

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Central Illinois Light Company d/b/a AmerenCILCO	:	
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Proposed general increase in rates for delivery service. (tariffs filed December 27, 2005)	:	06-0070
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Central Illinois Public Service Company d/b/a AmerenCIPS	:	(Cons.)
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Proposed general increase in rates for delivery service. (tariffs filed December 27, 2005)	:	06-0071
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Illinois Power Company d/b/a AmerenIP	:	(Cons.)
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Proposed general increase in rates for delivery service. (tariffs filed December 27, 2005)	:	06-0072
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APPLICATION FOR REHEARING OF THE CITIZENS UTILITY BOARD

December 21, 2006

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Pursuant to 220 ILCS 5/10-113(a), 83 Ill. Adm. Code § 200.880, the Citizens Utility Board (“CUB”) submit this Application for Rehearing with respect to the Illinois Commerce Commission’s (“ICC” or “Commission”) Final Order dated November 21, 2006 (“Order”). The Order presented the Commission’s decision in the delivery service rate case of Central Illinois Light Company d/b/a AmerenCILCO; Central Illinois Public Service Company, d/b/a Ameren CIPS; and Illinois Power Company, d/b/a Ameren IP (collectively “the Ameren Utilities”). While CUB submits that the Order does an excellent job addressing most issues in this proceeding, CUB respectfully requests that the Commission reconsider its determinations with regard to the following issues: General and Intangible Plant, Capital Structure, Cost of Common Equity, COSS Allocation Factor, Interclass Subsidization, and Relative Class Risk.

I. GENERAL AND INTANGIBLE PLANT

CUB respectfully requests that the Commission reconsider its decision to increase CILCO’s, CIPS’, and IP’s General and Intangible (“G&I”) plant. The Order increases CIPS G&I Plant from \$52.3 million to \$121.9 million, a rise of \$69.6 million or 133%, IP’s G&I plant by \$72.2 million, or 54%, from \$134.3 million to \$206.5 million, and CILCO’s G&I plant by \$13.2 million, or 46%, from \$28.9 million to \$42.1. Order at 20-21. These increases are unjustified and not supported by the record.

The Order’s conclusion hinges on a misunderstanding of the evidence presented by Staff. The Order concludes, “Staff fails to point out any specific assets which have been inappropriately assigned to G&I, or which were previously excluded from G&I and which Ameren is now attempting to add back in.” Order at 21. Staff was under no obligation to

address any particular asset. *See* 220 ILCS 5/9-201(c). In fact, it is not possible to do so, because Ameren failed to meet its burden to support its proposed reallocation of costs. *Id.* Staff witness Lazare pointed out that a critical step in Ameren’s functionalization methodology, which allocated costs between production and delivery, was outside the scope of its testimony and amounts to an off-the-record re-functionalization. Staff Ex. 6.0 at 10-13. Mr. Lazare explained that, “[i]n this case, the Ameren Companies propose to reallocate to distribution G&I plant that the Commission had allocated to production in the previous round of delivery service cases. The Ameren Companies’ decision to exclude production costs from the analysis in this case means there is no substantial support for the Ameren Companies’ proposed reallocation of these costs from production to distribution.” *Id.* 11-12. The large increase in G&I plant is not, then, solely a result of Ameren’s assignment approach, as the Order erroneously assumes, but is a function of a process conducted outside this record and not subject to review. *Id.* Although this refunctionalization is the key driver behind the increase in the Ameren Utilities’ G&I plant, it is largely ignored by the Commission’s Order.

