STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	)	
	)	
	)	**Docket No. 05-0597**
Proposed general increase in rates for delivery service	)	
	)	

INITIAL BRIEF ON REHEARING OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Table of Contents

Page

I. INTRODUCTION 1
II. UNCONTESTED ISSUES 2
  B. Rider ECR 2
III. CONTESTED ISSUES 3
  B. Rate Base 3
    1. General Plant 3
    2. Intangible Plant 11
    3. Pension Effects on Rate Base 11
      a. Pension Asset 12
      b. Alternative Pension Contribution Proposals 24
      c. Pension Expense 27
  C. Operating Expenses 28
    1. Administrative & General Expenses 28
    2. Pension Contribution and Pension Expense 42
  D. Rate of Return 42
    1. Capital Structure 42
      a. Staff's Position 42
      b. ComEd's Position 45
      c. Impact of Capital Structure on Cost of Debt 55
    2. Cost of Common Equity 56
      a. Staff's Position 56
      b. ComEd's Position 57
    3. Overall Cost of Capital 57
  E. Rate Design 58
    1. Rider GCB and GCB7 58
      d. Statutory construction 58
      e. Means of recovery of any subsidy 59
IV. CONCLUSION 62

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STAFF OF THE ILLINOIS COMMERCE COMMISSION

Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission's ("Commission"), respectfully submits its Initial Brief on Rehearing in the above-captioned matter.

I. INTRODUCTION

Commonwealth Edison Company ("ComEd" or the "Company") filed new tariff sheets on August 31, 2005, in which it proposed a general increase in rates for delivery service. On September 14, 2005, the Commission entered a Suspension Order commencing the instant investigation of ComEd's proposed general increase in rates and suspending operation of the Filed Rate Schedule Sheets, and on January 25, 2006 entered a Re-suspension Order extending the suspension to July 27, 2006. The Commission issued its Final Order on July 26, 2006 ("Final Order", "Order" or "July 26 Order").

Applications for Rehearing were filed by ComEd; Citizens Utility Board ("CUB"), City of Chicago, and Cook County State's Attorney's Office ("CCSAO"); Illinois Industrial Energy Consumers ("IIEC") and the United States Department of Energy ("DOE"); People of the State of Illinois ("AG"); City of Chicago ("City") and Cook County State's Attorney's Office; Constellation NewEnergy, Inc., Direct Energy Services LLC, U.S. Energy Savings Corporation, MidAmerican Energy Company and Peoples Energy Services Corporation as Collation of Energy Suppliers ("CES"); Building Owners and Managers Association of Chicago ("BOMA"); and Chicago Transit Authority ("CTA") and Northeast Illinois Regional Commuter Railroad Corporation d/b/a Metra ("Metra"). The Commission granted the Applications for Rehearing of IIEC and DOE and City and CCSAO. The Commission granted in part and denied in part the Applications for Rehearing of ComEd; CES; the AG; and CUB, City and CCSAO. The Commission denied the Application for Rehearing of BOMA

On Rehearing, the following witnesses submitted testimony on behalf of Staff: Theresa Ebrey (ICC Staff Exhibit 25.0), Michael McNally (ICC Staff Exhibit 26.0), and Peter Lazare (ICC Staff Exhibit 27.0 Corrected). In its testimony on Rehearing, Staff addressed five areas: the Pension Asset and Expense, General and Intangible Plant, Administrative and General expense, Cost of Capital, Rider ECR and Rider GCB. For the reasons stated below, Staff urges the Commission to approve its recommendations.

II. UNCONTESTED ISSUES

B. Rider ECR

As Staff witness Ebrey testified, Staff and ComEd have reached an agreement as to the limited issued on rehearing with respect to Rider ECR. ComEd has filed a revised Rider ECR tariff sheet that conforms to the agreement between Staff and the Company. (ICC Staff Exhibit 25.0, p. 18; ComEd Ex. 57.0, p. 4) Thus, Staff recommends that the Commission approve the Rider ECR language as agreed to by Staff and ComEd.

III. CONTESTED ISSUES

B. Rate Base

1. General Plant

The Commission's July 26 Order in this docket approved ComEd's proposed level of General and Intangible ("G&I") plant costs for inclusion in rate base. (July 26 Order, p. 27) The Commission granted the petitions for rehearing filed by the Illinois Industrial Energy Consumers ("IIEC") and the Coalition of Energy Suppliers ("CES") with respect to the appropriate level and functionalization of G&I plant. (Notice of Commission Action, ICC Docket No. 05-0597 (August 31, 2006); Notice of Commission Action, ICC Docket No. 05-0597 (September 14, 2006)) As explained in more detail below, Staff urges the Commission to reconsider its decision on G&I plant and enter an order on rehearing excluding from rate base in the instant rate proceeding the $304 million of G&I plant that the Commission excluded from rate base for delivery services in ComEd's previous delivery services rate case.

While the Commission's July 26 Order does not explicitly discuss the Commission's ruling on G&I plant in terms of burden of proof, the primary issue on rehearing for G&I plant is whether the Commission's July 26 Order – in approving ComEd's proposed level of G&I plant -- incorrectly concluded that ComEd met its burden of proof, including its burden of production. Staff submits that the Commission's ruling on G&I plant in its July 26 Order misunderstood or misapplied either the law or the facts or both. Section 9-201 of the Public Utilities Act specifically provides that in any hearing to determine the propriety of any proposed rate, charge, practice, rule or regulation “the burden of proof to establish the justness and reasonableness of the proposed rates or other charges, classifications, contracts, practices, rules or regulations, in whole and in part, shall be upon the utility.” (220 ILCS 5/9-201(c)) While Staff is certain that the Commission knows and understands that the burden of proof in rate proceedings resides with the utility, its ruling on G&I plant indicates that it misapplied that concept.

While the burden of proof is often regarded as the burden of persuading the trier of fact on each element of a claim, it is actually a two-pronged concept consisting of the burden of persuasion and the burden of producing evidence sufficient to make out a prima facie case. The second prong is generally referred to as the "burden of production," the "burden of producing evidence" or the "burden of going forward" on an issue. (See *Consolidated Communications Consultant Serv., Inc. v. Illinois Bell Tel. Co.*, Docket 99-0429, 2001 Ill. PUC LEXIS 568, *12-14 (June 4, 2001) (explaining the two-fold nature of the burden of proof)) The standard for a making out a prima facie case in Illinois can generally be stated as "A plaintiff establishes a prima facie case by proffering at least 'some evidence on every element essential to [the plaintiff's underlying] cause of action,'" *Sherman v. Cryns*, 203 Ill. 2d 264, 275 (2003), or "The plaintiff must have presented some evidence, more than a scintilla, on every essential element of his cause of action," *Happel v. Mecklenburger*, 101 Ill. App. 3d 107, 111 (1st Dist 1981). While a rate case is not a cause of action with a specific set of elements uniformly applicable in every case, a utility is obligated to establish that the costs it seeks to recover are just and reasonable and were prudently incurred. Moreover, once specific issues are identified based on the facts and circumstances presented in a rate case, a utility is obligated to produce sufficient evidence on that issue to meet its burden of production. If a utility fails to meet this burden by producing no evidence on a specific issue, then the Commission should rule against the utility on that issue for failure to satisfy its burden of production and burden of persuasion. (Cf. *Sherman*, 203 Ill. 2d at 275)

The Commission's analysis and conclusion of the G&I plant issue consisted of the following:

> At issue here is Staff and IIEC's proposal to disallow $304 million or at least $441 million respectively, of ComEd's General and Intangible Plant costs in rate base. ComEd's primary argument in opposition to these proposed adjustments is that these costs were reasonably incurred and that neither party has presented any evidence to the contrary. In order for the Commission to approve such costs the Commission must find that the costs were prudent and used and useful. **The Commission however, was not provided with any evidence by Staff nor the IIEC to support their proposed adjustments.** While Staff highlights the fact that in ComEd's last delivery services rate case the Commission found a reduction to general and intangible plant costs to be appropriate that is not a proper basis upon which the Commission should determine costs in this rate case. The Commission is required to look thoroughly at each docket on a case by case basis. The record established here by ComEd is supported by convincing evidence that the costs associated with general and intangible plant assets are reasonable.

(July 26 Order, p. 27 (emphasis added)) By focusing on whether evidence was proffered by Staff or the IIEC, the July 26 Order appears to (i) treat Staff and the IIEC as having the burden of proof or (ii) conclude that ComEd has met its burden of production and that the burden of production has now shifted to opposing parties. The former possibility would be contrary to the law, as the burden of proof always resides with the utility. To the extent that the Commission's analysis and conclusion reflects a determination that the burden of production had shifted from ComEd to other parties, that determination disregards the issue presented with respect to G& I plant and is not supported by the record.

The Commission was presented with the same issue and comparable facts in Illinois Power Company's 2001 delivery services rate case. (*Order*, Illinois Power Company, ICC Docket No. 01-0432, pp. 17-18 (March 28, 2002) ("*01-0432 Order*")) In the *01-0432 Order* the Commission held that an increase in G&I plant for delivery services resulting from a divestiture of generation assets requires a showing by the utility (i.e., its burden of production) that the remaining operations require the magnitude of the requested increase relative to amount established in its existing delivery services rates:

> . . . IP has argued that because of divestiture of its generation function all assets that were not sold or transferred remain to support the remaining operations of the Company. **The Commission finds such argument to be deficient in that there has been no showing that the remaining operations require such a large increase in G&I relative to the amount established by the Commission in 1999.** The Commission concludes that the amount of G&I plant that should be included in distribution rate base for purposes of this case is the amount proposed by Staff, as adjusted based on any specific adjustments to G&I plant that are adopted by the Commission in other sections of this Order.
>
> . . . The Commission recognizes that it is in the nature of common costs such as G&I plant that support multiple lines of business, that the fact that one line of business and its direct assets is divested, does not mean that the amount of G&I plant can or cannot be reduced correspondingly. Although IP has sold its generation assets and exited the generation business, as permitted under the Act, the Commission's approval in and of itself does not mean that the Commission has approved the accounting allocations made or that the amount of assets that were transferred are proper. The role of the Commission in divestiture of generation is limited by 16-111 (g). The Commission is of the opinion that IP can be required to continue to allocate a portion of its G&I plant investment to "generation" for purposes of setting its distribution rates. The

> G&I plant that IP retains subsequent to divestiture of its generation business may have always supported the distribution business, but it was formerly allocated among all of the lines of business for regulatory ratemaking purposes and **there has been no showing that the remaining lines of business require the level of assets as urged by IP**.

(*01-0432 Order*, pp. 17-18 (emphasis added))

The G&I plant that Staff has questioned in the instant proceeding was previously allocated by the Commission to the production function in ComEd's previous delivery services rate case. There is no question that ComEd has divested its direct generation assets since its last delivery services rate case and its G&I plant has increased as a result, identical to the situation presented in the Illinois Power proceeding. Evidence that "the costs associated with general and intangible plant assets are reasonable" does nothing to satisfy ComEd's obligation to make a showing that its remaining operations following divestiture require the requested increase in G&I plant relative to the amount established in ComEd's previous delivery services rate case. Assertions that these G&I assets remain at ComEd following divestiture similarly fail to make the required showing that such an increase is necessary. In this regard, the analysis and conclusion contained in the July 26 Order is totally inconsistent with the Commission's analysis and conclusion in the *01-0432 Order*. The Commission on rehearing should find that ComEd has not made the showings necessary under the facts of this case, and adjust ComEd's G&I plant as recommended by Staff.

The record also establishes the fundamental deficiencies in the Company's argument for its proposed 142% increase in G&I plant from $446,591,000[1] to

[1] *Commonwealth Edison Company, Petition for approval of delivery services tariffs and tariff revisions and of residential delivery services implementation plan and for approval of certain* (continued…)

$1,079,579,000. (ICC Staff Exhibit 6.0 Corr., p. 5) A key element in this increase is ComEd's proposal to restore to rate base G&I plant that the Commission had removed in Docket No. 01-0423. This proposal, which ComEd fails to either explain or support, is clearly inappropriate and should be adjusted downward as proposed by Staff.

