**STATE OF ILLINOIS**
**ILLINOIS COMMERCE COMMISSION**

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| **Central Illinois Light Company d/b/a AmerenCILCO** <br> **Proposed general increase in rates for delivery service (tariffs filed December 27, 2005)** | ) ) ) ) ) ) | **Docket No. 06-0070** <br> **(Cons.)** |
| **Central Illinois Public Service Company d/b/a AmerenCIPS** <br> **Proposed general increase in rates for delivery service. (tariffs filed December 27, 2005)** | ) ) ) ) ) ) | **Docket No. 06-0071** |
| **Illinois Power Company d/b/a AmerenIP** <br> **Proposed general increase in rates for delivery service (tariffs filed December 27, 2005)** | ) ) ) ) ) | **Docket No. 06-0072** |

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**REPLY BRIEF ON EXCEPTIONS OF THE**
**STAFF OF THE ILLINOIS COMMERCE COMMISSION**

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Table of Contents

Page

III. RATE BASE .......... 2
E. Reallocation of IP's Depreciation Reserve .......... 2
F. Other Post-Employee Benefits Liability .......... 3
1. Unfunded OPEB .......... 3
2. ADIT Treatment .......... 4
G. CWC .......... 5
IV. OPERATING EXPENSES AND REVENUES .......... 8
D. Rate Case Expense .......... 8
1. Delivery Service Rate Case Expense .......... 8
E. Administrative and General Expenses .......... 10
1. Functionalization .......... 10
V. RATE OF RETURN .......... 11
B. Capital Structure .......... 11
C. Measurement date of Short-term and Variable Interest Rates .......... 15
E. Cost of Common Equity .......... 17
VI. RATE DESIGN .......... 18
C. Cost of Service Issues .......... 18
1. Minimum Distribution System Study .......... 18
4. Interclass Subsidization .......... 19
CONCLUSION .......... 22

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**REPLY BRIEF ON EXCEPTIONS OF THE**

**STAFF OF THE ILLINOIS COMMERCE COMMISSION**

Now comes the Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned attorneys, and pursuant to Section 200.830 of the Rules of Practice of the Illinois Commerce Commission (“Commission”), 83 Ill. Adm. Code Section 200.830, respectfully submits this Reply Brief on Exceptions to the briefs on exceptions filed by Central Illinois Light Company d/b/a AmerenCILCO (“AmerenCILCO”), Central Illinois Public Service Company d/b/a AmerenCIPS (“AmerenCIPS”), and Illinois Power Company d/b/a AmerenIP (“AmerenIP”) (collectively, “Ameren” or the “Ameren Companies” or the “Companies”) or the Ameren Companies (“Ameren BOE”); Cities of Champaign, Urbana, and Bloomington, Town of

Normal and Champaign County or the Local Governmental Entities ("LGE BOE"); Constellation NewEnergy, Inc. and Peoples Energy Services Corporation ("CNE/PES BOE"); the Citizens Utility Board ("CUB BOE"); the Illinois Industrial Energy Consumers ("IIEC BOE"); Local Unions 51, 309, 649, 702, and 1306 of the International Brotherhood of Electrical Workers, AFL-CIO ("IBEW BOE"); and Wal-Mart Stores, Inc. ("Wal-Mart BOE") which were filed on October 18, 2006 in response to the Administrative Law Judges' Proposed Order ("Proposed Order" or "PO") issued October 4, 2006.

## III. RATE BASE

### E. Reallocation of IP's Depreciation Reserve

Response to Ameren

The Commission should reject Ameren's arguments and proposed replacement language regarding the reallocation of the depreciation reserve presented on pages 28-31 of Ameren's Brief on Exceptions. The Commission is correct in denying Ameren's request to reallocate AmerenIP's depreciation reserve. Reallocation does nothing to correct the problem of inaccurate depreciation rates and there is nothing to indicate that the methodology is acceptable under GAAP. (Jones Reb., ICC Staff Exhibit 14.0, pp. 8-9) Additionally, reallocating depreciation reserves would have no impact on AmerenIP's revenue requirement in the current rate proceeding. (Tr., p. 492)