The Commission’s Order also unlawfully reversed the burden of proof by allowing costs that have not been shown to be just and reasonable, based on *other parties’* purported failure to demonstrate the *unreasonableness* of those costs. Order at 21. As Mr. Lazare testified “[h]owever, the production plant previously owned by CIPS and CILCO is still owned by Ameren Corporation (“Ameren Corp.”) and would still require G&I plant. However, the Ameren Companies have placed this production plant outside the scope of their analysis of the issue. Thus, with no substantive evidence on the issue, Ameren Corp. is asking the Commission to take its word that production has received a reasonable allocation of G&I plant.” Staff Ex. 6.0 at 12. The Order recognizes “[w]hile it is correct that the burden is not on Staff to justify the

level of G&I costs proposed, the Commission finds Staff's arguments on this issue wholly unpersuasive. Staff's evidence, or the lack thereof, showing any errors contained in Ameren's ASP [Asset Separation Project] methodology or application, is insufficient to discount the ASP finding." Order at 21. The Commission's Order, however, does not require Ameren to demonstrate the justness and reasonableness of costs they seek to recover in rates, as required by the Public Utilities Act. 220 ILCS 5/9-201(c). Consequently, the Order should be revisited.

II. CAPITAL STRUCTURE

CUB respectfully requests that the Commission reconsider its decision to use the Ameren Utilities' actual capital structures in setting rates. Order at 101-06. These capital structures contain excessive amounts of equity and increase costs for consumers because the cost of equity (10.08% – 10.12%) is higher than the cost of debt (6.22% – 7.05%). *Id.* at 149. The question here should not focus on the use of "actual" or "imputed" capital structures. The Commission should focus on ensuring that the adopted capital structure will lead to rates that are just and reasonable and will give the Ameren Utilities a sufficient return on their investment to attract capital in the financial markets at competitive rates. 220 ILCS § 5/9-101, 5/1-102 (a) (iii) & 5/16-108.

The Appellate Court further clarifies:

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

CUB v. ICC, 276 Ill. App. 3d 730 (1995) at 745-46. CUB submits that the Commission's decision allows an inflated rate of return and results in rates that are not just and reasonable because they provide the Ameren Utilities with an excessive return on their investment.

As CUB explained in testimony and briefs, the use of the Ameren Utilities' actual capital structures is not appropriate because these capital structures increase costs for ratepayers. CUB Ex. 1.0 (corrected) at 86-88; Initial Br. at 3. As CUB's witness Edward Bodmer explained, there are two facts that confirm that the utilities actual capital structures contain excessive equity. CUB Ex. 1.0 (corrected) at 86-88. First, the utilities' parent company has inappropriately injected equity into the utilities in an attempt to increase costs for consumers. *Id.* at 88. Second, the restructured Ameren Utilities' are distribution-only utilities, which reduces their overall level of business risk. This relatively low level of business risk allows the company to maintain a relatively higher debt to equity capital percentage. *Id.* at 87. As Mr. Bodmer testified, the ICC should encourage distribution companies to take advantage of their very low business risk by carrying additional debt and reducing costs for consumers. *Id.* at 88. This will not impact the utilities' access to capital and will result in lower rates for ratepayers. *Id.* The capital structures adopted by the Commission simply contain more equity than is reasonable.

In rejecting CUB's recommendation, the Commission states:

“If the Commission were to impute additional debt into IP's capital structure, it might then become necessary to make adjustments to IP's embedded cost of debt. As previously stated, the Commission believes it is necessary for the adopted capital structure to be consistent with the adopted costs for the sources of capital. Imputing a capital structure would complicate determining an appropriate rate of return on rate base by adding the possibility of measurement error to determining the cost of debt.”

Order at 103. This argument represents a misunderstanding of the evidence in this proceeding and a mistake in the analysis of the reasonableness of the capital structure proposal. If the

Commission were to adopt CUB's recommended capital structures, it would not "impute additional debt" into any of the utilities' capital structures. Rather, the Commission would correctly acknowledge that restructuring the Ameren Utilities reduced their business risk. This reduced business risk allows the Ameren Utilities to reduce capital costs by carrying more debt in their capital structures. CUB Ex. 1.0 (corrected) at 87. Carrying more debt does not harm the utilities. Instead, reduced business risk gives them the ability to maintain appropriate credit ratings with less equity than when they faced greater business risk. *Id.* at 87-88. CUB has demonstrated that its proposal provides just and reasonable rates and a sufficient return on Ameren's investment, while the capital structures adopted by the Commission increase rates for customers.

