Init. Br. at 124-125). This makes the application of the A&P method for electric companies problematic.

CUB is hugely mistaken in the assumption that the allocation of demand related distribution costs on the basis of peak demands fails to give recognition to how customers use the system. (CUB Init. Br. at 16). To the contrary, it is CUB's method which fails to recognize how the system is used. Because the system is designed to meet customers' maximum demands, whenever and however they occur, customers are able to use the system 24 hours a day, 7 days a week, 365 days a year regardless of whether they consume 1 kWh or 1 billion kWh of electricity. This is because the system is designed to meet their highest or maximum demands. The frequency of the customers use of the system is irrelevant to the design of the system. Its design and size are the exclusive function of the number of customers to be served and the maximum demands they place on the system.

The CUB approach also penalizes those customers who use the system most efficiently. As IIEC witness Chalfant explained, the CUB approach is equivalent to charging customer A more for the same camera than customer B because customer A takes more pictures than customer B. (Chalfant, IIEC Ex. 5.0 at 19:393-401). Such an approach makes no economic sense, and penalizes customer A because he is able to use the camera most efficiently. Furthermore, the Ameren Companies' witnesses agreed that it would be unfair to charge two customers a different price for the installation, maintenance and operation of a driveway, assuming the two driveways are of the same design and construction, and capacity, simply because one customer elected to park two cars in his driveway, and the other customer parked only one. (DiFani, Tr.323-324) The CUB approach penalizes the customer who is able to make most efficient use of the driveway.

Likewise, on the utility system, charging customers for the demand related cost of the distribution system (the driveway) on the basis of their annual use as measured in kWh consumed, (cars parked) penalizes the customers who are able to make most efficient use of the system.

For all these reasons, CUB's proposal to use the A&P method for the allocation of demand related distribution cost should be rejected.

D. Inter-Class Allocation Issues

1. Allocation Methodology

CUB argues that the revenue allocation for each of the Ameren Companies should be based on an alleged class risk differential. (CUB Init. Br. at 19-22). CUB states:

> "Based on the record, CUB recommends that the Commission limit the residential class increase to 90% of the system average increase." (CUB Init. Br. at 22).

Specifically, CUB argues that the residential class is less risky to serve than the large commercial and industrial classes.

However, contrary to CUB's position, the record fails to show how the 90% ratio was developed. It fails to show how the 90% ratio reflects the relative riskiness of the residential class in relation to any other customer class. Indeed, CUB witness Thomas testified that no one has ever been able to quantify class risk differentials. (Thomas, CUB Ex. 4.0 16:328; Thomas Tr. 963-964). Therefore, there is no record support for the 90%. There is only pure speculation and the arbitrary determination of the CUB witness, that the 90% risk adjusted allocation factor for the residential class is appropriate. The Commission cannot adopt such an approach based on this type of record.

In order to quantify a concept such as CUB's risk adjustment, it is important to have a well defined yardstick to allow measurement. CUB's proposal lacks even the most basic component of such a yardstick - it has no starting point! Mr. Thomas was asked to explain what risk multiplier would be applied to a class with zero risk. The witness testified that:

> ". . . you might need to figure the average risk for all customers classes, and somehow reduce all the risk out for that customer class." (Thomas, Tr. 964).

The word "somehow" is critical here. It is the "somehow" that is missing from the CUB approach.

He also suggested as an alternative that a zero risk factor could be assigned to the particular risk free class. (*Id.*). This is clearly an unacceptable alternative, because it means that such a class would be responsible for none of the return the Company is allowed to earn.

Therefore, it is clear that not only does CUB have no basis for assigning an arbitrary 90% risk adjustment to the Residential class, it does not even have a yardstick that is useful in determining what the adjustment should be in the event it were determined that such adjustments should be made.

Furthermore, CUB has not offered any credible description of its revenue allocation proposals. (*See* Thomas, Tr. 976-977). Its analysis of the impact of the proposals either contained significant major errors or reflected the impact of an approach that produces highly unfair and unreasonable results. (Thomas, Tr. 965-977).

Also, contrary to CUB's arguments the residential customers are not less risky to serve — they are in fact more risky to serve than larger customers. (Jones Ameren Ex. 20.0 at 8-9:180-186; Chalfant, IIEC Ex. 5.0 at 23-24:481-491; Gorman, IIEC Ex. 6.0 at 26:580-592).

Specific elements of CUB's arguments are also contradictory of positions taken by CUB in other portions of the case. For example, CUB argues that large commercial and industrial customers are riskier to serve because they have the capability to respond to real time prices and residential customers do not. (CUB Init. Br. at 21). However, later in its Initial Brief CUB argues for approval of a real time pricing program for residential customers, presumably because CUB believes those customers have the ability to respond to higher prices by reducing consumption. CUB cannot have it both ways.

CUB also argues that large commercial and industrial customers are riskier to serve because they are more likely to relocate in response to high energy prices than residential customers. (*Id.*) If this is, in fact, true, then CUB's proposals to shift the responsibility for utility revenue requirement to levels well above the large commercial and industrial customers' cost responsibility would encourage them to relocate, thereby making the commercial and industrial class even riskier to serve in the future and presumably justifying even larger subsidies from those classes to CUB's constituency. CUB's argument, followed to its logical conclusion would eventually assure there were no commercial and industrial customers left to provide subsidies to CUB's constituency in the future. Admittedly, this illustration of the illogic of CUB's argument is greatly over simplified. However, it clearly demonstrates CUB's faulty reasoning.

