

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

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

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

CITIZENS UTILITY BOARD

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

**THE CITY OF CHICAGO
MARA S. GEORGES
CORPORATION COUNSEL**

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

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

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

TABLE OF CONTENTS

III. Contested Issues.....	1
A. Total Revenue Requirement and Base Rate Increase	
B. Rate Base.....	1
1. General and Intangible Plant: Functionalization and Amount.....	1
3. Pension effects on rate base.....	4
C. Operating Expenses.....	5
1. Administrative & General Expenses.....	5
D. Rate of Return.....	9
1. Capital Structure.....	9
2. Cost of Common Equity.....	20
3. Overall Cost of Capital.....	22

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

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

**INITIAL BRIEF ON REHEARING OF THE CITIZENS UTILITY BOARD,
THE COOK COUNTY STATE’S ATTORNEY’S OFFICE,
AND THE CITY OF CHICAGO**

Pursuant to 83 Ill. Adm. Code § 200.800, the Citizens Utility Board (“CUB”), the Cook County State’s Attorney’s Office (“CCSAO”), and the City of Chicago (“City”), (collectively “CUB-CCSAO-City” or “CCC”) submit this Initial Brief on Rehearing. The sections of this brief are organized in accordance with the agreed issues outline on rehearing submitted by Commonwealth Edison Company (“ComEd”) on October 13, 2006. CCC will address the issues of General and Intangible Plant, Administrative and General Expense, Pension Asset, Capital Structure and Cost of Common Equity.

ARGUMENT

III. CONTESTED ISSUES

B. Rate Base

1-2. General and Intangible Plant: Functionalization and Amount

The Commission granted petitions for rehearing regarding the level of general and intangible plant (“G&I”) submitted by the Illinois Industrial Energy Consumers (“IIEC”) and the Coalition of Energy Suppliers (“CES”). CCC submit that nothing presented in ComEd’s rehearing case rectifies the fatal flaw in its proposed adjustment to G&I, and therefore the

Commission should reverse its determination with regard to the level of G&I on which ComEd is allowed to receive a return, and remove \$304 million from rate base.

The Commission's Order erred in ignoring the Company's failure to support its G&I costs with sufficient evidence and unlawfully allowed a substantial increase in plant absent sufficient evidence justifying the increase. Order at 27. Instead, the Commission reverses the statutory burden of proof, which falls squarely on the Company (*see* 220 ILCS 5/9-201(c)), by claiming that the *other parties* failed to provide evidence contradicting the Company's unsupported assertions. *Id.* Said another way, it is not *intervenors'* burden to demonstrate the *unreasonableness* of the rate, but the Company's burden to demonstrate the justness and reasonableness of its proposed rates.

ComEd seeks to include an additional \$304 million in rate base in G&I plant, which was an amount previously allocated to production related costs. In its direct case, the Company provided no explanation for its inclusion of these costs in rate base other than its change in allocation methodology. Staff Ex. 27.0 at 3, L. 59. In its testimony on rehearing, ComEd witness Mr. Mitchell declines to provide additional evidence supporting its proposal, instead relying on its direct case. ComEd Ex. 53.0 at 11-12, L 213-220. Staff witness Peter Lazare, however, did present evidence demonstrating that ComEd's proposed increase in G&I plant has not been adequately explained, is not reasonable, and therefore should not be allowed. Staff Ex. 27.0 at 4, L.74-77. Mr. Lazare further testified that the direct assignment study utilized by ComEd to justify this astronomical increase was flawed and reverses the Commission's approach to allocation of G&I plant from the Company's previous two delivery services cases without explanation. *Id.* By ignoring this evidence, the Commission approved an unjustified allowance

for G&I plant that is 142% higher than the allowance approved in ComEd's last rate case. Staff Ex. 27.0 at 2, L. 47-49.

ComEd's functionalization of G&I departs from the order in Docket 01-0423 by allocating costs through direct assignment instead of the general labor allocator. *Id.* at 4, L. 74-77. That is, ComEd chose to use an allocation methodology that allocated more costs to the distribution function than in the past case. The Company, however, failed to explain how this approach is justified, given that the Company is functionally no different today than it was in 2001. *Id.* at 4, L. 90-96. Staff witness Mr. Lazare further pointed out that the Company's functionalization between production and delivery was outside the scope of its testimony and amounts to an off-the-record re-functionalization. Staff Ex. 27.0 at 6, L. 141-143. Thus, this methodology could not be properly viewed in the context of this case. Mr. Lazare explained that, "[o]nce G&I plant is arbitrarily assigned to the transmission and distribution utility, it does not matter significantly what method is used to functionalize G&I plant between transmission and distribution. Either way the distribution function will receive the lion's share of the costs." *Id.* at 7, L. 163-168. The large increase in G&I plant is not, then, solely a result of the Company's direct assignment approach, as the Commission erroneously assumes, but was a function of a process conducted outside this record, and therefore not subject to review. *Id.* at 7, L. 168-170. Although this methodology is the key driver to the increase in ComEd's G&I plant, it is largely ignored by the Commission's Order. Order at 27. The Commission's Order therefore erred in allowing ComEd to reinsert \$304 million of G&I plant into rate base, which the Commission found to be unreasonable in the prior DST case, where no additional evidence is presented to demonstrate the reasonableness of these costs.