AmerenIP ignores the fact that the Statement of Financial Accounting Standards ("FAS") 71 that it cites as supportive of the reallocation (Stafford Sur., Respondents' Exhibit 36.0, p. 17) merely specifies how the effects of different types of rate actions are reported in general-purpose financial statements. (Jones Reb., ICC Staff Exhibit 14.0, p. 9) AmerenIP also ignores the fact that reallocation of the depreciation reserve does nothing to correct the problem of inaccurate depreciation rates. (*Id*., p. 8) Ameren's claim that the reallocation will mitigate the future impact of changes in depreciation rates to customers (Ameren BOE, p. 29; Ameren IB, p. 18) is not meaningful. Just as shuffling accumulated depreciation among the individual depreciable asset groups does not change the total amount of accumulated depreciation, neither does it change the total amount of depreciation expense that will eventually be recovered for those asset groups.

### F. Other Post-Employee Benefits Liability

#### 1. Unfunded OPEB

Response to Ameren

The Commission should reject Ameren's arguments and proposed replacement language regarding the unfunded OPEB liability presented on pages 20-23 of Ameren's Brief on Exceptions. The Commission is correct in its decision to reduce rate base by the unfunded post-employment benefits ("OPEB") liability at December 31, 2004. Because OPEB expense is provided for in base rates, the unfunded liability reflects a cost-free source of capital on which shareholders are not entitled to receive a return. (Jones Reb., ICC Staff Exhibit 14.0, p. 19)

The Ameren Companies' arguments against reducing rate base by the unfunded OPEB liability at December 31, 2004 (Ameren IB, pp. 20-23) are unconvincing and demonstrate a lack of understanding of the ratemaking process. One cannot simply identify the amount of OPEB expense included in the cost of service on which current rates are based and state that is the amount the Ameren Companies have recovered each year that the rates have been in effect. (Ameren BOE, pp. 20-21; Ameren IB, p. 22)

It is inappropriate from an accounting perspective to single out any particular component of the cost of service and analyze that item in isolation. The cost of service must be considered in the aggregate. The components of cost of service are dynamic, in that the costs of some things increase, while the costs of other things decrease. The appropriate comparison is to compare what has been expensed with what has been funded. The OPEB liabilities reflect that the Ameren Companies have recorded more OPEB expense than they have actually paid. (Jones Reb., ICC Staff Exhibit 14.0, p. 19)

Based on the foregoing, the Proposed Order correctly decided to reduce rate base by the unfunded post-employment benefits liability at December 31, 2004. Thus, all of the Ameren Companies' arguments in its BOE must be rejected.

### 2. ADIT Treatment

Response to Ameren

The Commission should reject Ameren's arguments and proposed replacement language regarding accumulated deferred income taxes ("ADIT") presented on page 23 of Ameren's Brief on Exceptions. To be consistent with the inclusion of the OPEB liability in rate base, the related ADIT must also be included in rate base. Because the Commission made the decision to reduce rate base by the unfunded post-employment benefits ("OPEB") liability at December 31, 2004, the Commission is correct in its decision to include ADIT related to the unfunded OPEB liability in rate base.

## G. CWC

Response to Ameren

The Ameren Companies claim that because the Net Lag Methodology has been approved in prior proceedings, it should be approved in the current proceeding. (Ameren BOE, p. 31) This claim is without merit. First and foremost is that a rate case should be decided on the facts in the record for that proceeding. While a decision in a prior case can be instructive in a later rate case, that decision alone should not dictate the outcome in the instant proceeding. Second, the Ameren Companies' claim that the methodology has been accepted in prior proceedings is unsupported in the record. In fact, the ALJs' invited the Ameren Companies to cite just such information in its Initial Brief. (Tr., p. 370) Having failed to provide that information, the statement is unsupported and should be given no weight in the final determination on this issue. (Staff RB, p. 16)