III. COST OF COMMON EQUITY

CUB respectfully requests that the Commission reconsider its decision to determine the appropriate return on equity ("ROE") by averaging the results of the analysis performed by Staff witness Freetly and IIEC witness Gorman. CUB submits that this methodology produces rates that are not just and reasonable as required by 220 ILCS § 5/9-101, 5/1-102 (a) (iii) & 5/16-108. The Commission has granted the Ameren Utilities an unreasonably high ROE. As CUB demonstrated in its testimony and briefs, an ROE of 8.0% will allow the Ameren Utilities a "sufficient return on their investment to attract capital in the financial markets at competitive rates." CUB Ex. 1.0 (corrected) at 6; CUB Initial Br. at 14; 220 ILCS § 5/9-101, 5/1-102 (a) (iii) & 5/16-108. Even if the Commission decides that CUB's recommended ROE is low, it should correct critical errors in Staff witness Freetly's analysis to produce a more reasonable result for both consumers and the utility.

The Commission bases its decision, in part, on fatally flawed discounted cash flow (“DCF”) and capital asset pricing model (“CAPM”) estimates performed by the Staff. Staff witness Freetly’s DCF analysis produced a cost of equity estimate of 9.11% while her CAPM analysis produced an estimate of 11.39%. The midpoint between these two estimates is 10.25%. Staff Ex. 15.0 at 3. IIEC witness Gorman’s constant growth DCF analysis produced results of 9.6% and his CAPM analysis produced results of 10.2% with a midpoint of 9.90%. IIEC Ex. 3.0 (corrected) at 21 (DCF result), 29 (CAPM result). Using the methodology approved by the Order, averaging Mr. Gorman’s results with Ms. Freetly’s results produces a cost of equity estimate of 10.08% for CIPS and IP. The Commission determined that CILCO’s cost of common equity must be adjusted upward by 4 basis points to 10.12% to allow for a return on costs that have not been previously recovered. Order at 148. However, as CUB’s testimony shows, flaws in Ms. Freetly’s analysis inflate both her DCF and CAPM estimates. CUB Ex. 3.0 (corrected) at 5-6. When these flaws are corrected, Ms. Freetly’s analysis produces a DCF analysis result of 8.87% and a CAPM result of 7.56% with a midpoint of 8.22%. *Id.* at 14 (DCF result), 41 (CAPM result). Using the Commission’s averaging methodology and these corrections, CIPS and IP should be granted an ROE of no more than 9.06% and CILCO should receive an ROE of no more than 9.10%.

Staff’s DCF calculation inappropriately discounted earnings on a quarterly basis. As explained in Mr. Bodmer’s rebuttal testimony, this is inconsistent with the fact that utilities recover cash flow on a continual basis over the course of a year. CUB Ex 3.0 (corrected) at 28. Thus, the quarterly DCF adjustment allows the Ameren Utilities to recover more than their true cost of capital. *Id.* Quarterly discounting adjustments are not common, and are not used at the FERC. *Id.* at 29-30. Even the Ameren Utilities did not discount earnings on a quarterly basis in

their DCF calculation because of the improper upward impact it has on the ensuing ROE calculation. *Id.* at 30. Staff's DCF ROE estimate is 9.11%. Staff's Initial Br. at 89. When Staff's quarterly adjustment error is corrected, the DCF ROE estimate is 8.87%. CUB Ex. 3.0 at 16.

Staff's CAPM results also contain fatal errors. The CAPM has been used by regulatory Commissions for many years to estimate the cost of capital. CUB Ex. 1.0 (corrected) at 51. This basic theory identifies three drivers of value: (1) the rate of return that investors expect to receive on a risk free asset ("risk-free rate"), (2) the premium that investors expect to receive from an asset with the same risk as the overall market ("expected market risk premium"), and (3) a measure that compares the risk of the utility's operations to the overall market ("beta"). *Id.* at 54-69. These three value drivers are used as inputs to determine the total cost of capital. Mr. Bodmer demonstrated that two of the inputs used by Ms. Freetly are inaccurate.