ComEd further proposes that, if the Commission does reconsider its determination and disallow the \$304 million from rate base, then ComEd should have the right to recover those costs through the Supply Administration Charge (“SAC”), or some other similar cost recovery vehicle. ComEd Ex. 53.0 at 12, L. 223-225. This proposal ignores the central deficiency inherent in ComEd’s astronomical proposed increase in G&I: that the proposed increase is unexplained and unsupported, and therefore unrecoverable. The defects of the Company’s case are not cured if the Company were simply allowed to recover that amount in a separate charge. The Company cannot be allowed to recover its proposed unjustifiable increase in G&I in *any* portion of the rate – whether in the delivery charge or a separate supply charge - where it fails its burden of proof to demonstrate that the increase is just and reasonable. Because ComEd has failed to satisfy its burden of proof, the Commission should remove \$304 million of G&I plant from rate base, and reject ComEd’s proposal to recover those costs in any charge to rate payers.

3. Pension Asset

In its Order, the Commission correctly determined that ComEd should not be allowed to include \$853.2 million in pension asset to recover the costs of fully funding its pension plan. The Commission agreed with Staff witness Ms. Ebrey that, since the pension plan is not over-funded, there is no pension asset for which recovery in rate base is warranted. Order at 39. On rehearing, the Company attempts to provide the Commission with alternative accounting treatments of the pension asset that would allow it recovery of “at least some of the costs” of the pension contribution. ComEd Ex. 52.0 at 27-31. After reviewing each alternative, Staff witness Ms. Ebrey maintained that no allowance for the pension asset should be made, because no pension asset exists. Staff Ex. 25.0 at 13, L. 269-77. CCC concur and ask the Commission to reject ComEd’s post-hoc attempts at justifying any allowance of pension asset in rates.

C. Operating Expenses

1. Administrative and General Expenses

The Company requested rehearing on the issue of overall administrative and general (“A&G”) expenses, in a second attempt at convincing the Commission the \$79 million increase it originally proposed in the first phase of this proceeding is warranted. The Commission’s final Order correctly rejected ComEd’s requested increase and instead limited the overall increase in A&G expenses to the level approved in the prior delivery services case, Docket 01-0423, plus an inflation rate of 9.7%. Order at 68. The Commission rejected ComEd’s proposed \$79 million increase in A&G expenses, because “ComEd failed to explain what the individual increases entailed. Moreover, conspicuously absent is a discussion about how ComEd’s proposed increase to overall A&G expense is reasonable.” Order at 67-68. The same flaw exists on rehearing: ComEd’s testimony on rehearing fails to satisfy its burden of proof with regard to the requested increase. Once again, the Company operates from the false premise that, absent a finding of imprudence or unreasonableness, its stated costs should be presumed just and reasonable, whether supported by substantial evidence or not. ComEd Ex. 52.0 at 3, L. 57-58. This rationale necessarily reverses the burden of proof, which Illinois law requires remains with the Company (220 ILCS 5/9-201(c)). Therefore, the Commission should reject the Company’s efforts to include the unjustified, unsupported \$79 million in A&G expenses in delivery rates.

ComEd claims that “it is not plausible to identify each and every cost element that has changed over this period [approximately since 2000],” and therefore chooses to only identify a “few discrete factors” largely responsible for the increase in A&G expenses. ComEd Ex. 52.0 at 4-5, L. 87-90. ComEd identifies these four factors as: 1) employee costs; 2) Sarbanes-Oxley compliance costs; 3) post-restructuring depreciation costs; and 4) corporate governance costs.

Id. at 5, L. 91-102. Staff witness Mr. Lazare examined ComEd's additional evidence with regard to the certain categories of A&G expenses identified by ComEd in its rehearing testimony. *See* Staff Ex. 27.0. Mr. Lazare generally refuted ComEd's additional evidence as providing no basis for any increase in ComEd's A&G expenses over the level approved in Docket 01-0423. *Id.* at 9.