Ameren further argues that the difference in the two methodologies offered by the parties lies in the treatment of revenues. This also has been Staff's understanding throughout the case. Staff's proposed Gross Lag methodology more accurately excludes the effects of non-cash items from the determination of cash working capital. Ameren's Net Lag methodology does not consider the **amount** of cash revenues provided by ratepayers through base rates. Conversely, Staff's Gross Lag methodology does consider the amount of cash revenues (i.e., revenues received on account of cash expenses). (Staff IB, p. 30) Just as the level of the various cash expenses are used to determine the CWC requirement, so also must the level of cash revenues provided by ratepayers be considered. (Ebrey Reb., ICC Staff Exhibit 13.0 (Corrected), p. 5; Staff IB, p. 30) The Ameren Companies have never rebutted this statement. In fact, the

Companies admit through their Initial Brief that the Net Lag methodology does not include revenues. (Ameren IB, pp. 29, 30) As Staff witness Ebrey stated during cross examination,

> To the extent that the daily cash provided through base rate revenues exceeds the daily cash needs of the company, those funds are ratepayer-supplied and result in negative cash working capital.
>
> When the daily cash provided through base rate revenues is less than the daily cash needs of the company, the shortfall [is] with shareholder supply then results in positive cash working capital.

(Tr. 559-560) Without any measure of the **amount** of revenues provided by the ratepayers, the amount, if any, to be provided by shareholders cannot be determined. (Staff RB, p. 17)

For the second time in this proceeding[1], the Ameren Companies try to argue the appropriate level of revenues to be included in the CWC calculation in their brief. (Ameren BOE, pp. 31-32) Similar to its untimely argument relative to the appropriate level of expenses to be used in the CWC calculation in their Reply Brief, the Ameren Companies belatedly-provided "testimony" offered in their Brief on Exceptions should be given no weight in the decision in this proceeding.

The "correct calculation" of revenues attached to the Companies' BOE is nothing more than an alternate presentation of the Net Lag Methodology. The "Total Revenues in CWC calculation" included on the Ameren Schedules (Appendix A, page 7 of 8 (Corrected), Appendix B, page 7 of 8 (Corrected, and Appendix C, page 7 of 8 (Corrected)) are based on the sums of the "Expenses requiring Cash Working Capital"

[1] In its Reply Brief the Companies attempted to offer argument regarding the level of revenues to be included in the CWC calculation based on the Gross Lag Methodology. (Ameren RB, p. 16)

from the previous page of the respective appendices attached to Ameren's BOE. This presentation does not consider the **amount of revenues provided by ratepayers** to cover the cash requirements of the Companies. Thus, the schedules attached to Ameren's BOE should not be given any weight.

After presenting argument throughout this case, up to and including the BOE, of the shortcomings of applying the Gross Lag methodology for CWC calculation, Ameren back-pedals in its proposed language for the final Order stating that "The Commission does not by this action suggest that the Gross Lag approach is inappropriate for use in Illinois." (Ameren BOE, p. 33) During this proceeding, Ameren witness Adams contended that "the gross lag methodology produces illogical results and adds unnecessary confusion to the determination of the Companies' cash working capital requirements". (Adams Sur., Respondents' Exhibit 37.0, p. 43) However, this proceeding is the first time in Illinois that Mr. Adams or his consulting firm has proposed cash working capital based on anything other than the Gross Lag methodology which he now criticizes. (Tr., pp. 532 - 533) In fact, Mr. Adams' final proposal in the latest Illinois Power gas rate proceeding, Docket No. 04-0476, used the exact same format and gross lag methodology Staff has proposed in this proceeding. (ICC Staff Cross Exhibit 15) This history undermines the credibility of Mr. Adams' argument that "the gross lag methodology produces illogical results and adds unnecessary confusion to the determination of the Companies' cash working capital requirements." (Staff IB, pp. 32-33) Now, in an effort to ostensibly save face, Ameren seems to claim that either methodology would be appropriate. While Ameren appears to be on the fence as to which methodology is correct, Staff is certain. The gross lag methodology is most appropriate because it more accurately excludes the effects of non-cash items from the determination of cash working capital. Ameren's contradictory proposed language only further supports Staffs position which the Proposed Order also found appropriate.