The problems with the Company's proposal for G&I plant remain clear and unambiguous. Staff has identified a total of $304 million in 2000 test year G&I plant the Company restored to the revenue requirement that the Commission had explicitly excluded in Docket No. 01-0423. (ICC Staff Exhibit 27.0 Corr., p. 2) ComEd presented its proposal to restore these cost in an arbitrary fashion without explanation or supporting evidence. The Company even failed in its filing to acknowledge that this refunctionalization had taken place. Only in response to discovery did ComEd reveal that it had restored $405 million[2] in G&I plant that the Commission had removed. Thus, the Company has clearly fallen far short of justifying the inclusion of this G&I plant in rate base. (ICC Staff Exhibit 27.0 Corr., p. 3)

Another problem is that the direct assignment concept on which ComEd's functionalization process purports to be based has been found by the Commission to be fundamentally flawed, having been considered and rejected in ComEd's two previous delivery service cases (Docket Nos. 99-0117 and 01-0423). (ICC Staff Exhibit 27.0 Corr., pp. 3-4)

(continued from previous page)

other amendments and additions to its rates, terms and conditions, Ill. C.C. Docket No. 01-0423, Final Order, Appendix A, Schedule 3 (March, 28, 2003) ("01-0423 Order"))

[2] Staff reduced the original $405 million adjustment in gross plant by approximately 25% to $304 million, based on additional evidence presented in ComEd's rebuttal testimony. (ICC Staff Exhibit 17.0 Corr., p. 14)

ComEd's proposed direct assignment approach is even more problematic in the current proceeding. That is because the Company accords its direct assignment methodology only a cursory role in the process of functionalizing G&I plant to distribution. The Company uses its direct assignment approach solely to functionalize G&I plant within the transmission and distribution utility (ComEd Ex. 5.0, pp. 18-22, ComEd Ex. 5.2, WPB-1, p. 1 of 12). ComEd has removed from the process the more important step of functionalizing G&I plant between the utility and the now-deregulated production subsidiary from the record in this case, stating "there is no need to allocate general and intangible plant between a delivery business and a generation business." (ComEd IB, p. 43) As a result, the means by which ComEd functionalizes between the regulated utility and the unregulated production function remains unknown. (ICC Staff Exhibit 27.0 Corr., p. 4)

Thus, ComEd suggests that a business decision to divest somehow alleviates it of the responsibility to show the Commission that production receives a reasonable allocation of G&I plant. ComEd has instead arbitrarily assigned the large majority of G&I plant to the utility and then used direct assignment for the perfunctory purpose of functionalizing between transmission and distribution. When it comes to production, ComEd assumes that the decision to divest alleviates it of any responsibility to demonstrate that it has received a reasonable share of G&I plant. (ICC Staff Exhibit 27.0 Corr., pp. 4-5)

The shortcomings in the Company's argument on this issue are numerous. Nevertheless, the Commission did not scrutinize ComEd's arguments when it addressed the issue in its July 26 Order and, instead, endorsed the Company's proposal in perfunctory terms:

> Further, the Commission agrees with ComEd that the use of "direct assignment" of costs is the preferred approach over the general labor allocator approach. Because determining such costs is possible, the Commission is in agreement with ComEd that direct assignment be used in this case.

(July 26 Order, p. 27) The problem with this passage is that it does not address the fact that the Company's direct assignment analysis played a narrow and limited role in the functionalization of G&I plant to the revenue requirement since the process of functionalizing to production was placed outside the scope of the Company's analysis. ComEd's direct assignment approach is truly a bit player in the functionalization process and therefore cannot be used to justify the level of G&I plant that ComEd proposes to include in rate base. (ICC Staff Exhibit 27.0 Corr, p. 6)

The Commission also addressed the issue of a labor allocator for G&I plant, stating:

> Additionally, the Commission points out that the record evidence supports the fact that were the general labor allocator approach to be used in this case, general and intangible plant costs in rate base would in fact increase.

(Final Order, p. 27) While this discussion is designed to buttress the Company's proposed direct assignment approach for functionalizing G&I plant, it serves to reveal the deficiencies in that approach. That a labor allocator would produce a higher level of G&I plant than the Company's preferred direct assignment approach reveals how the scope of the debate narrows when production is removed from the functionalization process. Once ComEd has conducted the most significant step of the GI functionalization process off the record and G&I plant is arbitrarily assigned to the transmission and distribution utility, the method used to functionalize G&I plant between transmission and distribution becomes immaterial. Either way the distribution function will receive the lion's share of the costs. (ICC Staff Exhibit 27.0 Corr., p. 7)

The deficiencies in the Company's evidence clearly show that the Commission should accept the $304 million adjustment in G&I plant proposed by Staff in this proceeding. The $304 million adjustment is based on ComEd's failure to explain or justify its proposal to restore to rate base G&I plant that the Commission had excluded in Docket No. 01-0423. With ComEd providing the Commission no reasonable basis to reverse its conclusion in Docket No. 01-0423 on 2000 test year G&I plant, Staff's proposed $304 million adjustment remains relevant and appropriate.

2. Intangible Plant

For Staff's discussion of Intangible Plant, see Section III.B.1 of this Initial Brief.

3. Pension Effects on Rate Base

Staff recommends the Commission reaffirm its original decisions in its July 26 Order to deny the inclusion of ComEd's proposed pension asset in rate base and to base pension expense on the actual expense reflected in the current actuarial study. Since the pension plan is not over-funded, there is no net pension asset for which recovery in rate base is warranted. Further, the pension expense, which has always been treated as a separate issue from the ratemaking treatment of a pension asset, should be based on the latest actuarial study available. (ICC Staff Ex. 25.0, p. 2)

ComEd continues to request the inclusion of its prepaid pension asset in rate base, even though ComEd does not have a net pension asset. A net pension asset does not exist because the prepaid pension asset that is reflected on ComEd's books is offset by a pension liability that is reflected on Exelon's books. While ComEd has presented various accounting scenarios to give the impression that a proper pension asset exists, each of these tells only half of the story. ComEd wants the Commission to disregard the offsetting pension liability and include a pension asset in its rate base. In ComEd's view, this would achieve symmetry.

In its direct testimony on rehearing, ComEd still requests the inclusion of a pension asset in rate base and for the most part recycles the arguments it offered in the initial phase of this proceeding. (ICC Staff Ex. 25.0, pp. 7 - 8) Although it stands by its original proposal, ComEd offers the Commission three alternatives as a middle ground. If the Commission decides that the Company's shareholder should earn some level of return on prefunding of ComEd's pension costs, Staff recommends the Commission choose ComEd's third alternative, 4.75% weighted average cost of debt. This choice would not increase the revenue requirement above the revenue requirement that would have resulted if the pension contribution had not been made. Further, it would hold the ratepayers harmless with respect to the current revenue requirement.

a. Pension Asset

In the initial phase of this proceeding, Staff explained why the "pension asset" should not be included in rate base:

1. For ratemaking purposes, the pension contribution allocated to ComEd should not be considered separately from the offsetting pension liability attributed to ComEd that gave rise to the contribution;
2. The pension trust to which the contribution was made does not represent funds within the Company's disposition; and

3. The contribution was discretionary in nature.

(Staff IB, p. 21)

The Commission agreed with Staff's arguments and found that ComEd's asserted pension asset should not be included in rate base. In its conclusion, the Commission stated:

> The Commission finds Staff's arguments persuasive. Accounting principles, as well as common sense, dictate that no pension asset exists given that Exelon's infusion in ComEd's pension trust fund does not result in over funding. Further, even if the Commission were to find that a pension asset exists, this would not excuse ComEd from providing evidence that this particular method of funding the pension trust fund is reasonable before the Commission would allow it to be included in rate base. Simply stating that the contribution came from shareholders does not automatically make it reasonable. While the Commission is sympathetic to ComEd's concerns about its credit rating being downgraded if it issues debt to fund its pension obligations, the Commission may have been more sympathetic if ComEd had provided evidence of the cost of that debt and how it would compare to the cost of shareholder supplied funds. Or, perhaps ComEd could have shown how much it would cost ComEd to borrow the funds from Exelon instead of Exelon providing an equity infusion, given that debt tends to be less expensive than equity. Simply stating that credit rating concerns exist is not enough. Additionally, it is not clear why ComEd chose to fully-fund its pension obligations when it did. It seems that the timing of the funding also would affect the cost. The Commission needs to see numerical analyses to be able to perform an effective analysis of a utility's request for rate relief.

(July 26 Order, p. 39)

Company witness Houtsma mischaracterizes the Commission's Order as requesting "middle ground" for the pension asset issue. (ComEd Ex. 52.0, p. 1) Nothing in the language quoted above asks for any "middle ground." Rather, the language identifies evidentiary shortcomings in ComEd's case, and explains that it is impossible to effectively analyze ComEd's argument without this information. The Commission clearly indicates that evidence showing the cost of various scenarios (including evidence that the equity infusion would be a less costly alternative) would be needed to support the Company's proposal here. However, in its Application for Rehearing (Verified Application for Rehearing of Commonwealth Edison Company filed on e-docket on August 15, 2006 ("ComEd Application for Rehearing"), pp. 17-22) which the Commission granted in part, ComEd provides three alternatives to allow recovery of its prepaid pension asset.

While ComEd's Application for Rehearing sets forth three alternatives for the Commission to consider, ComEd does not claim to have additional evidence with respect to the pension asset much less provide an explanation as to why such evidence was not previously adduced. (See 83 Ill. Adm. Code 200.880 and ComEd Application for Rehearing) However, Company witness Holdren introduces a new accounting concept to justify the recovery of ComEd's pension asset by relying on guidance from the Federal Energy Regulatory Commission dated March 29, 2004 ("FERC guidance"). (ICC Staff Cross Exhibit No. 1 on Rehearing) Interestingly, while dismissing Staff's argument from the case in chief that the "pension asset" is a result of accounting entries, Mr. Holdren focuses on the accounting entries in his testimony on Rehearing citing Generally Accepted Accounting Principles ("GAAP"), the Statement of Financial Accounting Standards ("SFAS") 87 and FERC guidance as the Company's authority for its accounting entries. (ComEd Ex. 63.0, pp. 1 – 2)

Mr. Holdren proclaims that ComEd's prepaid pension asset is recorded in accordance with GAAP. (ComEd Ex. 55.0, p. 6) While Staff is glad to hear that ComEd is adhering to GAAP, this is not helpful in determining whether such an asset should be included in rate base. Clearly Mr. Holdren is confusing financial reporting purposes with ratemaking purposes. The fact of the matter is that ComEd must record all of its assets, liabilities, revenues and expenses in accordance with GAAP. The fact that a transaction is appropriately recorded on the books of an entity in accordance with GAAP does not automatically make it recoverable for ratemaking purposes. For example, ComEd's expenditures for political contributions must be recorded in accordance with GAAP; however, such expenditures are not allowed to be recovered for ratemaking purposes. Therefore, the fact that an asset was recorded in accordance with GAAP is not determinative of its ratemaking treatment.

Further, Mr. Holdren explains how annual pension costs are computed under SFAS 87. Interestingly, he needed to use the Exelon 10-K to compute the annual pension expense. He then concludes that since the liability related to pension expenses have never been included in ComEd's rates, ComEd is being denied recovery on the investor-supplied funds that made the contribution possible. (ComEd Ex. 55.0, p. 11) The fact that the pension liability has never been included in rates is a red herring. SFAS 87 allows for delayed recognition of the pension liability, allowing a company to recognize the obligation systematically and gradually over subsequent periods. This concept is unaffected by whether Exelon had contributed no funds or $803 million. For ratemaking purposes, a return is allowed if a company demonstrates that a net pension asset exists, meaning that the value of the pension assets exceeds the pension liability, and the net asset was a result of investor funds. Therefore, Mr. Holdren's argument must be rejected.