With regard to salaries and wages, for example, ComEd claims that, despite the fact that the number of employees in distribution has declined by one-third since 2000, an overall increase of \$9.1 million is nonetheless warranted. ComEd Ex. 52.0 at 10, L 163-165. ComEd derives this figure by comparing 2004 test year salaries and wages to salary levels applicable in 2000. Staff witness Mr. Lazare takes issue with this comparison, which he argues ignores the decline in the number of employees. Staff Ex. 27.0 at 10, L. 235-36. Mr. Lazare points out that, "the Company's own evidence indicates that total A&G salaries and wages have declined significantly since ComEd's last rate case." *Id.* In an attempt to more accurately reflect the level of salary and wage expense, Mr. Lazare instead compares ComEd's salaries and wages in its FERC Form 1 for the years 2001 and 2004. *Id.* at 11, L. 257-58. Using this data, Mr. Lazare determined that a reduction of \$36 million in salaries and wages is attributable to the distribution portion of ComEd's rates. *Id.* Mr. Lazare concludes from this data that the Company's requested increase is not only completely unsupported and unjustifiable, but that a reduction of \$36 million is actually warranted. *Id.* at 12, L. 273-75. Thus, the Company has overstated its salary and wage expense by \$45.1 million.

Mr. Lazare also refutes the Company's testimony regarding Sarbanes-Oxley compliance costs. Though in its direct case the Company failed to provide any specific estimate of these costs, it now presents a study by Charles River Associates to support a figure of \$7.8 million. ComEd Ex. 52.0 at 16, L. 298-302; ComEd Ex. 52.10. This study purports to show that

ComEd's stated \$7.8 million is comparable to costs incurred by other companies of similar size to ComEd. *Id.* Mr. Lazare examined the Charles River Associates study and compared it to ComEd's proposed level of Sarbanes-Oxley compliance costs and determined that ComEd's compliance costs "represent a far higher share of revenues than the average in the sample for the Charles River study," when compared to ComEd's jurisdictional revenue requirement. Staff Ex. 27.0 at 14, L. 322-23. Mr. Lazare therefore concludes that these costs are "clearly excessive." *Id.* at L. 325. If the average 0.10% of revenues from the Charles River study was applied to ComEd's revenue requirement, the result would be \$1.7 million in test year Sarbanes-Oxley compliance costs – \$6.1 million less than ComEd seeks. *Id.* at 14, L. 330-34.

To support its requested \$5.9 million increase in health care costs for active employees, the Company offers a report prepared by Towers Perrins. ComEd Ex. 52.5. This study actually demonstrates, however, that ComEd's active employee health care costs are considerably higher than average when compared to the companies in the study, and a whopping 88% higher than the level of medical costs for each ComEd employee in the year 2000. Staff Ex. 27.0 at 15, L. 358-63. The Company failed to adequately explain why these costs are so out of line with either the other companies in the Towers Perrins study, or even with its own historic levels. Mr. Lazare concludes that "[i]t would be unreasonable to ask ratepayers to foot the bill for a greater-than-average increase in employee health care costs that has not been fully explained by the Company." *Id.* at 16, L. 370-71. The Tower Perrins study suggests an average annual increase in health care costs of 12%, 13%, 15%, and 12% for the years 2001-2004, which amounts to a collective increase of 63% over those four years. *Id.* at 16, L. 370-71. Thus, Mr. Lazare proposes ComEd's employee health care costs be limited to a generous 63%, or approximately

\$2.0 million, which means the Company has overstated its proposed increase by approximately \$3.9 million. *Id.* at 16, L. 382-84.

In reviewing the cost categories above, Mr. Lazare determined that ComEd overstated its A&G expenses by at least \$55.1 million for these categories alone. *Id.* at 17, L. 390. Staff witness Ms. Ebrey further testified that the trends from 2001 through 2005 indicate that ComEd's actual operations costs are not rising as the Company claims. Staff. Ex. 25.0 at 17, L. 340-41. Instead, the Company's overall costs are trending downward, and not even keeping up with inflation levels. *Id.* Though the Company justifies its requested increase by claiming that certain isolated expenses have risen since the 2000 test year, it fails to take into consideration other expenses that have significantly decreased during this time period. *Id.* at 15, L. 304-06. As demonstrated by Staff witnesses Mr. Lazare and Ms. Ebrey, the "additional evidence" provided by ComEd to purportedly support its requested increase in A&G expense does not, in fact, justify the requested \$79 increase in A&G expense, and in fact supports a reduction of \$17.3 million from the level approved in the Commission's order in this proceeding. The Commission should, therefore, reject ComEd's proposed \$79 million increase in A&G as unreasonable and unsupported by substantial evidence.