Ameren's arguments in opposition of the Proposed Order regarding the appropriate methodology for calculating the CWC allowance have been shown to be without merit and, along with the proposed language change, should be disregarded. With the exception of the clarifications suggested by Staff (Staff BOE, pp. 9-10), the Proposed Order correctly concludes this issue.

## IV. OPERATING EXPENSES AND REVENUES

### D. Rate Case Expense

#### 1. Delivery Service Rate Case Expense

Response to Ameren

The Commission should reject Ameren's arguments and proposed replacement language regarding rate case expense presented on pages 25-28 of Ameren's Brief on Exceptions. The Proposed Order correctly addresses Staff's concerns regarding the Ameren Companies' lack of support for their rate case expense estimates. The Company errs in its statement that Staff refused to perform any "reasonableness" analysis of the Company's rate case estimates. (Ameren BOE, p. 28) The record supports Staff's claim that the Ameren Companies were unable or unwilling to provide Staff with any information with which to determine if the rate case estimates were reasonable. Thus, the absence of an analysis directly results from the Companies' inability or unwillingness to provide Staff with any information with which to conduct such an analysis. It is the Ameren Companies' responsibility to provide sufficient information about how they derived their estimates so that other parties can evaluate the reasonableness of the Ameren Companies' assumptions and how they arrived at the proposed amounts based upon those assumptions. The Ameren Companies simply failed to do so.

Although Company witness Stafford testified in surrebuttal testimony that service provider rates, contracts, letters of engagement, and historical data were used to derive rate case cost estimates (Stafford Sur., Respondents' Exhibit 36.0, p. 11), three contracts, one of which related to the BGS proceedings (Docket Nos. 05-0160/05-0161/05-0162 (Cons.)), were the only documentation provided to Staff in response to requests for how the Ameren Companies' estimates were determined. (Jones Reb., ICC Staff Exhibit 14.0, pp. 4-5) At the evidentiary hearings, Mr. Stafford acknowledged that several of the estimates with outside providers were based on verbal communications and that no calculations were performed for other categories of rate case estimates. (Tr., pp. 477-487)

Finally, it is creative, but irrelevant, to argue that Ameren's rate case expense must be reasonable because it is less than the rate case expense approved in Commonwealth Edison's DST proceeding (Docket No. 05-0587). (Ameren BOE, p. 26) Every case stands on its own merits. The fact that Commonwealth Edison Company or any other utility justified inclusion in its rates of a certain expense at a certain level says nothing about whether the Ameren Companies have met their burden to support their expenses, and in no way entitles the Ameren Companies to include any other utility's level of expense in their rates absent appropriate support.

The Commission is correct in accepting Staff's proposed disallowances to rate case expense.

## E. Administrative and General Expenses

### 1. Functionalization

Response to Ameren

The exceptions presented by the Ameren Companies on A&G expenses offer little substance and provide no basis to overturn the recommendation of the ALJs to adopt the Staff-proposed adjustments for AmerenCIPS and AmerenCILCO.

The Ameren Companies profess to be troubled by the precedent that would be set by adopting the Staff proposal. According to the Ameren Companies:

> The entirety of Staff's testimony is based on comparing previously approved expense levels with the Ameren Companies' current expenses, and opining as to whether the percentage increase of actual expense levels is appropriate.

(Ameren BOE, p. 24) The Ameren Companies go on to assure the Commission that "[t]his is an inappropriate ratemaking method". (*Id.*) Furthermore, they contend that current A&G levels should not be "based on past approved amounts". (*Id*.)