Ms. Freetly used an inappropriate expected market risk premium and incorrectly assumed that utility betas revert to a mean of 1.0, which would represent the same level of risk as the overall economy. CUB Ex. 3.0 (corrected) at 32. As Mr. Bodmer explained, both current theoretical research and practical valuation applications point to a much lower market risk premium. *Id.* at 32-33. Mr. Bodmer testified that current financial literature advocates an expected market risk premium considerably lower than Ms. Freetly's assumptions. Mr. Bodmer also testified that Staff has used growth rates to develop an expected market risk premium that is clearly out of line with reality, because it is based on clearly unsustainable assumptions. *Id.* at 33-35. When these two errors are corrected, Ms. Freetly's CAPM analysis produces a 7.56% ROE. *Id.* at 32.

The evidence supports correcting the errors that CUB has identified in Staff's analysis. In addition, the Commission should reconsider its rejection of the most important piece of evidence supporting a lower cost of capital: "arguments that market-to-book ratios should be directly used in establishing CILCO's, CIPS', and IP's cost of common equity in this proceeding." Order at 141. CUB has demonstrated that existing market-to-book ratios imply that the utilities have consistently earned more than their cost of equity, a situation that should not be allowed to continue. CUB Ex. 1.0 (corrected) at 10-11. On the other hand, Ameren argues that existing market-to-book ratios should be maintained and the cost of equity should be adjusted upward. Ameren Ex. 3.0 at 3-4. By failing to resolve the dispute between CUB and Ameren, the Commission allows inappropriately high capital costs to persist. CUB Ex. 1.0 (corrected) at 13.

As CUB's expert witness Bodmer explained, the market capital of the firm should be approximately equal to the original investment, or book value, if prices are set using market-based capital costs to determine the appropriate return on the firm's original investment, as is traditional in ratemaking proceedings. Thus, observed market-to-book ratios of approximately 1.0 provide evidence that companies are earning their cost of capital. CUB Ex. 1.0 (corrected) at 10. The Commission Order discounts this evidence on the basis that the Ameren utilities don't have observable market-to-book ratios. Order at 141. This is a misunderstanding of the evidence. It is true that the Ameren companies do not have an observable market-to-ratio, however it is also true that the cost of equity is an unobservable number. CUB Ex. 3.0 (corrected) at 4. The Commission cannot determine the unobservable cost of equity without also considering the unobservable market-to-book ratios.

In this case, the Ameren parent company has a market-to-book ratio of 1.95. This is

calculated by dividing the market capitalization by the equity investment, excluding goodwill. CUB Ex. 1.0 (corrected) at 11. This high market-to-book ratio indicates that, without any rate increases, the holding company is already earning more than its cost of equity capital. *Id.* This situation arises because returns granted by regulatory commissions remain at levels that clearly exceed market-based cost of capital calculations. As Mr. Bodmer further explained, market-to-book ratios are above 1.0 when companies earn a return on their original investment that exceeds their cost of equity capital. *Id.* Mr. Bodmer clearly demonstrated that CUB's ROE would result in a market-to-book ratio near 1.0. *Id.* at 82-84.