D. Rate of Return

1. Capital Structure – *The Commission Should Adopt Staff's Proposed 37.11% Equity and 62.89% Long-Term Debt Capital Structure.*

In its July 26, 2006 Order, the Commission adopted an imputed capital structure consisting of 42.86% common equity and 57.14% long-term debt.¹ Order at 130. The Commission explained that this was the capital structure it adopted in ComEd's last rate case (Docket 01-0423) and that the utility has been able to maintain an investment grade credit rating since that time. *Id.*

On rehearing, no party supported the Commission's 43%-57% capital structure. ComEd abandoned the equity-laden 54.20% common equity and 45.80% long-term debt that it advanced during the initial phase of this case. *See* ComEd Ex. 7.1. Instead, ComEd adopted the 46% common equity and 54% long-term debt capital structure used in the Proposed Order,² ComEd Ex. 51.0 at 16, L. 340-44, – a capital structure that the Commission at least implicitly rejected when it selected its 43%-57% capital structure. All other parties that weighed in on this issue supported Staff's proposed 37.11% common equity and 62.89% long-term debt capital structure.³ Staff Ex. 26.0 at 3, L. 66-68; CUB-CCSAO-City Ex. 7.0 (Revised) at 2, L. 43; IIEC Ex. 10.0 at 2, L. 16-18.

Illinois law and the record created in the initial phase of this case and on rehearing support adoption of Staff's 37%-63% capital structure. The Commission's July 26, 2006 Order should be modified accordingly.

¹ For purposes of brevity, the capital structure adopted by the Commission in its July 26, 2006 Order will be referred to as the "43%-57%" capital structure.

² It should be noted that in his rebuttal testimony, ComEd witness Mr. Mitchell described a "package" of issues that the utility, the Illinois Industrial Energy Consumers "(IIEC)" and the U.S. Department of Energy agreed were supported by substantial evidence. ComEd Ex. 58.0 (Corrected) at 4-5, L. 75-105. Among the issues included in the "package," is an agreement that the Commission's 43%-57% capital structure is supported by substantial evidence. *Id.* at 5, L. 95-97.

³ For purposes of brevity, Staff's proposed capital structure will be referred to as the "37%-63%" capital structure.

a. *Illinois Law Requires That the Capital Structure the Commission Adopts on Rehearing Must Exclude All of the Goodwill Asset From ComEd's Capital Structure.*

In its July 26, 2006 Order, the Commission stated that there were two capital structures proposed in the initial phase of this case – the 54%-46% capital structure supported only by ComEd and the 37%-63% capital structure proposed by Staff and supported by CUB-CCSAO-City and IIEC. Order at 125. The Order correctly noted that the difference between the capital structure supported solely by ComEd and the 37%-63% capital structure supported by all other parties taking a position on this issue is the treatment of a “\$2.634 billion goodwill asset” that ComEd asserted should be included in the common equity component of its capital structure. *Id.* at 126. The goodwill asset relates to ComEd’s transfer of nuclear plants to an unregulated affiliate. *Id.*

As the Commission’s Order so adroitly explained, the PUA and controlling Illinois case law prohibit including the effect of any part of the goodwill asset in ComEd’s capital structure. In particular, as the Order laid out, Section 9-230 of the Act provides that:

In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (i) incremental risk, (ii) increased cost of capital, or (iii) . . . , which is the direct or indirect result of the public utility’s affiliation with unregulated or nonutility companies.

Id. at 127 (quoting 220 ILCS 5/9-230).

After discussing the PUA, the Commission then interpreted *CUB v. ICC*, 276 Ill. App. 3d 730 (1995) (“*CUB*”) and *Ill. Bell Tel. Co. v. ICC*, 283 Ill. App. 3d 188 (1996) (“*Illinois Bell*”), both of which interpret Section 9-230. Order at 127-28. Discussing the *CUB* case, the Order noted that the court found that

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

Id. at 127 (quoting *CUB*, 276 Ill. App.3d at 745-46).

The Order then cited the *Illinois Bell* court's conclusion that

Before deciding whether to use a hypothetical capital structure, the Commission was required to determine whether either Bell's risk or cost of capital were increased because of its affiliation with Ameritech. ... We hold that if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR [rate of return] calculation.

Id. at 128 (quoting *Illinois Bell*, 283 Ill. App.3d at 206-207).

Based on this analysis, the Order concluded that

Staff, [CUB-City-CCSAO], and IIEC all argue that ComEd should not earn a rate of return on plant it does not own and does not use for providing distribution services. This view comports with the language of Section 9-230 of the Act, as discussed in the *CUB* and *Illinois Bell* cases. (See *supra*.) Furthermore, ComEd's equity figure contains the net \$2.634 billion in goodwill generated from the transfer of its plants. Including this figure in equity necessarily will raise the required rate of return, and therefore the rates set herein.

The Commission finds that ComEd may not make such a recovery through regulated rates. Any recovery of the cost of plant owned by an unregulated generating affiliate will be recovered through the cost of power procured from such affiliate. The Commission therefore further finds that a recovery of such costs in rates by counting the goodwill in equity constitutes a double recovery, is not related to the regulated activities covered by these rates, and accordingly is neither just nor reasonable within the meaning of Section 9-201 of the Act.

Id.