Having stated how the Commission should not proceed, the Ameren Companies go on to argue that "A&G expenses should be set according to the record evidence in this case". (*Id*.) As part of that record, the Companies claim to "have shown proper allocation of A&G costs among affiliates." (*Id.*)

Unfortunately, it is on this final point that the Ameren Companies' argument breaks down. As pointed out by Staff during this case, the Ameren Companies have arbitrarily undertaken a significant reallocation of expenses for Ameren Services

Company without explanation or support. The Ameren Companies' deficiency is summed up as follows in Staff direct testimony:

> Q. Do[ ] the Ameren Companies' filings offer any explanation or justification for this large-scale reallocation of A&G expenses to distribution?
>
> A. No, they do not. The only discussion provided in the Ameren Companies' filing are general explanations regarding why A&G expenses have increased from the last round of cases to the current proceeding. There is no discussion to indicate that the significant reallocation of A&G-related AMS expenses represents a significant deviation from the last round of delivery service cases.

(Lazare Dir., ICC Staff Ex. 6.0, p. 23, lines 535-539) Given the lack of explanation or support for the Ameren Companies' proposed reallocation of Ameren Services costs, Staff reasonably argued that the Ameren Companies had failed to provide any basis for revising the allocation of these costs that was adopted in the previous round of delivery service cases. Staff then proposed adjustments for AmerenCIIPS and AmerenCILCO that reflected their arbitrary changes to these previous allocations approved by the Commission.

Thus, the Ameren Companies' exceptions on this issue should be rejected and Staff's reasoned adjustment should be accepted in the Commission's Final Order for this proceeding.

## V. RATE OF RETURN

### B. Capital Structure

Response to IIEC

IIEC recommends that the PO's proposed capital structure for IP be rejected and an imputed capital structure be adopted. (IIEC BOE, pp. 10) IIEC argues that the PO's conclusion lacks supporting evidence, improperly reverses the burden of proof, and conflicts with the cost of equity adopted. Staff maintains that IIEC is incorrect with regard to the first two assertions, and disagrees with IIEC's proposed solution to the third.

First, the record evidence supports the PO's adoption of Staff's capital structure proposal. Staff demonstrated that its capital structure proposal for IP, which the PO adopts, produces financial ratios commensurate with an A+ rating, which indicates a strong but not excessive degree of financial strength. (Pregozen Dir., Staff Exhibit 5.0, p. 32) Furthermore, IIEC's proposed capital structure was properly rejected since IIEC's arguments rely solely on IIEC's improper analysis of IP's debt ratio exclusive of TFTNs. As Staff explained, a ratio analysis performed with a utility's TFTNs and their associated cash flows removed is inappropriate for assessing the utility's financial strength and cost of capital for rate making purposes. (Pregozen Reb., Staff Exhibit 16.0, pp. 19-21) IIEC's exclusive reliance on IP's debt ratio exclusive of TFTNs only exacerbates the problem, since the debt ratio does not account for the cash flow that is used to retire the TFTNs. Indeed, of the three published benchmark ratios S&P uses in its assessment of financial strength, the debt ratio is the only one that <u>always</u> improves with the removal of TFTNs. Therefore, IIEC's exclusive reliance on the debt ratio renders its arguments invalid.

Second, the PO's approach to setting the capital structure did not reverse the burden of proof. As the PO notes, the Commission's assessment of the appropriated capital structure must start somewhere. That starting point should be the actual capital structure supporting the utility's rate base. After the actual capital structure is established and is supported by evidence in the record that it is a reasonable capital structure, an alternative capital structure should not be imputed. This is the approach which Staff witness Pregozen followed. (Pregozen Reb., ICC Staff Exhibit 16.0, p. 22) Staff witness Pregozen testified in his rebuttal testimony that he first assessed whether the Ameren Companies actual capital structure was appropriate for setting rates which he concluded they were after making his adjustments. He then testified that because the actual capital structure was reasonable no need existed to consider alternate hypothetical capital structures. (Pregozen Reb., ICC Staff Ex. 16.0 Corrected, pp. 22-23) The Commission has followed this approach in the past, and has been affirmed on this issue. In a prior IP rate case, IP argued that its highly leverage actual capital structure was inappropriate for ratemaking purposes and therefore the Commission should have used a hypothetical capital structure. IP appealed, but the Court affirmed the Commission's holding that a hypothetical capital structure should only be used "when the utility's actual capital structure is found to be unreasonable, imprudent or unduly affected by such circumstances as double leverage as to unfairly burden the utility's customers", as well as the Commission's finding "that Illinois Power had failed to demonstrate that use of its actual capital structure was unreasonable, imprudent or unduly burdened the ratepayers. (Hartigan v. Illinois Commerce Commission, 214 Ill. App. 3d, 222, 228 (1991)