In addition, Mr. Bodmer presented a variety of additional reasons that the Ameren Utilities' ROEs should be lower than Staff's estimate and the Commission's decision. First, changes in tax laws have lowered the Ameren Utilities' pre-tax cost of equity. CUB Ex. 1.0 (corrected) at 15-17. The marginal income tax rate is currently 33%, down from 36% in 2001. The tax rate on dividends is 15%, compared to 33% prior to May 2003. The long-term capital tax rate is now 15%, compared to 20% prior to May 2003. *Id.* In addition, the ICC's rate orders grant utility companies a pre-tax return on equity rather than an after-tax return. *Id.* Investors, however, are ultimately interested in after-tax returns. Significant reductions in the income tax on dividends and capital gains paid by investors as a result of the tax law changes in 2001 and 2003 have affected the pre-tax return required by investors. *Id.* These tax reductions mean that if the ICC grants the same pre-tax return to the Ameren Utilities as before the tax reductions, it is in fact allowing investors to realize a greater after-tax rate of return. *Id.* at 15. The Commission dismisses this evidence on the basis that there is no record evidence allowing the Commission to quantitatively consider the impact of the tax law changes suggested by CUB. Order at 147. This is a misunderstanding of the evidence presented by Mr. Bodmer. Mr. Bodmer's testimony

identifies tax law changes as one of the factors supporting a lower cost of capital, not a factor that should be quantified mathematically by the Commission. *Id.*

Second, interest rates have also declined significantly since the Ameren Utilities' earlier rate cases. For example, the yield on a ten-year U.S. Treasury Bond has declined steadily from about 8.7% to 4.8% from 1990 to 2006. CUB Ex. 1.0 (corrected) at 18. These interest rate declines should lower the rate of return. *Id.* at 17-18. Third, the ICC's Order in the Ameren Utilities' auction case reduced the companies' business risk. Under the auction tariffs, every dollar spent by the utilities for power is passed directly to ratepayers. Thus, the Ameren Utilities will have virtually no commodity risk associated with uncertain volumes, supplier credit, or variation in supply prices. *Id.* at 21. Fourth, the Ameren Utilities will receive a greater proportion of their operating income from residential customers than they did as an integrated utility company. Residential revenues vary less with overall economic activity than other customer group revenues. For example, during a recession, residential revenues do not typically decline as much as industrial revenues. *Id.* The risk experienced by the Ameren Utilities, coupled with the overall cost of capital in the economy, determines the cost of equity capital. *Id.* at 22. Thus, these reduced risks should translate into a lower cost of equity capital.

Finally, the Ameren Utilities' corporate structure demonstrates the significant merger activity that has occurred since 1997. Reports from some of the merger transactions in the industry enable the Commission to take advantage of direct evidence of investor expectations. CUB Ex. 1.0 (corrected) at 20. This direct evidence is superior to evidence derived from theoretical computations such as the CAPM or the DCF model. *Id.* at 20-21.

In the process of making their valuations, investment banks discount cash flows at a cost of capital that reflects required investor returns. CUB Ex. 1.0 (corrected) at 20-21. Investment

bank valuation must be unbiased to correctly value companies. Thus, the cost of equity capital figures that underlie the valuation are presumably also unbiased. The cost of equity capital used by investment banks to discount future cash flows is the opportunity cost that measures required returns for investments of similar risk. *Id.* The ICC should use this same measure in this proceeding.

In the ComEd delivery service rate case, a letter from Lehman Brothers was introduced. CUB Ex. 1.0 (corrected) at 21. The letter was generated as part of the multi-billion dollar merger between Exelon and PSE & G, which was first proposed in 2004. This letter stated, “[f]rom a practical matter, regulatory authorized ROEs are typically 300 or more basis points more than the discount rates used in investment bank fairness opinions.” *Id.* CUB suggests that the judgment of bankers, who are more closely attuned to investor expectations, should be substituted for the judgment of consultants hired by utility companies. This direct evidence is superior to the theoretical computations such as the CAPM or the DCF model. *Id.* at 20-21. Thus the Commission should recognize a cost of equity far lower than that adopted in the Order.

All of the above factors lead to the conclusion that rates of return should be lower than what has been granted in previous rate cases. This information is also useful for analyzing the accuracy of the DCF and CAPM. The Commission should correct the flaws in its Order and adopt either CUB’s proposed 8% cost of equity or, at the least, correct the critical errors in Staff witness Freetly’s analysis to produce a more reasonable ROE of no more than 9.06% for CIPS and IP and an ROE of no more than 9.10% for CILCO.