The Order adds that the source of the goodwill asset – ComEd’s transfer of its nuclear plants to an unregulated affiliate

falls well within the “increased cost of capital ... which is the direct or indirect result of the public utility’s affiliation with unregulated or nonutility companies” prohibited by Section 9-230 of the Act. It similarly reflects the “inflated level of equity” discussed in *CUB v. ICC*, and the “one dollar more for capital because of its affiliation with an unregulated or nonutility company” holding of *Ill. Bell v. ICC* (*see supra.*) In light of all this, the Commission rejects ComEd’s proposed equity figure of 54.2%, which includes a recovery from rate payers based on billions of dollars of goodwill that was avoidable under Section 16-111(g)(4).

Id. at 129.

The Commission’s first-rate legal analysis supports only one capital structure advanced in either the initial phase or the rehearing phase of this case – the 37%-63% capital structure proposed by Staff and adopted by CUB-CCSAO-City and IIEC. The 37%-63% capital structure is the only capital structure in the record that excludes – as Illinois law dictates – the effect of ComEd’s goodwill asset on the utility’s capital structure.

In contrast, ComEd’ recommended 46%-54% capital structure on rehearing violates the legal principles that the Commission set forth in its July 26, 2006 Order. Including more than 37% equity in ComEd’s capital structure necessarily includes a portion of the goodwill asset that Illinois law requires be eliminated.

In sum, Illinois law – as interpreted by the Commission in its July 26, 2006 Order – requires that the Commission adopt the 37%-63% capital structure proposed by Staff and adopted by CUB-CCSAO-City and IIEC.

b. *The Record on Rehearing and During the First Phase of the Case Support Adoption of the 37%-63% Capital Structure.*

The evidence submitted both during the initial phase of the case and on rehearing support adoption of the 37%-63% capital structure. The 37%-63% capital structure is the only capital structure in evidence that excludes the effect of the goodwill asset created at the time of the Unicom-PECO merger that led to the formation of Exelon, ComEd's parent corporation. The Unicom-PECO merger created a \$4.926 billion goodwill asset that is recorded on ComEd's balance sheet. IIEC Ex. 7.0 at 5, L. 105-06. Because goodwill does not produce revenues or cash flows, it cannot be treated as debt. *Id.* at 8, L. 185-86. As a result, the goodwill on ComEd's balance sheet increases ComEd's equity balance. CUB-CCSAO-City Ex. 1.0 (Revised) at 23, L. 676-78.

ComEd proposed to remove a portion of the goodwill asset from its balance sheet for purposes of determining the appropriate capital structure. Specifically, ComEd suggested that \$2.292 billion be removed from the common equity balance. ComEd Ex. 18.0 at 26-27, L. 585-88. ComEd witnesses Kathryn M. Houtsma and J. Barry Mitchell asserted that the remaining portion of the goodwill asset – some \$2.634 billion – should remain as part of the utility's common equity balance. March 22, 2006 Tr. at 483-84 (Houtsma); March 30, 2006 Tr. At 2473 (Mitchell). According to ComEd, the \$2.634 billion goodwill asset should be included in its common equity balance is associated with its decision to transfer its nuclear plants to an affiliate – plants that ComEd no longer owns. IIEC Ex. 7.0 at 5, L. 113-18.

Mr. Bodmer, Ms. Kight and Mr. Gorman each testified that the costs approved in this proceeding must be shown to support distribution and transmission assets needed to provide service to customers. However, the \$2.634 billion goodwill asset that ComEd contended should be included in its common equity balance has nothing to do with providing delivery services to

ratepayers. In particular, Mr. Bodmer, Ms. Kight and Mr. Gorman testified, respectfully, as follows:

- “[G]oodwill has no benefits to delivery service customers.” CUB-CCSAO-City Ex. 1.0 (Revised) at 23, L. 669-70.
- “Since rates are based on original cost rate base, capital structure should also reflect the amount of capital originally invested in a utility’s assets (assuming that capital structure is reasonable from a cost standpoint), not reassessments of the fair value of the capital invested. Therefore, I agree that ComEd’s capital structure, which reflects estimates of fair value for financial reporting purposes, should be adjusted to reflect depreciated original cost. [Footnote omitted.]” Staff Ex. 4.0 at 5, L. 85-90.

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

- “Goodwill is not a transmission and distribution utility asset, and common equity that was created at the same time the Goodwill asset was recorded does not represent investor capital supporting transmission and distribution assets.” IIEC Ex. 7.0 at 8, L. 173-75.
- “Staff witness Kight was correct to adjust common equity by removing the full amount of the Goodwill asset. The Company’s smaller common equity adjustment doesn’t reflect the reality that the nuclear generating assets were written-down, which reduced common equity, and that these nuclear assets were transferred to an unregulated affiliate at the restated value.” *Id.* at 8, L. 176-80.