Third, Staff agrees with IIEC that the adopted capital structure conflicts with the cost of equity; however, Staff believes it is the cost of equity that should adjusted, rather than the capital structure. Staff's cost of equity was derived from a sample of companies with an average rating of A–. Since IP's capital structure indicates a less risky A+ rating, Staff concluded that a downward adjustment of 29 basis points was necessary. (Freetly Dir., Staff Exhibit 4.0, pp. 22-26) Staff maintains that its recommended adjustment to the cost of equity is the appropriate solution to the inconsistency between the capital structure and the cost of equity, rather than the capital structure adjustment IIEC proposes. This was more fully addressed in Staff's BOE. (Staff BOE, pp. 24-26)

For the foregoing reasons, IIEC's exceptions to the PO's capital structure and the corresponding proposed language changes should be rejected.

Response to CUB

CUB argues that the Commission should reject the PO's capital structure as overly conservative and, instead, impute a capital structure producing financial ratios in the BBB range. (CUB BOE, pp. 2-3) Staff does not agree that the PO's capital structures are overly conservative. Indeed, Staff found those capital structures, and the corresponding implied credit ratings, to be reasonable. (Pregozen Reb., Staff Exhibit 16.0, p. 22) Furthermore, Staff does not endorse the targeting of a BBB rating, nor any one particular rating, as *the* optimal benchmark, given the difficulties in measuring the relationship between credit rating and cost of capital and the cost of financial distress. (Pregozen Reb., Staff Exhibit 16.0, p. 24) Thus, the Commission need not impute a hypothetical capital structure in this proceeding.

In addition, CUB compares the ratings implied by the capital structures adopted for the Ameren Companies to the rating implied by the capital structure adopted in the recent ComEd rate case and argues that "a dramatically different capital structure between this DST case and the ComEd DST case makes no sense." (CUB BOE, p. 3) However, as noted above, there is no single optimal capital structure or target rating.

Thus, the Commission should not reject a utility's actual capital structure, so long as it is reasonable. As noted above, Staff believes the ratings implied by the capital structures adopted in the PO are reasonable and use of an imputed hypothetical capital structure is unnecessary.

For the foregoing reasons, CUB's exceptions to the PO's capital structure and the corresponding proposed language changes should be rejected.

### C. Measurement date of Short-term and Variable Interest Rates

Response to LGE

LGE takes exception to the PO's adoption of the interest rate for short-term and variable rate long-term debt proposed by Ameren, which was measured as of May 19, 2006. (LGE BOE, pp. 2-3) LGE argues that the Commission should instead adopt the six-month average interest rate recommended by LGE witness Cuthbert. LGE claims that the PO fails to explain why spot rates are superior to average rates. In fact, LGE argues, the use of spot rates is worse, since it enables parties to manipulate the cost of debt by "cherry-picking" a measurement date that produces the desired interest rates. Moreover, LGE argues that the adoption of a May 19, 2006 spot rate mismatches the measurement date for the capital structure and the measurement date for the costs of the capital structure components.

Staff agrees that the use of May 19, 2006 interest rates is inappropriate. (Staff BOE, pp. 17-22) However, Staff does not agree that a six-month average should be adopted; rather, Staff recommends the use of an April 4, 2006 spot rate. (Id.) The Commission has rejected average interest rates in numerous previous proceedings. (See, ICC Docket No. 02-0798 (October 22, 2003 Order, p. 72) and ICC Docket No. 99-

0534 (July 11, 2000 Order, p. 43)) Spot rates are superior to average historical interest rates because they reflect the most recently available data without incorporating obsolete information like historical averages do.