Mr. Holdren concludes that if ComEd had been a stand-alone company (not a wholly-owned subsidiary), for ratemaking purposes, the outcomes are exactly the same.

(ComEd Ex. 63.0, p. 5) Staff agrees – a net pension asset would not exist whether ComEd is a wholly-owned subsidiary or a stand-alone company. The contribution did not create a net pension asset that the Commission should include in ComEd's rate base any more than the contribution created a pension asset that Exelon should report on its balance sheet. As Company witness Houtsma so clearly stated, the "pension asset" is not disclosed on Exelon's consolidated financial statement since it was combined with an offset by a liability that was recorded at Exelon. (Tr., p. 444) The item that remained on Exelon's consolidated financial statements was the decrease to equity. In the same way, if all of the transactions were recorded at the ComEd level, the additional minimum liability would be offset by the prepaid pension asset, leaving the regulatory asset (representing the decrease to equity) to be considered for recovery in rates in subsequent periods. By its very definition – and, as discussed in the FERC guidance (ICC Staff Cross Exhibit No. 1 on Rehearing, Company Response to Staff data request TEE 22.07), due to the delayed recognition feature of SFAS 87 -- the regulatory asset is to be included in rates "systematically and gradually in subsequent periods". Thus it is not recoverable in rate base currently.

Mr. Holdren disagrees with Staff's position that the regulatory asset should not be included in rate base, claiming that the distinction between a pension asset and a regulatory asset is insignificant. Mr. Holdren contends that the inclusion of either asset in rate base is to allow for a return on the unrecovered capital provided by investors. (ComEd Ex. 63.0, p. 7) Mr. Holdren's argument that a pension asset and a regulatory asset are interchangeable simply betrays a results-oriented approach that confuses the fundamental nature of a pension asset and a regulatory asset.

The regulatory asset the FERC guidance speaks of is in no way a substitute for a net pension asset. First, as stated in the FERC guidance, the regulatory asset is for accounting purposes only and to avoid the otherwise necessary charge to accumulated other comprehensive income. Thus, in lieu of reducing shareholder equity, a company is allowed to record a regulatory asset. Second, the regulatory asset the FERC guidance speaks of reflects the delayed recognition feature of SFAS 87 and the fact that this item will be included in rates systematically and gradually in subsequent periods. (ICC Staff Cross Exhibit No. 1 on Rehearing, p. 2) The regulatory asset comes about because of the additional minimum liability, not because of an extra contribution. What this means is that the regulatory asset would exist even if the contribution at issue had not been made. Clearly, a pension asset and regulatory asset should not be used interchangeably as Mr. Holdren suggests.

What is ironic is that the very FERC guidance Mr. Holdren relies upon clearly supports the Commission's finding that a pension asset should not be included in ComEd's rate base at this time. The FERC guidance states:

> An entity that determines its pension allowance included in its cost based regulated rates on the basis of SFAS No. 87 adopts that same delayed recognition feature for ratemaking purposes. That is, changes in the pension obligation and <u>assets set aside to meet those obligations</u> are not included in rates when they occur but are included systematically and gradually in subsequent periods.

(ICC Staff Cross Exhibit No. 1 on Rehearing, p. 2, emphasis added) FERC's expectation is that recognition of both changes in the pension obligation and assets set aside to meet those obligations are deferred and included in rates systematically and gradually in subsequent periods.

Therefore, Mr. Holdren's argument must be rejected, since a net pension asset would not exist whether ComEd is a wholly-owned subsidiary or a stand-alone company.

Previous Commission Orders

ComEd also relies upon previous Commission Orders to support its position. First, ComEd cites to the Commission's Order in Central Illinois Light Company, Docket No. 94-0040 (Order, *Central Illinois Light Company, Proposed General Increase in Gas Rates*, Dkt. 94-0040, 1994 Ill. PUC LEXIS 577 *10, *58 (Dec. 12, 1994) ("CILCO Order")) as supporting the Commission's approval of a "Prepaid Pension Expense". (ComEd Ex. 52.0, p. 21) However, the Company has failed to show that the facts in that case are similar to the facts in this case. The reference to "Prepaid Pension Expense" at page 10 (Lexis page cited by ComEd) of the CILCO Order is simply a line item in a table. While there is no reference to "Prepaid Pension Expense" at Lexis page 58 cited by ComEd, Staff assumes that cite was intended to be Lexis page 59 where the phrase appears again as a line item in a table. There is no indication in the CILCO Order that any party contested the "Prepaid Pension Expense" included in rate base. In fact, there is no substantive discussion of a pension asset or prepaid pension expense in the CILCO Order at all.

Further, the discussion of the CILCO Order in the Commission's Order in Northern Illinois Gas Company, Docket No. 95-0219, (Northern Illinois Gas Company, Proposed General Increase in Rates for Gas Service, Dkt. 95-0219, 1996 Ill. PUC LEXIS 204, *21, *22 (Final Order April 3, 1996)) ("NICOR 1995 rate case")), also discussed by Company witness Houtsma (*Id.*), only states that CILCO's pension asset was a result of a cash contribution by CILCO. Neither of these Orders explains the circumstances surrounding the cash contribution in the CILCO proceeding and the resulting funded status of CILCO's pension plan. Thus, there is no indication from the information available that the cash contribution made by CILCO fully funded the pension trust or over-funded the pension trust. Further, the pension assets in the NICOR 1995 rate case and the NICOR 2004 rate case (Docket No. 04-0779) referenced in Company witness Houtsma's testimony (ComEd Ex. 59.0, pp. 20 – 21) were the result of **over-funding** based on superior earnings in the pension trust. The Company's blanket claim that the fact that the Commission previously allowed rate base treatment of a pension asset that resulted from cash contributions not provided by customers (ComEd Ex. 59.0, pp. 20 – 21) is faulty without a clear definition of the circumstances that lead to the inclusion of a pension asset in rate base. Lacking full details of the circumstances surrounding the pension asset issue in the CILCO rate case, the decision in that Order is not instructive in this case. (ICC Staff Ex. 25.0, p. 10)

Finally, the Company provides *United Cities Gas v. Illinois Commerce Commission*, 255 Ill. App. 3d 771 (4th Dist. 1992), as an example of a court decision recognizing symmetrical treatment of costs and benefits. (ComEd Ex. 52.0, pp. 25 – 26 and ComEd Ex. 54.0, p. 8) ComEd's reliance on *United Cities* is misplaced. The basis for the Court's opinion in *United Cities* was its conclusion that the Commission's finding that the agreement whose costs were at issue did not benefit ratepayers was contrary to the evidence:

> The ICC's conclusion that there is nothing which establishes that the cost of the consulting and noncompete agreement confers benefits on United

> Cities' Illinois ratepayers is belied by the evidence that the agreement was an integral part of the acquisition of Union Gas, and that the acquisition would not have occurred absent such an agreement. Thus, the consulting and noncompete agreement benefited United Cities' Illinois ratepayers to the same extent as the other terms and conditions of the acquisition of which it was an essential part.

(*United Cities*, 255 Ill. App. 3d at 777) Neither Staff's argument nor the Commission's Order in the instant proceeding are based on the assertion or finding that ComEd's contribution has not conferred any benefit on ratepayers. Rather, as discussed above, it is the offsetting pension liability, the lack of control of the funds by the Company, and the discretionary nature of the contribution that give rise to the exclusion of these costs from rate base (but not current period pension expense) in the instant case.

Moreover, the prepaid pension expense at issue here is fundamentally different than the consulting and noncompete agreement costs ("CNC costs") at issue in *United Cities*. Unlike the CNC costs in *United Cities*, the pension contribution in the instant proceeding was made to fund the additional liability resulting from the present increase in forecasted pension liability (from the lower amount forecasted when those expenses were included in prior rates). The CNC costs in *United Cities* did not represent additional costs to correct changes in forecasted CNC costs recovered in prior rates. While recovery of additional pension expense due to an updated pension liability forecast (i) is generally allowed if those costs are otherwise just and reasonable and prudently incurred and (ii) does not give rise to retroactive ratemaking concerns due to the unique nature of pension expenses (costs for investing money now to satisfy defined obligations due in the future), this fundamental difference in the costs at issue in *United Cities* and the costs at issue in the present proceeding renders the *United Cities* opinion inapposite to the present case. The Commission correctly found here that there is no reason for ratepayers to bear the costs of Exelon's decision to fully fund at the present time the currently forecasted additional pension liability.

Further, the costs at issue in the *United Cities* case were **required** to complete the transaction. (ComEd Ex. 54.0, p. 8) ComEd was under no such requirement to fully fund its pension plan in March 2005 (Staff's IB, p. 25); therefore, the comparison is also deficient in this regard. (ICC Staff Ex. 25.0, p. 11) ComEd tries to spin this into a "Which came first – the chicken or the egg" issue (ComEd Ex. 59.0, p. 19) but the fact remains that the costs incurred in the *United Cities* case were required while there was no similar requirement related to the pension contribution.

ComEd's Policy Concerns must also be Rejected

Company witness Merrill claims that the Order's treatment of the pension contribution violates the "restitution principle". (ComEd Ex. 54.0, p. 11) Company witness Holdren makes a similar claim that the "investors are owed a return on the funding they provided to ComEd". (ComEd Ex. 63.0, p. 7) The Commission, in its July 26 Order in this proceeding addressed just this issue: "Simply stating that the contribution came from shareholders does not automatically make it reasonable." (Order, p. 39) Put another way, simply expending funds does not make those funds recoverable in rates; all circumstances surrounding the expenditure need to be considered. (ICC Staff Ex. 25.0, p. 11) Staff previously set forth the reasons the "pension asset" should not be included in rate base:

1. For ratemaking purposes, the pension contribution allocated to ComEd should not be considered separately from the offsetting pension liability attributed to ComEd that gave rise to the contribution;
2. The pension trust to which the contribution was made does not represent funds within the Company's disposition; and
3. The contribution was discretionary in nature. (Staff IB, p. 21)

Company witness Merrill, in his discussion of the pension contribution's benefit to ComEd's ratepayers (ComEd Ex. 54.0, p. 11), ignores the detriment to ratepayers of ComEd's original proposal for the treatment of the pension contribution. The Company's proposal is to include $853.2 million as a pension asset, offset by the associated Accumulated Deferred Income Tax of $214.6 million, in rate base. The impact of this proposal is to increase the overall revenue requirement by $49.5 million. (ICC Staff Exhibit 13.0, Attachment D, line 5)

Company witness Holdren states that "pension costs are a legitimate cost of service and the costs that ComEd incurs to fulfill its pension obligations should be recoverable from customers as an element of rates". (ComEd Ex. 55.0, p. 9) Staff does not disagree with Mr. Holdren's statement that pension costs are a legitimate cost of service to be included in rates. Staff does disagree with the Company on the definition of what comprises the pension obligation. Company witness Houtsma confirmed that the contribution was voluntary. (Tr., p. 375) Ms. Houtsma further stated that "the pension asset represents funds that have been contributed to satisfy future obligation that have not been provided by customers". (Tr., p. 496) Thus, the question becomes should ratepayers pay for something that the Company was under no obligation to do, yet did for the primary reason that it was able to do so at the current time? (Staff IB, p. 25) The fact remains that the obligation is offset by the contribution which fully funded the plan at that point in time. (*Id.,* p. 26)

Conclusion

The Company resurrected a number of arguments already considered in this proceeding. Among those arguments are:

1) ComEd's ability to attract and retain experienced and qualified workers necessitates the contribution;
2) ComEd has costs related to the pension contribution;
3) Staff proposed asymmetrical treatment of the pension contribution and pension expense;
4) The contribution was made with shareholder-supplied funds; and
5) The ratemaking treatment of pension expense should be tied to the ratemaking treatment of a pension asset.

(July 26 Order, pp. 38 – 40) To the extent that these arguments have already been considered, they should not now be revisited lacking new evidence in support of the claims.