In sum, CUB proposes to limit the residential increase to 90% of the system average increase on the basis of a class risk differential that cannot be calculated, because it does not exist, and that could not be calculated even if it did, using an allocation ratio that has no factual or empirical foundation in the record. CUB's recommendation should be rejected.[10]

[10] In its testimony in this proceeding CUB recommended an allocation methodology that reflected the application of its A&P method, its 90% limitation on the residential customer rate increase, and a minimum 75% increase for all customer classes and the allocation of any remaining unallocated revenue to the DS-4 class. (Thomas, CUB Ex. 4.0 at 18:370-373). IIEC assumes that because CUB did not discuss each of the elements of its original allocation methodology, that it no longer is a proponent of the entire methodology in this case. To the extent that CUB expands the discussion, in its Reply Brief, to include a discussion of its full methodology, IIEC refers the

2. Minimum Distribution Study

IIEC requested that the Ameren Companies recognize the minimum distribution system ("MDS") concept in their next ECOSS or, in the alternative, be required to provide parties with the results of such a study in the next case, in order for the Commission to be able to consider the merits of the MDS approach in the next rate proceeding. (Chalfant, IIEC Ex. 2.0 at 3:45-51). Wal-Mart supports the use of the MDS concept. (Wal-Mart Init. Br. at 13-15). The Ameren Companies correctly recognize the merits of this approach. (Ameren Init. Br. at 137). The Commission itself has recently expressed a willingness to consider such an approach in future rate proceedings. (*Commonwealth Edison Company*, ICC Dkt. 05-0597 Order, July 26, 2006 at 165). Under the circumstances, and because the utility is the only party able to perform and provide such a study, it is logical to adopt IIEC's position so that the Commission may in fact consider the application of this approach in the Ameren Companies'next rate cases.

However, the Ameren Companies and Staff oppose IIEC's recommendation that the Ameren Companies either incorporate this approach in the ECOSS presented in its next rate case or at least provide the results of such a study for the parties use in the next rate case so the Commission may in fact consider the use of the minimum distribution system approach. (Ameren Init. Br. at 134; Staff Init. Br. at 144)

Commission to its cross-examination of Mr. Thomas, Tr. 963-977. The cross demonstrates either (i) there are flaws in the methodology, as measured by its resulting impacts, or (ii) there were major errors made by CUB in demonstrating the impacts of its full allocation methodology. These flaws or errors justify the rejection of the methodology, in this case, because the Commission cannot be sure of its ultimate impact.

IIEC recognizes that the Commission refused to require Commonwealth Edison to incorporate the MDS approach in the cost of service study presented in its next case. (*Commonwealth Edison Company*, ICC Dkt. No. 05-0597, Order, July 26, 2006 at 165.). However, the record here establishes that Ameren Companies have performed such studies in the past, and have recommended their use to the Commission. (Chalfant, IIEC Ex. 2.0 at 20-21:411-427). The Ameren Companies are uniquely able to perform the analysis associated with the study recognizing the MDS concept. Other parties are not able to do so in the context of a litigated rate case, because the information required for such a study is within the control of the utility, and there is no realistic opportunity for an intervenor in the case to obtain the necessary information and perform the study in time for the completion of the case within the 11-month statutory time period. Therefore, if the Commission is to give fair consideration to the use of the MDS approach in a future proceeding, it must be the utility that provides the study, either in the context of its proposed cost of service study or in the context of a cost of service study that it makes available to the parties for their use in the next rate proceeding.

IIEC notes that Staff appears to argue, in opposition to IIEC's recommendation, that unless the Commission actually intends to use the MDS concept, the Commission should not direct the Ameren Companies to perform any study incorporating the MDS concept. Clearly, the Commission need not decide the merits of this issue in order to request the Ameren Companies to provide the information necessary for the Commission to consider the merits in the first instance. IIEC believes the information the Ameren Companies would provide will allow fair consideration of the appropriateness of the MDS concept in the next case, without requiring the Commission to determine whether it will accept the approach at this time. Adoption of Staff's position would constitute a prejudgement of the issue and prevent a fair consideration of the MDS concept in a future case.

CUB misunderstands or misapprehends the concept of the MDS. It states:

> "The minimum distribution method ignores the fact that distribution demand cost is not only related to the number of customers connected to the system, but also their demand for electrons." (CUB Init. Br. at 18).

CUB fails to realize that the minimum distribution method does not address the allocation of "demand related costs," but is used to determine which particular distribution costs are, in fact, demand related, and which are customer related. However, it is encouraging to know that in this portion of their Initial Brief, CUB appears to accept the idea that distribution costs are in fact customer and demand related and not related to the volume of kWh consumed as assumed by the A&P method discussed in Section IV.C. above.

VI. Responses to Commissioners' Questions

Staff has indicated that there are potential system wide benefits that could be realized from demand response programs and these benefits are more likely to be realized if there is significant participation among the utilities' largest customers. (Staff Init. Br. at 171). IIEC agrees with the Staff. For that reason IIEC has recommended that the Ameren Companies be directed to present the rate impacts of a change in the method of calculation of billing demand from a 24-hour a day demand basis to an on-peak demand basis, in the context of the next delivery service rate case. (IIEC Init. Br. at 46-47). The Ameren Companies did not address this issue in their Initial Brief. Such a modification has the potential to encourage the use of off-peak consumption, which will impact the cost of energy for customers in the same procurement segment, who take auction-based electric supply from the Ameren

Companies. (Stephens, IIEC Ex. 4.0 at 15:280-299). As Ameren Companies' witness Mr. Cooper testified, the market has historically rewarded or produced lower prices for flatter load patterns. (Cooper, Tr. 872). Customers who have the ability to modify their demand to create these flatter load shapes should be encouraged to do so. IIEC's recommendation should be adopted.

CONCLUSION

For the reasons stated herein, IIEC's position on the issues described should be adopted by the Commission.

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Respectfully submitted,

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