Nevertheless, one drawback of using spot rates is, as LGE correctly points out, that they can be manipulated.2 Staff expressed this same concern previously. (Staff IB, p. 86; Staff RB, p. 47; Staff BOE, p. 18) The Commission should be very wary of spot interest rates measured well in advance of, or updated after, a party's initial filing, particularly if the measurement date precedes or follows a period of significant interest rate change. However, Staff believes the manipulation concern is mitigated if costs are measured using "the most recent market spot rate" practicable prior to a party's initial filing for capital components for which costs are market-based. This approach avoids the inclusion of stale interest rates while minimizing the opportunity for manipulation.

Finally, LGE's concern with regard to a mismatch between the capital structure and the component cost measurement dates is unwarranted. A match between the capital structure and the component cost measurement dates is not required. Indeed, because a capital structure measurement period can be either historical or projected (83 Ill. Adm. Code Part 285 Section 285.4000), neither of which is desirable for measuring the component costs, it is neither unreasonable nor unusual to have a mismatch between the structure period and the component cost measurement dates.

For the foregoing reasons, LGE's exceptions to the PO's capital structure and the corresponding proposed language changes should be rejected.

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[2] Of course, historical average interest rates are not immune to manipulation either, since no standard rules apply for selecting the period over which average interest rates are measured. Thus, in addition to reflecting obsolete information, average interest rates do not provide a solution to the manipulation concern as LGE implies.

### E. Cost of Common Equity

Response to LGE

LGE argues that natural gas distribution utilities are not a proper proxy for electric distribution utilities and Mr. Cuthbert's use of sustainable growth rates in his DCF models is proper. (LGE BOE, pp. 4-5) The record does not support LGE's claim that natural gas distribution companies are riskier than electric distribution companies, which the PO correctly rejected. (PO, p. 141) Staff demonstrated the risk comparability of its sample, which included both electric utilities and natural gas distribution companies, to the Ameren Companies and proposed adjustments to the sample cost of equity to reflect the stronger financial position of CILCO, CIPS and IP relative to the sample. (Staff IB, pp. 92-94) As the PO points out, LGE presented no quantitative analysis to support its position. (PO, p. 141)

With regard to sustainable growth rates, Staff testified that Mr. Cuthbert's use of sustainable growth rates in his DCF models should be rejected, as summarized on pages 106-107 of Staff's Initial Brief. Staff further stated that analyst growth rates, such as the Zacks growth rates used by Staff in its DCF analysis, provide a realistic and representative growth proxy for what investors expect. The PO appropriately rejected the sustainable growth rate in favor of analyst growth rates. (PO, p. 144)

Response to CUB

CUB continues to advocate a rate of return on common equity of around 8%, claiming that it would result in "just and reasonable rates" while assuring the Companies a "sufficient return on investment." (CUB BOE, pp. 5-15) As confirmation of his 8.0% rate of return estimate, he cites Ms. McShane's 8.8% DCF calculation using IBES growth rates and claims that Staff's DCF calculation is 8.87% when quarterly discounting is eliminated. However, since a DCF model incorporates time-sensitive valuation factors, it must accurately reflect the timing of the dividend payments that a stock price embodies. Staff used a quarterly DCF model because the companies in Staff's sample pay dividends quarterly. (PO, p. 121) The PO properly relied upon a quarterly version of the DCF model and rejected CUB's suggestion to use an annual DCF model. (PO, p. 146)

Staff addressed CUB's flawed cost of equity analysis in its testimony and briefs. Staff's arguments concerning adjusted betas (Staff IB, pp. 109-110) and Mr. Bodmer's market to book value analysis (Staff IB, 116-117), P/E model (Staff IB, pp. 123-124) and investment bank estimate of the cost of equity (Staff IB, p. 124) are summarized in its Initial Brief. The PO correctly rejected Mr. Bodmer's entire cost of equity analysis.