Staff must also note that new evidence introduced on rehearing in connection with Administrative and General Expenses completely undermines one of ComEd's arguments on the pension asset issue. As noted above, ComEd argues that the pension contribution to its defined benefit plan was necessary to maintain its ability to attract experienced and qualified workers. At the same time, ComEd admits that in an effort to control costs the defined benefit plan to which it made the contribution has not been available to new employees since 2002: "Beginning in 2002, new employees were no longer eligible to participate in the existing ComEd defined benefit plan." (ComEd Ex. 52.0, p. 13) Obviously, ComEd's contribution to a defined benefit plan to which new employees may not participate does nothing to improve ComEd's ability to attract new employees.

Finally, as evidenced by the foregoing, pension accounting is complex; however, the determination of whether a net pension asset exists is straightforward. If the value of the pension assets exceeds the pension obligation, a net pension asset exists. For ComEd, this simply is not the case. In this proceeding, the record demonstrates that the pension obligation is fully-funded, meaning the value of the pension assets equal the pension obligation. If a net pension asset existed, only then is an analysis of contributions necessary. Therefore, Staff strongly recommends that the Commission continue to reject the inclusion of ComEd's prepaid pension asset in rate base.

b. Alternative Pension Contribution Proposals

The Company offered three alternatives to its original proposal to include a pension obligation in rate base with disregard to the offsetting liability. Further the Company agrees that if any of the three alternatives is adopted by the Commission, the issue of an allowance for the pension contribution in rates would be resolved. (ComEd Ex. 59.0, p. 22)

The Company's first alternative would set the pension expense to be included in the revenue requirement to the level that would have existed had the March 2005 contribution to the pension plan not been made. (ComEd Ex. 52.0, pp. 27-28) This alternative ignores the known and measurable change in 2005 as supported by the August 2005 Towers Perrin actuarial study. (Company response to Staff data request TEE 3.08 (ICC Staff Exhibit 2.0, Attachment E)) Alternative 1 is also contrary to the Commission's position regarding updating pension expense based on the most recent actuarial study for evaluating pension expense. (ICC Staff Ex. 2.0, pp. 13 – 13)

In rebuttal, Company witness Houtsma argues that rather than "ignore" the effects of the 2005 actuarial study, she simply proposes to "adjust" the results of the study for the impact related to the contribution. (ComEd Ex. 59.0, p. 18) Semantics aside, the result is the same. In effect, this adjustment to the actuarial study does nothing more than increase pension expense by $30.2 million despite the fact ComEd did not have to pay these expenses. ComEd's position is contrary to ratemaking principles. The Commission clearly has discretion to reject a claimed expense that was not actually paid by a utility. (Staff RB, pp. 24-25) Therefore, the Company's first alternative should be rejected.

The Company's second and third alternatives both attempt to derive a cost of debt that ComEd would have experienced had it directly issued debt to raise the funding to make the contribution to the pension plan. The second alternative uses ComEd's weighted average cost of long term debt as of June 30, 2005. (ComEd Ex. 52.0, pp. 28-29) The third alternative uses a financial analysis prepared by Barclays Capital as the basis for an estimated 4.75% weighted average cost of debt. (*Id.*, pp. 29 – 30; ComEd Exhibit 52.15, page 1) If the Commission decides that the Company's shareholder should earn some level of return on the $803 million contribution to fully-fund the pension obligation, Staff recommends that the Commission choose ComEd's third alternative, 4.75% weighted average cost of debt.

Applying a 4.75% weighted average cost of debt to the March 2005 pension contribution does not increase the revenue requirement above the revenue requirement that would have resulted if the pension contribution had not been made. The annual pension expense resulting from the March 2005 contribution was reduced by $30.2 million. Applying a 4.75% weighted average cost of debt results in an allowance for pension contribution of $25.3 million versus the $34.5 million allowance for pension contribution resulting from the 6.48% weighted average cost of debt. (ICC Staff Exhibit 25.0, pp. 3-7 and Schedule 25.3) Including the allowance for pension expense of $34.5 million resulting from the 6.48% weighted average cost of debt would increase the revenue requirement above what it would have been had the pension contribution not been made. Thus, only the pension allowance resulting from the 4.75% weighted average cost of debt leaves ratepayers in no worse position than they would have been absent the pension prepayment. (ICC Staff Ex. 25.0, pp. 4 – 5)

Company witness Houtsma argues that under the current Order, ratepayers receive the entire benefit of the $30.2 million reduction in pension expense with shareholders receiving no return on the funds they advanced for the pension contribution. She further states that ratepayers will continue to be the beneficiaries under Alternative 3 since the lower pension expense of $30.2 million is more than the $25.4 million increase to revenue requirement. (ComEd Ex. 59.0, pp. 18 – 19) The revenue requirement approved in the Commission's July 26 Order in this proceeding approves recovery of ComEd's cost to provide electric distribution service to its ratepayers. Any allowance in addition to that revenue requirement provides a return to shareholders over and above the costs to provide service. Thus, the allowance for pension contribution which results in a revenue increase of $25.485 million (ICC Staff Ex. 25.0, Schedule 1, Line 26, column (f)) benefits shareholders through providing a return above and beyond ComEd's cost of service.

In summary, Staff continues to maintain its position from the case in chief that since the pension plan was fully-funded rather than over-funded by the contribution in March 2005, no pension asset exists to be considered for recovery in rate base. Likewise, Staff's position, which was also confirmed by the Commission's Order, that pension expense should be based on the latest actuarial study, should also be upheld. If the Commission is persuaded by the Company's arguments that some allowance for the Pension Contribution should be included in rates, the revenue requirement as computed on ICC Staff Exhibit 25.0, Schedule 25.1 sets forth the position that would hold ratepayers harmless for the actions of Exelon. (ICC Staff Ex. 25.0, p. 13) Of note is that the Company agrees with the adjustment to the calculation of revenue requirement reflecting the allocation to reselling municipalities. (ComEd Ex. 59.0, p. 21)

c. Pension Expense

Company witnesses Mitchell and Houtsma argue that the July 26 Order errs in the amount of pension expense included in the final revenue requirement. (ComEd Ex. 51.0, p. 14 and ComEd Ex. 52.0, p. 14 and p. 24) As discussed more fully in the section on the level of A&G Expenses, the Company is viewing a single item of A&G Expense in isolation. ComEd's claim, that A&G Expenses are under-recovered because Pension Expense has increased from the level approved in Docket No. 01-

0423, ignores the fact that other A & G Expense items have significantly decreased. No "correction" need be made to Pension Expense based on the Company's selective logic. (ICC Staff Exhibit 25.0, pp. 8-9)

C. Operating Expenses

1. Administrative & General Expenses

The Company on rehearing has again failed to justify its proposed increase in Administrative and General ("A&G") expenses for this proceeding. ComEd seeks the same $79 million increase in A&G expenses from $176.7 to $255.7 million that it proposed at the final stage of the previous phase of this proceeding. (ComEd Ex. 52.0 Corr., p. 1) In support of this increase, ComEd witness Houtsma claims that costs have increased in a number of areas, including: employee health care, retiree health care, salaries and wages, pension expense, Exelon Way severance costs, Sarbanes-Oxley compliance costs, depreciation of IT assets, SEC allocation and Corporate governance allocation costs. (ComEd Ex. 52.0 Corr., p. 6) According to Ms. Houtsma, these changes netted against accounting adjustments and other cost savings produce a $79 million increase in A&G expense. (ComEd Ex. 52.0 Corr., p. 6)

However, Staff has unearthed fundamental weaknesses in the Company proposal. Staff has found the evidence presented in rehearing to support ComEd's proposed increase to be sorely lacking. As a result, there is no justification for any increase in A&G expenses over the level approved by the Commission in Docket No. 01-0423. (ICC Staff Ex. 27.0 Corrected, p. 9)

Salaries and Wages Increase

One problem uncovered by Staff concerns the $ 9.1 million upward adjustment to A&G-related salaries and wages proposed by Company witness Houtsma (ComEd Ex. 52.0 Corr., p. 9). Ms. Houtsma begins her analysis of the issue by reducing the Company's 2004 test year salaries and wages figure of $67.3 million by 15.7%, which is her estimate of the cumulative increase in ComEd's salary and wage rates since the last rate case. (ComEd Ex. 52.0 Corr., p. 9) Taking 15.7% of $67.3 million produces a change in salaries and wages of $9.1 million. Thus, Ms. Houtsma concludes that salaries and wage rate increase have increased A&G expenses by $9.1 million since the last case. (ComEd Ex. 52.0 Corr., p. 10)

This upward adjustment is flawed because it fails to look at all of the components of salaries and wages. The amount the Company pays in salaries and wages depends not just on wage levels, but also on the number of employees being paid. If salaries and wages go up but the number of employees goes down, then total salaries and wages may not increase.

In fact, the Company's own evidence indicates that total A&G salaries and wages have declined significantly since ComEd's last rate case. (ICC Staff Exhibit 27.0 Corr., p. 10) The first piece of evidence on this issue comes from Ms. Houtsma's own testimony, which notes that "the number of ComEd employees engaged in delivery services (distribution and customer) in 2004 is one-third lower than was reflected in the 2000 test year" (ComEd Ex. 52.0 Corr., p. 4). This 33% decline in headcount has a far greater impact on salaries and wages than the 15.7% increase in wage levels cited by

Ms. Houtsma and produces a decline in overall expenditures on salaries and wages since the last rate case. (ICC Staff Exhibit 27.0 Corr., p. 10)

Corroborating evidence that these costs have declined comes from a comparison of salary and wage information provided in the Company's FERC Form 1 since ComEd's last delivery service case. Comparing 2004 levels with data for 2000 (the test year for Docket No. 01-0423) would not be appropriate because ComEd remained vertically integrated in 2000 and did not restructure as a transmission and distribution utility until January 1, 2001. Therefore, Staff compared A&G salaries and wages on ComEd's FERC Form 1 for 2001 and 2004. The data reveals that total A&G salaries and wages declined from $78,092,261 in 2001 (2001 FERC Form 1, p. 354, line 24) to $37,756,966 in 2004 (2004 FERC Form 1, p. 354, line 24). This represents a reduction of $40,335,295 in A&G salaries and wages from 2001 to 2004. Since 89.2% of A&G expenses may be considered jurisdictional, this would indicate that distribution accounts for $36.0 million of this reduction in A&G wages and salaries. (ICC Staff Exhibit 27.0 Corr., p. 11)

This comparison indicates that the Company's proposed $9.1 million increase in A&G wages and salaries is completely unsupported. Instead, the most reasonable conclusion based on FERC Form 1 data is that salaries and wages have declined by $36.0 million since the Company's last delivery service. Thus, Staff's analysis produces a $45.1 million reduction from the $9.1 million increase suggested by ComEd. (ICC Staff Exhibit 27.0 Corr., p. 12)

In rebuttal, Ms. Houtsma responded to Staff's argument by denying that she ever claimed salaries and wages had declined since the last case. She explains her position accordingly:

> I also did not overlook the fact, as Mr. Lazare suggests, that total A&G salaries and wages have declined significantly since the last case. My direct testimony specifically acknowledged that our existing workforce is now much smaller than it was at the time of the last case, and that is why I estimated what the increase in salaries due to wage rate inflation was *only for* the workforce as it existed in the 2004 test year.

(ComEd Ex. 59.0, p. 7) This statement is problematic in two respects. First, Ms. Houtsma did, in fact, suggest in direct testimony that A&G wages and salaries have been increasing as the following passage attests:

> First, ComEd's employee costs such as health care, salaries and wages and pensions have risen at rates in excess of general inflation.

(ComEd Ex. 52.0 Corr., p. 5) Second, Ms. Houtsma's subsequent acknowledgement that overall A&G salaries and wages have declined since the last case raises questions about her proposed $9.1 million upward adjustment of these costs. By focusing solely on salary and wage rate increases and ignoring the total amount actually expended on salaries and wages, Ms. Houtsma is cherry-picking only the favorable cost data that supports its proposed increase. Staff has shown that a more complete view supports a quite different conclusion concerning trends in A&G salaries and wages expense.