IV. COSS ALLOCATION FACTOR

CUB respectfully requests that the Commission reconsider its decision to use a non-coincident peak cost of service allocation method. Instead, the Commission should accept CUB's Average and Peak cost of service allocation method. The Commission's Order is inconsistent with past Commission decisions on similar issues in distribution-only rate cases. Today's Ameren Utilities are structured much more like a gas distribution utility than in the past, when the Commission commonly used the non-coincident peak allocation method. Consequently, the Commission should change its cost of service allocation method to the Average and Peak method. Failure to do so will cause residential customers to see rate increases in excess of the actual costs that they cause and to pay for a portion of the Ameren Utilities' costs to serve commercial and industrial customers.

In its testimony and briefs, CUB asked the Commission to take a fresh look at the allocation of distribution demand costs. CUB Ex. 4.0 at 5-6; Initial Br. at Pg. 20. Historically, the Commission has allocated distribution demand costs for vertically integrated electric utilities solely on a non-coincident peak basis. CUB Ex. 2.0 at 11. Thus, the costs of the facilities used to meet demand year-round are allocated to customers based on demand during the one single hour when they use the most electricity. *Id.* at 9. Such an allocation ignores customers' dependence on the distribution system to meet their demands every day, not just when they are using the most electricity. *Id.* at 10. Actual demand patterns are important because they are reflected in the companies' investment decisions and the methods that the Ameren Utilities use to recover costs from customers. *Id.* In addition, the allocation has a dramatic impact on customers. Customers are charged for their usage over the entire year - not just on the single day

or hour that they use the most electricity. *Id.* The Ameren Utilities' Schedule 10.6 shows that between 60% and 70% of the Ameren Utilities' residential delivery services revenue comes from per-kWh delivery charges. *See* Ameren Ex. 10.0, Schedule 10.6.

The Commission's decision to maintain the non-coincident peak allocation methodology is contrary to past decisions on substantively similar issues. In examining allocation methodologies for natural gas distribution companies, the Commission has found that "a utility cannot justify its T&D [transmission and distribution] investment on demands for a single day." CUB Ex. 2.0 (corrected) at 10, citing Order, Docket 94-0040 at 138-139. There, the Commission recognized the importance of the relationship between cost recovery and cost allocation. However, in reaching its decision in this proceeding, the Commission disregarded this relationship.

The Order in this docket cites "[d]ifferences in the ability to store the commodities [electricity and natural gas] and the period over which peak demand is measured (day versus hour) ... among the arguments for the continued use of different demand allocators for the gas and electric industries." Order at 164. However, CUB is unable to identify any record evidence that the Commission could have relied on to justify continued use of the non-coincident peak demand method over the Average and Peak method. CUB is perplexed at the Commission's determination that differences in electricity and natural gas distribution network engineering could change the relationship between cost recovery and cost allocation. Additionally, the Commission's finding is inconsistent with past Commission decisions, which have found that cost allocation methods are used to allocate the costs of the system among ratepayers and not for engineering purposes. CUB Ex. 4.0 at 4, citing Order, Docket 04-0779, September 20, 2005 at 102.

The Commission also seems to accept the suggestion that distribution system costs are incurred based on the number of customers and their demand, but not their usage. Order at 165. This is inconsistent with other sections of the Order. Only a few sections earlier, while rejecting the minimum distribution system (“MDS”) method, which allocates costs based solely upon the number of customers, the Commission states “The MDS method fails to properly emphasize the purpose of the distribution system—that being to satisfy a customer’s daily demand for electricity.” *Id.* at 160-161.