Perhaps the most compelling evidence adduced during the case showing that ComEd’s goodwill asset does not support the distribution and distribution assets used to provide service to customers occurred during the cross-examination and re-direct examination of IIEC witness Mr. Gorman in the first phase of this case. During cross-examination by Staff, Mr. Gorman testified that ComEd includes more than \$11 billion in capital on its balance sheet. Yet, the utility has a

little more than \$6 billion in rate base. March 29, 2006 Tr. at 1986. Mr. Gorman explained the discrepancy.

So, clearly, there's a significant mismatch between the capital on the balance sheet and the amount of rate base. That difference in -- from my perspective, that difference in the capital in rate base is largely attributable to almost a five billion dollar goodwill asset which is not the transmission and distribution utility asset. And that asset -- that goodwill asset is completely supported by common equity.

So the amount of capital -- ComEd's common equity in that 11 billion dollar capital component needs to be reduced by the value of that goodwill asset. That's supported only by common equity or roughly five billion dollars -- or no, 4.96 billion dollars. So when you take ComEd's common equity and reduce it by 4.96 billion dollars of common equity and say that's supporting the goodwill asset and the remaining common equity is supporting transmission and distribution utility plant, then you get a capital structure that roughly matches rate base.

Id. at 1986-87.

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

COMMONWEALTH EDISON COMPANY			
<u>Capital Supporting T&D Rate Base</u>			
<u>Line</u>	<u>Test Year</u>	<u>Amount (000)</u>	<u>Source</u>
1	Total Unadjusted Capital ⁽¹⁾	\$11,874,770	ComEd Ex. 7.1, Schedule D-1 and WPD-1
2	T&D Rate Base	<u>6,189,171</u>	Schedule A-2
3	Incremental Capital Above Rate Base	5,685,599	Line 1, less Line 2
4	Good Will/Other Intangibles	4,926,000	ComEd Ex. 7.0 at 7
5	Incremental Capital Excluding Good Will	759,599	Line 3, less Line 4
<hr/> <small>⁽¹⁾ Total Capital \$9,582,770, add book common equity adjustment of \$2,292,000 made on WPD-1.</small>			

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

That additional capital clearly is not being used to finance transmission distribution utility rate base. What is it being used to finance? Mostly, the goodwill asset that I identified in my testimony. The goodwill has a balance of 4 billion 926 million dollars. So most of that incremental capital, that's the subject here,

is financing the goodwill asset, which is a distinct asset and separate from the assets included in the company's transmission

and distribution regulated utility rate base. Goodwill is supported by common equity. It's important to remove the common equity from the \$11 billion total capital to identify what capital's available to support, and the cost associated with financing, for regulated utility transmission and distribution utility rate base.

Id. at 2057-58.

In sum, the record developed during the first phase and rehearing phase of the case supports adoption of the 37%-63% capital structure. It is the only capital structure that eliminates completely the effect of the goodwill asset on ComEd's capital structure. The goodwill asset is wholly unrelated to the objective of this case: determining the costs needed to provide utility service. The goodwill asset merely inflates the common equity component of the utility's capital structure and, therefore, the rates that customers must pay. As a result, the Commission should adopt the capital structure proposed by Staff witness Kight and adopted by CUB-CCSAO-City witness Bodmer and IIEC witness Gorman.

c. *On Rehearing, CUB-CCSAO-City Witness Mr. Bodmer and Staff Witness McNally Showed That the 37%-63% Capital Structure is Just and Reasonable.*

According to the July 26, 2006 Order, the Commission did not adopt a 37%-63% capital structure because it was concerned that it would not allow ComEd to maintain an A- credit rating. Order at 129-30. Thus, the Commission rejected the 37%-63% capital structure in favor of its 43%-57% capital structure. On rehearing, Mr. Bodmer and Mr. McNally each showed that the Commission's conclusion was in error and that a 37%-63% capital structure is just and reasonable.

It should first be noted that, as Mr. McNally testified, the Commission's July 26, 2006 Order does not explain why it is necessary for ComEd to maintain an A- credit rating. Staff Ex. 26.0 at 4, L. 79-81. Mr. McNally also pointed out that since 1991, ComEd has mostly been in

the BBB range. *Id.* at f.n.1. The Commission’s A- target for ComEd appears arbitrary and unnecessarily increases the amount of common equity in the utility’s capital structure and, therefore, rates for customers.

In any event, both Mr. Bodmer and Mr. McNally showed that a 37%-63% capital structure would allow ComEd to maintain an A- credit rating. Mr. Bodmer pointed to a presentation that Exelon made to the investment community on September 27, 2006. CUB-CCSAO-City Ex. 7.0 (Revised) at 5, L. 93-101. In that presentation, Exelon stated key credit measures for ComEd and certain of its affiliates. *Id.* at L. 100-01. Mr. Bodmer testified that the credit metrics for ComEd show it to be an A- rated company. *Id.* at L. 97-99.