<u>Sarbanes-Oxley Compliance Costs</u>

ComEd goes on to contend that $7.8 million of its proposed increase in A&G expenses represents Sarbanes-Oxley compliance costs. (ComEd Ex. 52.0 Corr., p. 15) According to Company witness Houtsma, this amount reflects ComEd's share of

Sarbanes-Oxley costs incurred by its parent company, Exelon. (ComEd Ex. 52.0 Corr., p. 15)

Clearly, Sarbanes-Oxley represents a new cost that the utility should be able to recover if justified. However, the available evidence indicates that the Company has overstated the level of these costs. (ICC Staff Exhibit 27.0 Corr., p. 13)

Ms. Houtsma identifies the support for the proposed $7.8 million in Sarbanes-Oxley costs as follows:

> I have also attached, as ComEd Ex. 52.10, a study done by Charles River Associates that shows that, while Sarbanes-Oxley compliance costs necessarily vary from company to company, ComEd's Sarbanes-Oxley compliance costs are comparable to such costs incurred by other companies similar in size to ComEd.

(ComEd Ex. 52.0 Corr., p. 16) Unfortunately for Ms. Houtsma, the attached study undermines, rather than supports, her claim that the Company's costs are reasonable. The companies in the study averaged $8.1 billion in revenue and had average compliance costs of $7.8 million. Thus, compliance costs average approximately 0.10% of revenues for the sample in the study. (ComEd Ex. 52.10, p. 2) However, ComEd proposes a much higher level of Sarbanes-Oxley compliance costs. ComEd's proposed $7.8 million amounts to 0.46% of the $1.68 billion delivery services revenue requirement approved by the Commission in this proceeding (July 26 Order, Appendix A, p. 1, line 5, column (I)). In other words, ComEd's compliance costs represent a far higher share of revenues than the average in the sample for the Charles River study, ComEd Exhibit 52.10. So Ms. Houtsma's only support for the reasonableness of these costs indicates that ComEd's proposed Sarbanes-Oxley compliance costs are excessive. (ICC Staff Exhibit 27.0 Corr., pp. 13-14)

Based on the Charles River study, Staff finds that amount by which the Company has overstated test year Sarbanes-Oxley costs to be $6.1 million. The starting point for Staff's estimate is the average expenditure on Sarbanes-Oxley for the sample contained in the Charles River Associates study (ComEd Ex. 52.10). As previously noted, this sample spent on average 0.10% of revenues on Sarbanes-Oxley. Applying this 0.10% average to the $1.68 billion revenue requirement approved for ComEd in this proceeding produces a total of $1.7 million in test year Sarbanes-Oxley compliance costs. Comparison of this figure with ComEd's total of $7.8 million produces a $6.1 million overstatement of supported or properly recoverable costs. (ICC Staff Exhibit 27.0 Corr., p. 14)

In rebuttal, Ms. Houtsma seeks to discount Staff's comparison of ComEd's expenditures with the averages in the Charles River study. She argues as follows:

> The CRA [Charles River Associates] study (ComEd Ex. 52.10) does not suggest in any way that Sarbanes-Oxley compliance costs should vary in direct proportion to revenues, nor does it in any way suggest that any amount of spending above the average is excessive. The level of spending necessary to comply with the requirement of Sarbanes-Oxley will necessarily vary from company to company for many reasons completely unrelated to the levels, including the complexity of billing systems and processes, the amount of training and system modifications require, availability of new software and other factors.

(ComEd Ex. 59.0, p. 12) The problem is that Ms. Houtsma is ultimately arguing with herself. The Charles River study is her exhibit which she provided in direct to show that "while Sarbanes-Oxley compliance costs necessarily vary from company to company, ComEd's Sarbanes-Oxley compliance costs are comparable to such costs incurred by other companies similar in size to ComEd." (ComEd Ex. 52.0 Corr., p. 16) As Staff witness Lazare stated in cross "by having this [the Charles River study] as the only supporting exhibit…and using the Charles River analysis as a basis for determining a foundation for Sarbanes-Oxley compliance cost, I think she's saying that this is the standard to be used." (Tr., pp. 174-175)

The fact that ComEd's costs are not comparable to other companies in the study creates a credibility problem for Ms. Houtsma. The Charles River study is her criteria for evaluating ComEd's proposal and by this criteria the proposal falls short. The problem for the Company is epitomized in the following cross of Staff witness Lazare:

> Q. Is it your practice to accept utility tests for recovery of operating expenses, whatever they suggest, you'll accept?
>
> A. Well, if a company presents a test, throws in a test and then they fail their own test, it certainly raises questions in my mind.

(Tr., p. 184) Even if one accepts the unreasonable and nonsensical assertion that the Charles River study was not introduced to support the reasonableness of ComEd's Sarbanes-Oxley compliance costs, then the Commission must still reject ComEd's claim as the record continues to be devoid of evidence supporting the reasonableness of ComEd's claim for recovery of increased costs.

<u>Health Care Costs for Active Employees</u>

The Company's proposed $5.9 million increase in A&G-related health care costs for active employees is also unjustified. Company witness Houtsma explains the Company's proposed increase as follows:

> Health case costs for active employees allowed in the 2000 test year were $23.4 million. In this case, we are asking for $29.3 million. This $5.9 million increase over the amount allowed in the last rate order is the net effect of (a) a $7.8 million reduction due to fewer employees and (b) a $13.7 million increase due to the upward trend in health care costs.

(ComEd Ex. 52.0 Corr., p. 8) In support of the proposed increase, Ms. Houtsma presents a report prepared by Towers Perrins on health care costs as a supporting exhibit (ComEd Ex. 52.5).

The Company's proposed increase in health care costs appears excessive compared with the figures presented in the Towers Perrins study. ComEd Exhibit 52.4 estimates a level of $23.411 million in medical costs for the 2000 test year. After accounting for a 33.35% reduction in delivery service employees from 2000 to 2004, ComEd calculates a base level of 2000 medical costs for current employees of $15.603 million. ComEd then indicates that medical expenses for these employees have increased by $13.688 million to a total of 29.3 million. This represents an increase of 88% from 2000 to 2004 in the level of medical costs for each ComEd employee. (ICC Staff Exhibit 27.0 Corr., p. 15)

That 88% increase is considerably higher than the average increase in costs for health care plans presented in the Tower Perrins study included as ComEd Ex. 52.5. That study suggests average annual increases of 12%, 13%, 15% and 12% for the years 2001-2004 (ComEd Ex. 52.5, pp. 1-3) which amounts to a collective increase of 63% over four years. The question not answered by Ms. Houtsma is why ComEd fails to keep pace when it comes to controlling health care costs. (ICC Staff Exhibit 27.0 Corr., pp. 15-16) As Staff witness Lazare noted in cross:

> No one asked ComEd to provide this study for this proceeding. They did this on their own volition. So if that's the case, well, now they've opened up the box, so to speak, in terms of ComEd's own evidence. And if there is a discrepancy now, they have the responsibility of explaining that discrepancy between their actual costs and the evidence they chose to provide.

(Tr., p. 193)

Under the circumstances, it would be unreasonable to ask ratepayers to foot the bill for a greater-than-average increase in employee health care costs that the Company failed to explain. Limiting the increase to 63%, the average increase in ComEd's own study would still be generous to the Company. Applying the 63% increase to the $15.603 million base level of 2000 medical costs for current employees yields $25.434 million in 2004 test year medical costs, an increase of $2.023 million over the $23.411 million in 2000 test year health care costs for ComEd. Thus, $2.0 million represents the more reasonable increase in health care costs for active employees between 2000 and 2004 that would be reasonable to pass along to ComEd ratepayers. This figure is $3.9 million less than the Company's proposed $5.9 million increase in health care costs for active employees between 2000 and 2004. (ICC Staff Exhibit 27.0 Corr., p. 16)

In sum, the analysis by Staff witness Lazare indicates that the Company has overstated the proposed increase in the A&G salaries and wages, Sarbanes-Oxley compliance costs and employee health care costs by $45.1 million, $6.1 million and $3.9 million, respectively. This amounts to a total overstatement of $55.1 million for these cost categories alone. (ICC Staff Exhibit 27.0 Corr., pp. 16-17)

<u>ComEd's Criticisms of the Commission's Order Must be Rejected</u>

In criticizing the Commission's conclusion regarding A&G Expense, Company witness Hill claims that 1) the Commission's methodology effectively provides no recovery of certain A&G expenses that the Order specifically deemed recoverable and 2) viewing A&G costs in isolation presents a distorted picture for ratemaking purposes. (ComEd Ex. 53.0, pp. 5 – 11)

The inflation factor methodology approved in the July 26 Order in this proceeding utilizes the overall level of A&G expenses allowed in the Final Order in Docket No. 01-0423 rather than any specific line item within that overall level. That is to say, the inflation factor is applied to the overall level, not to any specific line item within that category of costs. While it is true that the inflation factor methodology does not specifically identify any line item as being increased or added from 2000 to 2004, neither does it identify any line item that has significantly decreased during that same time period. (ICC Staff Exhibit 25.0, pp. 14-15)

In his discussion of the inflation factor methodology, ComEd witness Hill claims that "it would be only by coincidence that the use of this methodology…would produce an accurate and fair result. Such a coincidence does not exist here." (ComEd Ex. 53.0, p. 8) Mr. Hill's claim is contradicted by the facts when analyzing ComEd's actual results of operations for the periods under review. ComEd's operating expenses in total, and A & G expenses in particular, have not risen but have decreased since ComEd restructured as a transmission and distribution utility on January 1, 2001. (ICC Staff Exhibit 25.0, p. 18)

The Company focuses on the fact that certain line items have increased since 2000 but ignores the fact that certain other line items have significantly decreased during that same time period. For example, using the Company's theory applying the inflation factor to specific line items and comparing the result to 2004 test year costs, it can also be argued that Office Supplies and Expenses are being *over* recovered by over $33 million. (ICC Staff Exhibit 25.0, Schedule 25.4) Likewise, as further discussed in Staff witness Lazare's testimony on rehearing (ICC Staff Exhibit 27.0), A&G salaries expense has decreased since the last rate case. This decrease in salaries and wages would also result in decreases to payroll tax expense and other employee benefit expenses. (ICC Staff Exhibit 25.0, p. 15)

Furthermore, the Company is inconsistent in the application of its theory. The Company argues that it is inappropriate to consider the actual change to the overall A&G expense level in isolation, but then proceeds to break out isolated components of A&G expense and analyze them in isolation. The facts are clear. ComEd's actual operating results demonstrate that both A&G expenses and overall expenses have declined since ComEd restructured as a transmission and distribution utility on January 1, 2001. The Company's attempt to cobble together isolated expense components fails to show otherwise. (*Id*., pp. 15 – 16)

Company witness Hill provides Figures 1 and 2 (ComEd Ex. 53.0, pp. 10 – 11) in an attempt to compare costs approved in the Order in Docket No. 01-0423 with ComEd's 2004 costs. This comparison may show what Mr. Hill wants the Commission to believe but a more meaningful comparison is presented in Staff's variance analysis. (ICC Staff Exhibit 25.0, Schedule 25.5) Focusing on ComEd's actual results of operations, it becomes readily apparent that ComEd's costs have been trending downward since the 2001 rate case. When data from 2005 is also considered, the Commission's conclusion regarding the level of A & G expenses ComEd is likely to incur during the period these rates will be in effect is reasonable since actual results of operation prove that costs have not risen as the Company claims. (*Id*.)

Staff's variance analysis (ICC Staff Exhibit 25.0, Schedule 25.5) shows that from 2001 to 2004, ComEd's overall costs related to electric distribution business are trending downward, not even keeping up with inflation levels. Total Direct Electric Distribution Expenses decreased from $361,535,275 in 2001 to $279,335,937 in 2004. Total A&G Expenses showed a 5% overall increase from $319,177,378 in 2001 to $336,611,189 in 2004. Total Electric Operation and Maintenance Expenses (disregarding Direct Power Production and Transmission Expenses) results in an 8% overall decrease from $874,197,422 in 2001 to $805,740,536 in 2004.