The Commission’s decision here is also inconsistent with prior Commission decisions. First, in numerous natural gas rate cases, the Commission has found a strong relationship between average usage and system distribution demand cost. For example, in Docket 04-0779, the Commission adopted the Average and Peak method for allocating Nicor’s distribution demand cost by explaining: “the Commission rejects the IIEC’s contention that A&P inappropriately considers average demand costs. The Commission has previously determined that a utility cannot justify its transmission and distribution investment on demands for a single day.” CUB Ex. 4.0 at 4, citing Order, Docket 04-0779 at 102. Second, the Commission has consistently rejected the allocation of distribution demand cost based on the number of customers connected to the system. For example, in Docket No. 00-0802 the Commission explained: “distribution systems are designed primarily to serve electric demand, and the Commission agrees with Staff that attempts to separate the cost of connecting customers to the electric system from the cost of serving their demand remain problematic.” Final Order, Docket No. 00-0802 at 42. Third, prior Commission Orders have concluded “[t]he A&P method properly emphasizes the average component to reflect the role of year-round demands in shaping

transmission and distribution costs”. *See* Docket 04-0779, September 20, 2005 at 102, citing Docket 04-0476 at 74-75 and Docket 02-0837 at 90-91.

The Order results in an over-allocation of costs to residential consumers. As discussed above, allocating distribution-demand costs based solely on the non-coincident peak demands ignores the impact of average demand on the system. Because the residential class tends to use considerably more energy on peak days than on average days, the residential class share of total system demand is considerably greater during peak times than it is on average. CUB Ex. 2.0 (corrected) at 9. Thus, allocating costs based on peak usage tends to attribute more costs to residential end users than they actually cause. *Id.*

To correct this inequitable situation, the Commission should adopt an Average and Peak allocation of distribution demand costs for electric distribution utilities. CUB Ex. 2.0 (corrected) at 11-12. CUB has presented evidence demonstrating that there is no reason to treat distribution demand costs for electric utilities any different than distribution demand costs for natural gas distribution utilities. *Id.* at 11. As Mr. Thomas testified, “[t]his issue may have been overlooked in previous electric distribution cases, because of the existing rate freeze or issues surrounding utility-owned generation cost, but the Commission now has an opportunity to take a fresh look at the allocation of distribution demand costs.” *Id.*

Finally, the Commission Order cites concerns “with the accuracy of CUB’s A&P [Average and Peak] analysis. We cannot conclusively determine that the total revenue will indeed be recovered under CUB’s proposed Average and Peak method.” Order at 165. The Staff proposed two solutions to address the concern in their Brief on Exceptions. Staff BOE at 36-38. Either method would successfully address the Commission’s concerns and would result in a fair allocation of distribution demand costs. Mr. Thomas’ mathematical error regarding the

total revenue allocation is irrelevant, as the ALJ recognized in the Proposed Order. Proposed Order at 163.

V. INTERCLASS SUBSIDIZATION

CUB respectfully submits that the Commission's Order in this proceeding should consider important facts in the record that support interclass rate support and produce rates for residential customers that are just and reasonable. The Order states "...circumstances in this case lead us to believe that no customer class here should subsidize the delivery services rates of another. The Commission directs the Ameren companies, in compliance filings, to file tariffs based on cost of service using the NCP allocation method." Order at 175. However, the Commission fails to cite any specific sources. Indeed no such circumstances exist. In testimony, CUB and Ameren agree that the Commission should adopt a method of rate design that mitigates the impact of a rate increase on residential customers. CUB Ex. 2.0 (corrected) at 4; Ameren Ex. 10.0 at 6. Both parties recognize that an unmitigated rate increase will have a negative impact on residential customers. CUB Ex. 2.0 (corrected) at 4; July 27, 2006 Tr. at 883. Staff also supports mitigating the increase on residential customers. Staff Ex. 7.0 at 7-8.

The Order failed to address specific evidence such as Ameren witness Jones' testimony that:

"It has been many years since the Ameren Companies have had a bundled rate increase, and in 2007 most customers (and all residential customers) will be paying, separately stated, Delivery Service rates for the first time. Consequently, rather than eliminate inter-class rate subsidies in a single rate case, the Ameren Companies propose the above revenue requirement allocation methods to mitigate the effect on the residential rate class."