Similarly, Mr. McNally examined two credit metrics for ComEd and found that a 37%-63% capital structure would permit ComEd to maintain the financial strength of a company with a BBB+/A- rating. Staff Ex. 26.0 at 5, L. 94-106. Mr. McNally added that the chance that ComEd’s actual capital structure may not permit the utility to attain an A- credit rating is not a sufficient reason to reject it. *Id.* at 5-6, L. 111-13. This is especially true where ComEd’s actual capital structure will allow it to achieve a credit rating of BBB+/A-. *Id.* at 6, L. 113-18.

d. *ComEd’s Testimony Regarding Recent Downgrades by Three Credit Rating Agencies is Misleading.*

In his direct testimony on rehearing, Mr. Mitchell stated that the impact of the Commission’s July 26, 2006 Order was “immediate and dramatic.” ComEd Ex. 51.0 at 3, L. 53. Mr. Mitchell goes on to state that both Moody’s Investor Service (“Moody’s”) and Fitch Ratings (“Fitch”) downgraded ComEd’s credit rating after the Commission issued its Order. *Id.* at 4, L. 56-63. Mr. Mitchell also cited the Negative Credit Watch issued by Standard and Poor’s. *Id.* at L. 64-67. The implication of Mr. Mitchell’s testimony is that there is a direct correlation

between the Commission's July 26, 2006 Order and the actions taken by the three credit rating agencies. Mr. Mitchell's testimony on this point is misleading.

Mr. Bodmer testified that Mr. Mitchell's interpretation of the Moody's report is inconsistent with the words included in the document. CUB-CCSAO-City Ex. 7.0 (Revised) at 6, L. 116-28. Indeed, the Moody's report lists three reasons for the downgrade. The first one has to do with actions taken or threatened by the Governor and the Illinois General Assembly. ComEd Ex. 51.1 at 1. The second is a concern that ComEd will not be able to recover its power procurement costs. *Id.* The third has to do with actions taken by management to further isolate ComEd from its affiliates. *Id.* As Mr. Bodmer testified, the Moody's report makes no mention of the Commission's July 26, 2006 Order as a basis for its downgrade. CUB-CCSAO-City Ex. 7.0 (Revised) at 6, L. 116-17.

The Standard and Poor's Negative Credit Watch also does not refer to the Commission's July 26, 2006 Order. Like the Moody's report, the Standard and Poor's document bases its action on threats of "rate freeze" legislation made by the Governor and the General Assembly. Staff Ex. 26.4 at 1. There is nothing in the Standard and Poor's report regarding the July 26, 2006 Order.

Although the Fitch report does refer to the Commission's Order, it also refers to concerns that the utility will not be able to recover its procurement costs. ComEd Ex. 51.2 at 1. It is clear from reading the three reports that the credit rating agencies are almost exclusively concerned with ComEd's ability to recover its procurement costs. Of course, this makes sense because, as stated by Standard and Poor's, an extension of the rate freeze could "result in revenue shortfalls of about \$1 billion or more per year." Staff Ex. 26.4 at 1.

Moreover, as Mr. McNally noted, the Commission should not base its decision in this case based on events that might not occur. Staff Ex. 26.0 at 9, 183-85. Mr. McNally explained that if the Commission were to increase ComEd's rate of return based on speculative events that do not occur, then customers will pay for risks that do not materialize. *Id.* at 8, L. 165-68.

e. *ComEd's Recommended 46%-54% Capital Structure is not Based on Substantial Evidence and Should be Rejected.*

As noted above, ComEd disowned the 54%-46% capital structure it proposed during the initial part of this case in favor of the 46%-54% capital structure adopted by the Proposed Order. ComEd Ex. 51.0 at 16, L. 340-44. In changing the Proposed Order's finding, the Commission rejected a 46%-54% capital structure. It should do so again, as ComEd's now preferred capital structure has no support in the record and should be rejected.

The Proposed Order's – and now ComEd's – proposed 46%/54% capital structure has no basis in the record. No party submitted evidence supporting a 46%/54% capital structure. Thus, adopting ComEd's capital structure would be reversible error in that it is a finding that is not supported by substantial evidence. 220 ILCS 5/10-201(e)(iv)(A). Moreover, adopting ComEd's recommendation would violate the Administrative Procedures Act's requirement that "Findings of fact shall be based exclusively on the evidence and on matters officially noticed." 5 ILCS 100/10-35(c). Also, adoption of a capital structure for which there is zero record support is arbitrary and capricious. *Central Ill. Pub. Serv. Co. v. Ill. Comm. Comm'n*, 268 Ill. App. 3d 471, 480-81 (4th Dist. 1994).