The downward trends in costs continue into 2005 with Direct Distribution Expense totaling $286,020,138, Total A & G Expense totaling $280,018,531 and Total Electric Operations and Maintenance Expense totaling $751,412,944. (*Id*.) If anything, the results of this analysis indicate that the 9.7% inflation factor applied in the Commission's Order was generous.

In rebuttal, Mr. Hill claims that Staff's analysis showing the downward trend in costs does not present any valid reason for rejecting ComEd's requested increase in allowed A & G Expenses. (ComEd Ex. 60.0, pp. 11-16) He further argues that using unadjusted FERC Form 1 data should not be used to support the level of A&G expenses to be recovered in rates. (*Id.*, pp. 14 -15) Staff's analysis was never provided as a basis for the level of allowable A&G Expense. Rather, Staff's analysis was done to illustrate the reasonableness of the Commission's conclusion that ComEd had not supported its requested increase in A&G costs since the last rate case. (ICC Staff Exhibit 25.0, pp. 16 – 18) While Staff's analysis contains raw data from the Company's FERC Form 1 for the years 2001 through 2005, that does not impact the downward trend. Applying the Company's 89% allocation factor to total Company A&G expenses that are trending downwards would result in jurisdictional A&G expenses that are also trending downwards.

In his criticism of Staff's analysis related to A&G costs, Mr. Hill argues that Staff overlooked increases in Depreciation expense and Taxes Other than Income Tax Expense. (ComEd Ex. 60.0, p. 12) Since these costs are separate and distinct from A&G expenses, his argument is misplaced and should not be given any weight in the Commission's conclusion.

<u>Record does not Support ComEd's Increase in A&G Expenses</u>

The Company's inability to justify its proposed increase in A&G expenses was fully demonstrated in the hearing process. ComEd had the following exchange with Staff witness Lazare concerning the Company's supporting evidence in Exhibit 52.1:

> Q. All right. And the net effect of all of the additions and decreases on this schedule or this exhibit is to show increases in ComEd's A&G expenses of about $79 million between 2000 and 2004, correct?
>
> A. That's what it claims to show.
>
> Q. And the—this is precisely the breakdown that the Commission was interested in receiving on rehearing as far as you know, correct; a line-by-line, item-by-item reconciliation of the $79 million increase?
>
> A. No, I would disagree.

(Tr., pp. 145 – 146) Staff witness Lazare then proceeded to identify the shortcomings in Schedule 52.1. He noted that alongside the $79 million in upward adjustments explained in Ms. Houtsma's testimony, Exhibit 52.1 contains "a magnitude of even larger amounts of adjustments that are not explained between Columns N and P." (Tr., p. 229) Mr. Lazare noted that the Exhibit contains a $47 million reduction in combined accounts 920 and 921 "that is not explained in the direct or rebuttal testimony of Ms.

Houtsma". Mr. Lazare goes on to state, "So there is no basis on the record to whether that was—that adjustment was reasonable or not." (Tr., p. 229)

Mr. Lazare then discusses other A&G accounts:

> And then if you go to, for example, Account 923, the adjustments she does discuss are in Columns J, K, L and M, which come to about $38 million. But then when you go to Column N to Column P, you have an adjustment, upward adjustment of $48 million that, again, is not discussed in her direct or rebuttal testimony.
>
> And as you go down that column, you'll see other adjustments that again are not the subject of her adjustments--of her testimony, so the problem is a lot of the process by which she gets to her final proposed A&G level that she's recommending the Commission to accept in this case, there is just a large part of the story that's not being told. And so that's why I don't think the company has lived up to or fulfilled the requirement laid out by the Commission in accepting this proposal for rehearing.

(Tr., p. 230)

The Company's response to Mr. Lazare's discussion of the problems with the Company's exhibit was telling. ComEd counsel stated, "Ms. Houtsma will be here and she can explain where all this information is in the record." (Tr., p. 234) He later stated, "Ms. Houtsma is here, she can explain that column, she can explain where that information is in the record. If anybody is interested in hearing that, we're willing to present her for that limited purpose this afternoon." (Tr., pp. 242 – 243)

The Company's statements inviting further discussion are recognition that ComEd through two rounds of testimony in this rehearing phase of the process still has not provided a full and complete accounting of its proposed $79 million increase in A&G expenses. The exhibit that the Company trumpeted as "precisely the breakdown that the Commission was interested in receiving" was shown to be clearly deficient and, as a result, the Company sought one more chance to tie the numbers together under cross.

This solicitation of additional cross to explain its case stands as an acknowledgement by the Company that it has failed to make its case on the issue of A&G expenses.

The results of the rehearing obviate any need to increase A&G expenses over the level approved by the Commission in Docket No. 01-0423. Since the Company has not justified any increase in A&G expenses over the level approved in Docket No. 01-0423, it should receive no increase in these costs. Because the Final Order in the first phase of this case granted ComEd a $17.3 million increase in A&G expenses, Staff proposes in rehearing that the Commission reduce that amount by $17.3 million to ensure the same level of A&G expenses as granted in Docket No. 01-0423. (ICC Staff Exhibit 27.0 Corr., pp. 17-18)

If the Commission continues to believe that some increase in A&G expenses is warranted, Staff' second recommendation is that the increase be limited to the $17.3 million granted in the first phase of this proceeding. Thus, Staff would recommend no further increase in A&G expenses for the Company in this phase of the case. (ICC Staff Exhibit 27.0 Corr., p. 18)

2. Pension Contribution and Pension Expense

See Staff's discussion of ComEd's pension contribution and pension expense in Section III.B.3 of this Initial Brief.

D. Rate of Return

1. Capital Structure

a. Staff's Position

Staff's position with regard to the capital structure that the Commission should adopt for ComEd has not changed. Although the Commission's Order adopted a capital structure of 42.86% common equity and 57.14% long-term debt for ComEd, Staff steadfastly maintains that a capital structure comprising 37.11% equity and 62.89% long-term debt is more appropriate for ComEd at this time. (ICC Staff Exhibit 26.0, p. 3) Staff demonstrated that when appropriate adjustments are made to fully remove goodwill and affiliate-owned plant from the capital structure, ComEd's rate base is supported by 37.11% equity and 62.89% long-term debt. Indeed, the Order found that "Staff's adjustments have merit, and the Commission is satisfied that Staff's capital structure properly reflects ComEd's level of debt." (Docket No. 05-0597, Order dated July 26, 2006, p. 129) Thus, it is clear that Staff's proposal represents the actual capital structure supporting ComEd's rate base.[3] The only question remaining is whether a capital structure of 62.89% debt and 37.11% equity is just and reasonable. As Staff has demonstrated, it clearly is.

The July 26 Order's rejection of Staff's proposed capital structure is unfounded. (ICC Staff Exhibit 26.0, p. 4) The Order rejects Staff's proposed capital structure on the basis that it "may not be sufficient to allow the utility to maintain its financial strength or A– credit rating." However, the Commission's conclusion sets forth no specific reasons for that finding nor any discussion or assessment of Staff's detailed analysis supporting the reasonableness of Staff's proposed capital structure for determining ComEd's overall rate of return. Further, the Order neither discusses the criteria the Commission used to determine whether a given capital structure would be sufficient to allow to ComEd to maintain its financial strength, nor explains its reasoning or cites any

[3] The critical issue is not, as the Company suggests, what ComEd's "actual" capital structure is (i.e., a capital structure that supports both utility and non-utility assets (e.g., goodwill)), but rather, how much capital, and in what proportions, is *actually* invested in ComEd's delivery services operations. (Staff RB, pp. 45-46)

evidence to support why it is necessary for ComEd to maintain at least an A– credit rating. The "need" to maintain at least an A– rating is particularly perplexing since A– was the highest S&P issuer credit rating ComEd held at any time since 1991. In fact, contrary to the Order's implication, for a majority of the time since 1991 ComEd maintained its financial health with a rating somewhere in the BBB range.

Under Staff's proposed capital structure and rate of return on common equity, and the Order's conclusion regarding rate base and operating expenses, ComEd's Funds From Operations to Debt ("FFO/debt") ratio is 17.73%, which falls in the top third of S&P's benchmark range for a BBB utility with a business profile score of 4, while its Funds From Operations Interest Coverage ("FFOIC") ratio is 3.74x, which falls toward the low end of the middle third of the A range.[4] (ICC Staff Exhibit 26.0, p. 5) Together, those two ratios indicate that Staff's proposed rates are sufficient to support financial strength that is commensurate with a credit rating of BBB+/A–. Such a rating is very near the A– credit rating that the Company purports to target and the Commission found, for reasons unexplained, to be critical. In addition, a BBB+/A– rating is perfectly consistent with the average rating of the sample that forms the basis for Staff's 10.19% cost of equity estimate. Furthermore, such a credit rating is consistent with the issuer credit ratings ComEd held from 1991 through October 2005, which fluctuated from a low of BBB to high of A–. Thus, the actual capital structure supporting ComEd's rate base, 37.11% equity and 62.89% long-term debt, is just and reasonable and should be adopted.

[4] Based on the Order's conclusion with regard to rate base, which affects the calculation of Funds From Operations. The rate base adopted in the Order differs from that which Staff proposed.

b. ComEd's Position

Curiously, despite calling for a rehearing on the basis that a capital structure with a 42.86% equity ratio is insufficient, the Company now has no objection to such a capital structure. Indeed, the Company now advocates a capital structure including either 46.0% equity and 54.0% long-term debt or the 42.86% equity and 57.14% long-term debt the Company previously found objectionable. (ComEd Ex. 58.0, pp. 27-28) Company witness Mitchell's argument shifted from stating that "the evidence supports approval of…a common equity ratio of 54.26%" (ComEd Ex. 51.0. p. 16), to stating that "the Commission should review the significant evidence that supported…a common equity ratio of 46%" (ComEd Ex. 51.0. p. 16), and, finally, to finding that there is "support in the record of a 42.86% common equity ratio capital structure." In fact, if the Company obtains its desired outcome on other issues, Mr. Mitchell is apparently willing to stipulate that "the imputed ComEd capital structure with a common equity ratio of 42.86% approved in the July 26 Order is supported by substantial evidence." (ComEd Ex. 58.0, pp. 5 and 27-28)

The "substantial evidence" Mr. Mitchell cites consists of: 1) Staff witness McNally's inference that the Commission believes, despite a lack of explicit evidentiary support, that the capital structure adopted in Docket No. 01-0423 will enable ComEd to maintain its financial strength going forward; 2) the claim that a recent Exelon 10-Q report suggests that ComEd's June 30, 2006 and 2007 capital structures support the Order's 42.86% equity ratio; and 3) a list of 10 utility companies with equity ratios in the vicinity of 42.86%. (ComEd Ex. 58.0, pp. 27-29) The first argument is fundamentally flawed because it fails to address the key question of whether or not a capital structure composed of 37.11% common equity and 62.89% debt would enable ComEd to maintain its financial strength going forward.[5] The evidence indicates the answer to that question is yes. First, a 37.11% common equity ratio, when combined with the cash flows from ComEd's revenue requirement, is indicative of financial strength commensurate with a BBB+/A– credit rating. (ICC Staff Exhibit 26.0, p. 5) Second, Staff witness Kight testified that:

> A BBB credit rating indicates an adequate capacity to meet financial commitments. A debt issuer with a BBB credit rating has access to debt capital under most, if not all, financial market conditions while taking greater advantage of the tax-deductibility of debt interest than capital structures that support higher credit ratings. (ICC Staff Exhibit 4.0 Corrected, p. 10, lines 186-190)

Third, ComEd has operated successfully with a BBB or BBB+ issuer credit rating nine out of the last fourteen years. (ICC Staff Exhibit 26.0, Schedule 26.1, page 1) Hence, the evidence clearly demonstrates that a credit rating <u>as low as BBB</u> is a sufficient degree of financial strength.