## VI. RATE DESIGN

### C. Cost of Service Issues

#### 1. Minimum Distribution System Study

<u>Response to IIEC</u>

The Proposed Order correctly rejects IIEC's recommendation that the Commission order Ameren to complete a Minimum Distribution System ("MDS") Study prior to its next rate proceeding. (PO, pp. 158-159) IIEC disagreed with the Proposed Order's rejection of the MDS requirement and continues to advocate that Ameren conduct a MDS study. (IIEC BOE, pp. 18-21)

According to IIEC, the primary reason that a MDS should be completed is that a distribution system is composed of both demand costs and customer costs. (*Id.*, p. 19) The IIEC BOE does not mention that the cost of service study ("COSS") already allocates different components of the distribution system according to customer costs and demand costs. The COSS allocates customer-specific costs such as meters and service connections according to customer count, while common-use or shared distribution equipment costs such as wires, substations, and poles are allocated according to the use of the corresponding equipment. (Final Order dated December 11, 2001, Docket No. 00-0802, pp. 42-43) The differentiation of allocation factors according to voltage further ensures that customers that do not use equipment applicable to lower-voltage usage are not charged for the use of that equipment. The COSS adequately separates customer-based costs and demand-based costs so that each customer class is appropriately allocated its share of costs of the distribution system. The Proposed Order properly rejects IIEC's attempt to shift costs, based upon a questionable cost causation theory, onto customer classes that will already be paying delivery service rates that far exceed the amount per average kWh that large customers (DS-4 customers) will pay.

Therefore, Staff recommends that the Commission reject the arguments made by IIEC (IIEC BOE, pp. 18-21) and Wal-Mart (Wal-Mart BOE, pp. 7-8). The Proposed Order properly rejected the MDS methodology and found it unreasonable and unnecessary for Ameren to conduct such a study. (PO, pp. 158-159)

### 4. Interclass Subsidization

Response to IIEC

Staff agrees with the Proposed Order's conclusion (PO, pp. 172-173) that DS-1 rate relief should be supported, in part, by customer class DS-4, in addition to customer classes DS-2 and DS-3. (Staff BOE, p. 38) In its exception to the Proposed Order, IIEC claims that “Ironically, under the Staff’s approach to revenue allocation, substantial increases in commodity costs to DS-4 customers would justify even larger delivery service revenue allocations . . . “ (IIEC BOE, p. 34) However, Staff did not recommend a cause and effect relationship between the percentage of commodity (power supply) costs as part of the total cost of electric service and support for DS-1 rate relief whereby an increase in the cost of power supply would result in an increase in the percentage of support for DS-1 rate relief. Staff only explained that a lower percentage of delivery service costs compared to the total cost of electric service should not be a reason to exclude a given rate class from support of DS-1 rate relief. (Staff IB, p. 138) As Staff explained, a lower percentage of delivery service costs suggests that the corresponding rate class should be included in the revenue support for DS-1 rate relief because the increase in the cost of delivery service would be less significant to the overall cost of electric service than to another customer class where the cost of delivery service is a larger component of the overall cost of electric service. (*Id.*)

The Commission should disregard IIEC’s mischaracterization of Staff’s recommendation that DS-4 customers provide revenue support for DS-1 rate relief. If rate relief is granted to DS-1 customers, DS-4 customers should be included in the revenue support rather than burdening customer classes DS-2 and DS-3 with the entire amount of DS-1 rate relief. As noted in the Proposed Order, DS-4 customers pay far less per average kWh for delivery service than other customer classes, only 11 percent of the average per kWh as customer class DS-2 and 17 percent of customer class DS-3. (PO, pp. 168-169) Combined with apparently more alternative power supply options than other customer classes, the low rate per average kWh for DS-4 delivery service makes the DS-4 customer class better equipped to handle not only an increase in delivery service rates, but better able than customers in the DS-2 and DS-3 rate classes to support a small reduction in the rates paid by DS-1 customers.

Based on the foregoing, the Proposed Order correctly concluded that customers in the DS-4 rate class should be included in the revenue support of DS-1 rate relief. The Commission should reject the arguments set forth by the IIEC (IIEC BOE, pp. 31-38) and Wal-Mart (Wal-Mart BOE, pp. 2-7).

## CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding.

Respectfully submitted,

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