2. Cost of Common Equity – *The Commission Should Adopt CUB-CCSAO-City witness Bodmer's Recommended 7.75% Cost of Common Equity.*

In several previous pleadings, CUB-CCSAO-City have described in detail why the Commission should adopt Mr. Bodmer's investment bank analysis for determining ComEd's

Cost of common equity. *See* CUB-CCSAO-City Initial Brief at 25-37; CUB-CCSAO-City Reply Brief at 22-32; CUB-CCSAO-City Brief on Exceptions at 18-26; CUB-CCSAO-City Reply Brief on Exceptions at 14-17. For sake of brevity, we will not repeat all of our arguments here. However, it must be noted that it is not certain that the Commission considered the totality of Mr. Bodmer's analysis. While the Commission rejected Mr. Bodmer's investment bank analysis for deriving ComEd's cost of common equity, Order at 154, and Mr. Bodmer's market-to-book analysis, *Id.* at 155, there is no indication that the Commission considered the discounted cash flow ("DCF") and capital asset pricing model ("CAPM") analyses Mr. Bodmer conducted.

As Mr. Bodmer testified on rehearing, his DCF and CAPM analyses avoided "the fundamental errors typically made by cost of capital analysts in rate cases." CUB-CCSAO-City Ex. 7.0 (Revised) at 14, 289-90. In particular, Mr. Bodmer testified that his:

DCF analysis avoided errors that occur from using upwardly biased analyst forecasts or adjustment for quarterly discounting.
[My] CAPM analysis avoided errors that occur from assuming that Beta reverts to a mean of 1.0 and assuming an equity market risk premium that is above what investors actually expect.

Id. at 290-94. Mr. Bodmer's CAPM analysis yielded a range for cost of common equity of 6.69 to 7.31%. CUB-CCSAO-City Ex. 1.0 (2nd Revised) at 47, L. 1411-12. Mr. Bodmer's DCF analysis yielded a cost of common equity of 7.88%. *Id.* at 68, L. 2058. These results confirm that Mr. Bodmer's investment bank analysis produces a reasonable cost of equity.

The reasonableness of Mr. Bodmer's recommended 7.75% cost of common equity was confirmed – perhaps inadvertently – by ComEd. In its surrebuttal testimony, ComEd submitted a letter from Lehman Brothers provided to the utility at ComEd's request. ComEd Cross Ex. 6. Mr. Bodmer stated that the most interesting part of the Lehman Brothers letter was the author's assertion that returns on equity "are typically 300 or more basis points more than the discount

rates used in investment bank fairness opinions.” ComEd Cross Ex. 6 at 3. As Mr. Bodmer testified on rehearing, “[t]his statement implies that the cost of equity used by Lehman Brothers was 8% – the 11% request made by ComEd less 3%. Lehman Brothers’ 8% rate is in line with my recommended 7.75% cost of common equity.”

In sum, Mr. Bodmer’s investment bank analysis was confirmed by the DCF and CAPM analyses he performed. His proposed 7.75% cost of common equity was further confirmed by the Lehman Brothers letter submitted by ComEd. Mr. Bodmer’s analysis demonstrates that his recommendation is just and reasonable and should be adopted by the Commission.

3. Overall Cost of Capital– *The Commission Should Adopt a 6.96% Overall Cost of Capital.*

A utility’s overall cost of capital is a function of three things: (1) its capital structure; (2) its cost of long-term debt; and (3) its return on common equity. Using the capital structure proposed by Staff and adopted by CUB-CCSAO-City and IIEC (37.11% common equity and 62.89% long-term debt), the Commission’s July 26, 2006 Order’s 6.48% long-term cost of debt and Mr. Bodmer’s proposed 7.75% cost of common equity yields an overall cost of capital of 6.96%.

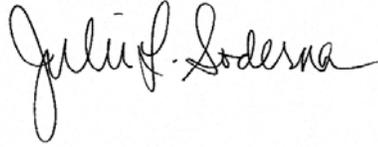
CONCLUSION

WHEREFORE, for the above stated reasons, the Citizens Utility Board, Cook County State’s Attorney’s Office and the City of Chicago request that the Commission enter an order establishing just and reasonable rates for Commonwealth Edison based upon the arguments presented above.

Respectfully submitted,

CITIZENS UTILITY BOARD,

November 14, 2006



By: _____

JULIE SODERNA

CITIZENS UTILITY BOARD

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

Respectfully submitted,

November 14, 2006

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

A handwritten signature in black ink, appearing to read "Marie D. Spicuzza", written over a horizontal line.

MARIE D. SPICUZZA
Assistant State's Attorney

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

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

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

November 14, 2006

Respectfully submitted,

**MARA S. GEORGES
CORPORATION COUNSEL
CITY OF CHICAGO,**



By: _____

RONALD JOLLY
Senior Counsel

**MARA S. GEORGES
CORPORATION COUNSEL**

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