With regard to the "support" from an Exelon 10-Q report, Mr. Mitchell essentially argued that adjusting the capital structure measurement date to June 30, 2006 or June 30, 2007 would support a 42.86% equity capital structure. (ComEd Ex. 58.0, p. 28) However, that is irrelevant. The Company chose a June 30, 2005 capital structure measurement period. The actual capital structure supporting ComEd's rate base (with the appropriate adjustments) as of that date consisted of 37.11% equity and 62.89% long-term debt. If the Company wished to use June 30, 2006 or 2007 capital structure measurement date, it should have elected to do so from the start and measured all of its cost of capital components consistently as of that date. The Commission should not

[5] Obviously, Staff does not dispute that <u>any</u> capital structure incorporating more than 37.11% common equity would enable ComEd to <u>at least</u> maintain its financial strength going forward.

allow a party to selectively update a single piece of the revenue requirement to suit that party's agenda, particularly in the last round of responsive testimony when no other party has a chance to respond.[6] Moreover, Mr. Mitchell's off-the-cuff calculation of the June 30, 2007 equity ratio, derived by adjusting the June 30, 2006 capital structure for scheduled retirements of Transitional Funding Trust Notes ("TFTNs," also referred to as Transitional Funding Instruments or "TFIs"), failed to fully investigate the comprehensive effects of such an adjustment.[7] Adjustments to a company's capital structure do not occur in a vacuum. For example, Mr. Mitchell's rudimentary analysis assumes that the TFTNs retired in 2006 and 2007 would not be replaced by other capital issuances; however, without a fully developed analysis of the projected financial circumstances, such an assumption is purely speculative. For the foregoing reasons, this "support" from the Exelon 10-Q report should be disregarded.

Mr. Mitchell's third form of "support" for a 42.86% equity ratio capital structure is a list of 10 utility companies with equity ratios in the vicinity of 42.86% that was selectively filtered from a much larger list. (ComEd Ex. 28.0, p. 29) However, Mr. Bodmer culled from that same master list a subset of 15 utility companies with equity ratios of 38% or lower. (Revised CUB-CCSAO-City Exhibit 7.0, pp. 12-13) Given those conflicting findings, it is obvious that the mere existence of utilities with equity ratios

[6] If ComEd had chosen a measurement date with a higher a common equity ratio closer to 42.86%, Staff might have either selected a different sample or adjusted its cost of common equity recommendation downward. Further, selective capital structure updates are contrary to 83 IL Adm. Code 285.4000(b).

[7] Utilities selecting a forecasted capital structure are required to provide a complete set of forecasted financial statements through the capital structure measurement date, supporting forecast assumptions, and a comparison of previous forecasts with actual results. (83 IL Adm Code 285.4010(c) and 285.4090) ComEd did not provide the information required in 285.4010(c), while the schedules filed under 285.4090 end June 30, 2005.

near a party's desired target equity ratio, does not mean that the target equity ratio is applicable to ComEd. This exemplifies the overriding flaw in the Company's entire capital structure analysis: a sole reliance on dubious equity ratio comparisons as determinative of the capital structure to be approved by the Commission.

The Company argues that credit metrics applied by ratings agencies are not determinative of the capital structure to be approved by the Commission and, thus, Staff's arguments for a 37.11% equity ratio based on the resulting financial ratios should be disregarded. (ComEd Ex. 58.0, pp. 10-12) Instead, the Company continues to argue that the appropriate capital structure should be determined on the basis of a comparison to other utility capital structures. The Company claims that such a comparison indicates that the proper equity ratio for ComEd should be higher than the 37.11% Staff proposes. (ComEd Ex. 51.0, pp. 16-17) To support this position, the Company presents several examples of the previous proceedings in which the Commission used capital structure comparisons to help gauge the appropriateness of a given capital structure proposal. (ComEd Ex. 58.0, pp. 11-12) Significantly, in none of those cases did the Commission dismiss proposals based on financial coverage ratios in favor of proposals based on capital structure comparisons, as the Company proposes the Commission do in this proceeding. Staff does not dispute that the Commission has, in the past, used capital structure comparisons to help gauge the appropriateness of a given capital structure proposal. However, as discussed below, in this new era of utility purchase accounting adjustments (e.g., goodwill) and asset securitization (e.g., TFTNs) a review of financial coverage ratios provides more insight into a company's financial strength than capital structure comparisons, particularly in this proceeding, given the distortion created by inclusion of TFTNs in ComEd's capital structure. Ironically, despite the Company's apparent disdain for credit metrics in evaluating a capital structure, its entire analysis is based on a credit ratio – the equity ratio (i.e., the leverage metric). Unfortunately, while that ratio may best suit the Company's agenda, it is the least significant of the three credit metrics presented in this proceeding. Thus, the Company's argument is flawed and should be rejected due to its exclusive reliance on the equity ratio.

First, the Company's equity ratio comparison is misleading, as the equity ratios on both sides of the comparison are distorted. The Company's calculation of the equity ratio for the other utilities to which it compares ComEd assumes that all capital other than long-term debt is equity. That incorrect assumption causes the Company to overstate the equity ratio the Company claims should be determinative of the capital structure to be approved by the Commission. For example, the Company states that the average equity ratio for Staff's comparable sample is 48%; however, as Staff noted, when short-term debt is properly included, the equity ratio is actually just over 45%. (Tr., pp. 1804-1806) More significantly, the inclusion of TFTNs in ComEd's debt balance renders ComEd's leverage metric misleading. This is because the leverage metric does not consider the risk and cost associated with the debt in the capital structure and, thus, fails to differentiate between conventional debt and lower risk TFTNs. Since ComEd's TFTNs are less risky than conventional debt, a position argued by ComEd in Docket No. 98-0319, ComEd is less risky than its 62.89% combined debt/TFTN ratio suggests. (ICC Staff Exhibit 26.0, pp. 6-7) Although Staff believes that TFTNs are properly included in ComEd's capital structure, one must acknowledge that the lower risk of TFTNs makes comparisons of ComEd's capital structure to other capital structures and capital structure benchmarks misleading.

Second, the Company's approach completely ignores the Funds from Operations Interest Coverage ("FFOIC") and Funds from Operations to Debt ("FFO/debt") ratios, each of which provides a less distorted measure of ComEd's risk than the equity ratio. (ICC Staff Exhibit 26.0, pp. 6-7) Unlike the equity ratio, the FFOIC and FFO/debt ratios both reflect the cost of a company's debt and the cash flows available to meet its debt service obligations.[8] Thus, the Company's approach relies on the least instructive of the three ratios while ignoring the two that are most informative. Significantly, of those three ratios, the ratio that most fully accounts for both the amount and costs of debt and consequently, is the least distorted measure of ComEd's risk, is the FFOIC ratio, which indicates the highest rating, A/A–.[9] That is, the more fully one accounts for the lower risk of TFTNs in ComEd's capital structure relative to conventional debt, the better the implied rating. Consequently, the implied credit rating of BBB+/A– resulting from Staff's cost of capital recommendations and the Commission's other revenue requirement findings appears to be conservative.

The Company further argues that even if one accepts credit metrics as determinative of a capital structure, a 37.11% equity ratio is not acceptable because it

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[8] This explains why, in contrast to the Company's approach, ComEd witness Mitchell found that S&P relies primarily on the FFOIC and FFO/debt ratios while it does not rely on the leverage metric to a significant degree. (ICC Staff Exhibit 26.0, p. 6)

[9] Although to a lesser extent than the equity ratio, the FFO/debt ratio also gives the appearance of greater risk than ComEd truly face because the denominator in that ratio does not distinguish between lower risk TFTNs and conventional debt. The FFOIC ratio is the only one of those three financial ratios that fully accounts for the risk/cost associated with ComEd's TFTNs in the calculation of both its numerator and denominator.

produces credit metrics that are weaker than before, which the Company claims were already too weak. (ComEd Ex. 58.0, pp. 12-14) The Company's conclusion is incorrect. Although the resulting credit ratios are slightly weaker when Staff's cost of capital recommendations are combined with the Order's rate base than with Staff's proposed rate base, as Staff originally presented, those ratios still indicate a sufficient level of financial strength. As noted previously, the updated FFOIC and FFO/debt ratios indicate that Staff's proposed capital structure is sufficient to support a level of financial strength commensurate with a credit rating of at least BBB+/A–. In contrast, Staff demonstrated that the capital structures the Company advocates, of either 46% or 42.86% equity, both produce credit ratios indicative of an A rating or better. (ICC Staff Exhibit 26.0, pp. 9-10) An A credit rating is higher than the credit rating that the Company purports to target, the credit rating the Commission found to be critical, the average credit rating of the sample that forms the basis for Staff's cost of equity estimate, and the issuer credit ratings ComEd held from 1991 through October 2005, which are reflected in the costs of debt for which ComEd requests compensation from its customers. Thus, there is no need to impute an equity ratio greater than the 37.11% Staff recommends.

The Company also argues that recent downgrades to ComEd's credit rating suggest that the Order's findings with respect to the capital structure has had an adverse effect on ComEd's financial condition. (ComEd Ex. 51.0, pp. 3-4 and 17) The Company concludes that the Commission should approve a less leveraged capital structure to account for ComEd's current S&P credit rating of BBB– and business profile score of 8. (ComEd Ex. 51.0, pp. 17-18 and ComEd Ex. 58.0, pp. 16-18) The Company's argument should be rejected.

First, contrary to Mr. Mitchell's claim, since the Order *increased* ComEd's rates, it obviously could not worsen ComEd's prospective financial condition. In fact, S&P states that ComEd's corporate credit rating was downgraded due to S&P's "concern about increased political rhetoric in Illinois regarding a rate-freeze extension and that legislation extending the rate freeze (while not an eventual certainty) appears to be gathering momentum." S&P explains that recent calls for a special session of the legislature to pass legislation extending the current rate freeze heighten business risk for ComEd substantially; consequently, S&P has changed ComEd's business profile score from 4 to 8. However, S&P also notes that if legislative action is not taken, it will reconsider ComEd's ratings at that time.[10] Further, the Moody's report dated July 26, 2006, which Mr. Mitchell attached to his direct testimony on rehearing, notes that its downgrade reflects a difficult political and regulatory environment. Significantly, in its discussion of the "difficult political and regulatory environment," Moody's makes no mention of the Order, but does specifically note concerns regarding the recovery of power procurement costs. In addition, the Fitch Ratings report dated July 31, 2006, which Mr. Mitchell also attached to his direct testimony on rehearing, notes that its downgrade reflects "the increased business risk that result form the ongoing regulatory

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[10] On October 10, 2006, Moody's Investors Service issued a report in which it did not immediately downgrade ComEd's ratings but did place them under review for possible downgrade. Moody's stated, "The rating review will assess the prospects for relatively timely recovery of increased costs, the likelihood of legislative or regulatory action that would impair timely recovery, and the implications for credit quality and liquidity should some form of rate freeze legislation be imposed." Moody's Investors Service, Commonwealth Edison Company Ratings Action, October 10, 2006.

uncertainty in Illinois."[11] All the above indicate that ComEd's rating decline was based on increased risk relating to uncertainty with regard to a possible freeze in bundled rates, rather than the capital structure adopted in the Order.

Second, ComEd's capital structure should not be adjusted to reflect ComEd's current S&P credit rating of BBB– and business profile score of 8, since, as discussed above, they reflect the threat of a bundled service rate freeze. If the Commission increased ComEd's rate of return in this proceeding to reflect ComEd's S&P rating decline and business profile adjustment, and the bundled service rate freeze is not extended, then customers will end up being unfairly charged for risks that did not materialize. Alternatively, if the Commission increased ComEd's rate of return in this proceeding to reflect ComEd's S&P ratings downgrade and business profile adjustment, and the bundled service rate freeze is extended, then only unbundled service customers would absorb the increase in cost of capital arising from a bundled service rate freeze. That, too, is inherently unfair. Thus, the Commission is not in a position to take meaningful, appropriately targeted, compensating action in this proceeding. Furthermore, ComEd's ratings may be negatively affected by the risk of ComEd's non-regulated affiliates; the Company has not demonstrated otherwise. For the foregoing reasons, ComEd's current ratings are not relevant in this proceeding.

[11] In its discussion, Fitch notes that the downgrade also "reflects the unfavorable rate order issued by the Illinois Commerce Commission." Significantly, it does not state that the Order was a contributing factor to the downgrade, but merely that it is reflected in the downgrade. That is, one may infer from Fitch's discussion that the "uncertainty regarding the power procurement process" was the driving force behind the downgrade, as uncertainty is the basis of risk; the "unfavorable rate order" merely provided a "less than expected rate increase" to offset power procurement risk.

The above notwithstanding, even if ComEd's capital structure were adjusted to reflect ComEd's current credit rating and business profile score, the Company has failed to establish that its call for a less leveraged capital structure would reverse ComEd's recent downgrades. If the capital structure is the cause of ComEd's ratings downgrades, as ComEd suggests, than ComEd's capital structure proposal should alleviate that concern. Obviously, the effects of the capital structure on ComEd's financial condition are dwarfed by the political risk surrounding power procurement. Thus, inappropriately altering ComEd's capital structure is not the solution.

Staff recommends the Commission base its capital structure decision on the law as it currently stands, and not base rates on the assumption of legislative actions that may or may not be taken, as the Company proposes. That is, the Commission should assume that utility rates will remain subject to the decisions of the Commission and auction power prices. Since no one can accurately predict the future, it is best that the Commission base its decision on current law, rather than speculation. If the Commission bases its decision on current law, rates would be properly set unless the Legislature acts to freeze bundled rates, which would prevent the Commission from reflecting the rate freeze's effect on the cost of capital component of bundled service rates. Conversely, if the Commission bases rates on the assumption of a rate freeze, the results will be unfair to rate payers regardless of the Legislature's actions. Thus, despite the recent downgrade, a capital structure of 37.11% equity and 62.89% long-term debt remains just and reasonable at this time.

c. Impact of Capital Structure on Cost of Debt

The Order properly concluded that ComEd's embedded cost of long-term debt is 6.48%. However, Staff acknowledges that, like the cost of equity discussed below, the appropriate cost of long-term debt depends on the capital structure adopted. (ICC Staff Exhibit 26.0, pp. 4 and14) Thus, should the Commission elect to adopt a capital structure with an equity ratio greater than 37.11%, the cost of long-term debt needs to be adjusted downward from 6.48%, since many of ComEd's long-term debt series carry the higher interest rate associated with the lower credit rating ComEd had at the time of their issuances. For example, if the Commission should decide to impute a hypothetical capital structure targeting an A– credit rating, it should adjust the cost of ComEd's debt series to reflect the interest rates that would have been available if ComEd had had an A– credit rating at the time of those issuances.[12] This approach is consistent with the financial tenet that lower risk reduces costs. (ICC Staff Exhibit 5.0, p. 9) Obviously, it would be inherently unfair to rate payers to reflect in rates both a new, higher authorized equity ratio *and* the old, higher cost debt associated with the old, lower equity ratio. As with the cost of equity, Staff recommends the Commission adjust Staff's cost of long-term debt downward, if necessary, using bond spreads in the manner described in Staff Schedule 26.5.

[12] It should be noted that the capital structures included in the Proposed Order and Final Order are both indicative of an A credit rating, rather than the A– rating the Commission found to be significant. Any adjustment should be based on the actual implied ratings produced, if different from those targeted.

2. Cost of Common Equity

a. Staff's Position

Staff continues to recommend an investor-required rate of return on common equity of 10.19% for ComEd. (ICC Staff Exhibit 26.0. pp. 12-15) That estimate, based on a sample of utility companies comparable in risk to ComEd, was derived from properly specified models and appropriate inputs. (ICC Staff Exhibit 5.0, p. 18) As noted above, Staff's 10.19% cost of equity estimate combined with ComEd's 6.48% embedded cost of long-term debt and Staff's proposed capital structure of 37.11% equity and 62.89% long-term debt produces financial ratios indicative of a reasonable degree of financial strength while minimizing the cost of capital.

Nevertheless, Staff acknowledges that the appropriate cost of equity depends on the capital structure adopted. (ICC Staff Exhibit 26.0, pp. 13-15) Thus, should the Commission elect to adopt a capital structure with an equity ratio greater than 37.11%, the cost of equity needs to be adjusted downward from 10.19%, since that estimate reflects the risk of a sample of companies with an average credit rating of BBB+/A–; as noted previously, the capital structures included in the Proposed Order and Final Order are both indicative of an A credit rating, signifying lower risk than Staff's proxy sample. Should such an adjustment be necessary, Staff recommends the Commission adjust Staff's cost of equity estimate downward as it has in previous cases by using bond spreads to measure the cost differential related to the risk of the target company relative to the proxy sample from which the cost of equity was derived, as set forth in Staff Schedule 26.5.

b. ComEd's Position

The Company maintains that ComEd's original 11.0% recommendation "reflects the actual cost of raising equity capital and is reasonable when compared to the costs of comparable companies and the results of recent cost of equity determinations in Illinois and other jurisdictions" and argues that "[a]t a minimum the Order should be changed to either reflect Staff's estimate, or if the Commission continues to average other calculations with Staff's, ComEd's and not only IIEC's should be included." (ComEd Ex. 51.0, pp. 19-21) The Company notes that an average of Staff's, IIEC's and the Company's cost of equity estimates would yield a cost of equity of 10.36%.

The Order properly rejected the Company's 11.0% proposed cost of equity. The Company's cost of equity estimate is unacceptable for all the reasons Staff previously presented, which Staff will not repeat here. (ICC Staff Exhibit 5.0, pp. 18-28; ICC Staff Exhibit 16.0, pp. 2-15) The Company's testimony on rehearing presented no evidence aside from that which was already available to the Commission for consideration in formulating its conclusions in the Final Order. Thus, the Commission should once again give no weight to the Company's 11.0% proposed cost of equity. Moreover, Staff recommends the Commission explicitly state in its Order on Rehearing that it finds the Company's use of a historical GDP growth rate to be a sufficient basis to reject the Company's cost of equity estimate in its entirety.

3. Overall Cost of Capital

Staff recommends that ComEd's Commission-authorized rate of return reflect a capital structure of 37.11% common equity and 62.89% long-term debt, Staff's cost of common equity estimate of 10.19%, and ComEd's embedded cost of long-term debt of

6.48%. Nonetheless, adjustments to the above costs of equity and debt would be necessary if the Commission were to impute a capital structure for ComEd. However, Staff submits that the Commission should impute a capital structure for ComEd if and only if the capital structure that reflects the actual proportions of debt and common equity invested in ComEd's delivery services assets would not enable ComEd to raise necessary capital at a reasonable cost. The weight of the evidence in this proceeding demonstrates that ComEd's delivery services capital structure, comprising 37.11% common equity and 62.89% debt, would enable ComEd to raise necessary capital at a reasonable cost. Therefore, the Commission should not impute a capital structure for the purpose of setting ComEd's delivery services rates and, consequently, no adjustments are needed for Staff's proposed costs of common equity and long-term debt either.

E. Rate Design

1. Rider GCB and GCB7

d. Statutory construction

As discussed below, while Staff finds ComEd's alternatives to recover the revenue shortfall which would result from ComEd having to continue to offer Rider GCB rather than GCB7 reasonable (with the alternatives favored in a hierarchy), it is Staffs' position that the Commission need not reach the issue of which alternative is the most reasonable. The reason being is that Staff does not support the position that ComEd is required to continue offering Rider GCB after the end of the mandatory transition period. As Staff set forth in its response to ComEd's application for rehearing, the Commission's July 26th Order interpreting Section 16-125A of the Public Utilities Act

(“Act”) (220 ILCS 5/16-125A) fails to consider Section 16-111(i) of the Act. As set forth in Section 16-111(i), the Commission in any rate proceeding to establish rates for tariffed services subsequent to the mandatory transition period, shall only consider the then current or projected revenues, costs, investments and cost of capital directly or indirectly associated with the provision of those tariffed services. (220 ILCS 5/16-111(i)) Since the Commission’s July 26th Order would forever freeze into rates, rates that were in effect on May 1, 1997 (ComEd Ex. 57.0, p. 3), those rates would not be based upon post mandatory transition period current or projected revenues, costs, investments and cost of capital related to the provision of the service to the governmental customers.

While the Governmental parties argue that Section 16-125A of the Act has no sunset provision (City Exhibit 3.0, p. 6), and assuming that is a valid argument, a statute capable of two interpretations should be given that which is reasonable and which will not produce absurd, unjust, unreasonable or inconvenient results that the legislature could not have intended. (Collins v. Bd. Of Tr. of the Firemen’s Annuity & Benefit Fund of Chicago, 155 Ill.2d 103, 110 (1993), citing Mulligan v. Joliet Regional Port District, 123 Ill. 2d 303 (1988); Harris v. Manor Healthcare Corp., 111 Ill. 2d 350, 363 (1986)) It is difficult to imagine anything more unreasonable and absurd then the governmental parties’ position that the statute requires ComEd to provide service to them at a 1997 rate for ever into the future.

e. Means of recovery of any subsidy

Based on an analysis of Rider GCB and the Company’s alternative Rider GCB7, Staff agrees with ComEd witnesses Crumrine and Alongi that ComEd’s proposed Rider GCB7 most accurately reflects the cost of service for eligible governmental customers in the Post-2006 electricity market. The existing Rider GCB will present problems in the Post-2006 era because it bases customer bills on existing frozen rates. If governmental customers are allowed to continue service under Rider GCB in the Post-2006 environment when rates will rise, the bills they pay will not keep pace with the underlying costs, producing a revenue shortfall for the utility. (ICC Staff Exhibit 27.0 Corr., pp. 18-19)

The most reasonable solution to this problem would be to replace Rider GCB with ComEd's proposed Rider GCB7 which would reflect fully cost-based rates for the Post-2006 era rather than the current frozen bundled rate embedded in Rider GCB. This would avert a revenue shortfall for these selected governmental customers. (ICC Staff Exhibit 27.0 Corr., p. 19)

Staff also finds acceptable the ratemaking alternative proposed by the Company in the event the Commission finds it necessary to continue offering Rider GCB in its current form. In that situation, ComEd has presented a number of mechanisms for the Commission's consideration that would recover the resulting shortfall from other customers.

The Company's preferred mechanism would recover the shortfall from Chicago ratepayers. ComEd's second alternative would recover the shortfall from all ratepayers. The Company's third alternative would recover the shortfall from bundled customers only through the Accuracy Adjustment Factor (AAF). If the Company receives permission to recover this shortfall from other customers, then Staff finds the hierarchy of proposals presented by the Company to be reasonable. (ICC Staff Exhibit 27.0 Corr., pp. 19-20)

The guiding principle should be to recover the shortfall from the ratepayers who derive benefits from the governmental bodies receiving the subsidized rates. For Chicago or Cook County governmental agencies taking service under Rider GCB, that would include all residential, commercial and industrial ratepayers within the City or County. Furthermore, the benefits received from the lower rates for governmental bodies would not differ for bundled or unbundled customers. Therefore, it would be appropriate to recover these costs on the delivery service portion of these customers' bills. (ICC Staff Exhibit 27.0 Corr., p. 20)

The next best alternative would be to recover these costs from delivery service charges applicable to all ratepayers in ComEd's service territory, bundled and unbundled service customers. Again, there would be no logical basis to distinguish between bundled and unbundled customers when it comes to recovering this shortfall. (ICC Staff Exhibit 27.0 Corr., p. 20)

The least favored alternative from Staff's standpoint would be to recover the shortfall from bundled customers only. The problem is that this approach would burden bundled customers and spare delivery service customers even though there is no logical basis for making such a distinction. (ICC Staff Exhibit 27.0 Corr., pp. 20-21)

IV. CONCLUSION

Staff respectfully requests that the Illinois Commerce Commission approve Staff's recommendations in this docket.

Respectfully submitted,

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