Ameren Ex. 10.0 at 6-7. In addition, the Order did not address CUB witness Thomas' testimony:

“The Commission should be very careful to avoid shifting undue cost burdens to residential consumers when it in realigns interclass revenue structures and sets rates. While industrial and commercial customers might be able to bear the capital costs necessary to reduce demand, residential customers could be forced to choose between paying their electricity bill and paying for their medications or food. Any changes to residential rates must minimize potential rate shock. I believe that this is what Mr. Jones meant when he stated, “...the movement to an equalized rate of return may produce too large of an impact on customers whose delivery service bill constitutes a larger relative portion of their total electric power bill.”... As I mentioned before, cost recovery is not the only objective that needs to be considered when setting rates. The concept of gradualism, or slowly and systematically moving customers toward cost of service, is also a well-accepted principal of utility rate design. Additionally, the Illinois Legislature requires the Commission to consider customer impacts when setting rates. Mitigating class revenue requirements based on customer impacts implicitly recognizes that cost of service is not the sole criteria for rate design.”

CUB Ex. 2.0 (corrected) at 17 (internal citations omitted). By ignoring the testimony of these witnesses, the Commission has adopted a rate design that forces greater increases on residential customers while it even gives rate cuts to other customer classes.¹ The rates approved under the above methodology are not equitable for the residential class and should be corrected.

The Order also inappropriately uses the term “subsidy.” The Order states “[a]ny rate design that includes recovering less than the cost of service from a customer class undoubtedly creates the need for one or more of the other customer classes to shoulder the burden of the revenue shortfall. In other words, a subsidy is created.” Order at 175. However, evidence in the

¹ See Ameren Ex. 10.1 at 1, 3, and 5. These pages demonstrate the relative impact of allocating revenue based solely on Ameren’s NCP allocation methodology. Ameren Ex. 10.1. Although there have been changes to both the power and delivery service components, the relative level of the increases should be similar because both are allocated to customer classes based on the same methodologies used in the schedule. Examining the total increase (delivery service, transmission service, and power) demonstrates that, with the exception of the DS-5 (lighting customer class), residential customers bear the highest rate increases. For example, using the assumptions in Ameren Ex. 10.1, Ameren CILCO residential customers would see rate increases of 19.7% while DS-4 customers would have their rates cut by almost 1%.

record does not support a conclusion that any “subsidies” exist. The cost of service studies before the Commission allocate costs to customers based upon an equal class rate of return. CUB Ex. 2.0 (corrected) at 15. However, CUB has presented evidence pointing out that this equal class rate of return is an oversimplification that distorts any meaningful discussion of cost. The Ameren utilities incur different levels of risk in serving different customer classes. *Id.* at 15-16. The parties may disagree over which class is riskier, but no party can demonstrate that a class risk differential does not exist. As Mr. Thomas testified, there is no way to accurately calculate the class risk differential necessary to demonstrate the existence of a subsidy. CUB Ex. 4.0 at 16. The courts have previously recognized this critical point. Rate design or the distribution of inter-class revenue requirements is a question of sound business judgment, as opposed to the strict application of some mathematical formula. *See Illinois Bell Telephone Company v. Commerce Comm’n*, 55 Ill.2d 461, 470 (1973). Rate design requires the use of pragmatic adjustments and the Commission has discretionary authority to design rates that are equitable. *Id.* The Commission has not done this in the instant case, and has inequitably increased rates for the residential customer class.

VI. RELATIVE CLASS RISK

CUB respectfully requests that the Commission reconsider its decision and take the class risk differential into account when setting rates. The Order incorrectly rejects CUB’s position that Ameren Utilities incur less risk by serving the residential and governmental classes as compared to the large commercial and industrial classes. Order at 178-79. CUB maintains that a utility should recover a higher rate of return from serving customer classes that pose higher risk to the utility. The opposite is also true - the less risk a utility incurs by serving a particular

customer class, the lower the rate of return that should be recovered from that class. This principle is known as the “class risk differential.” Class risk differentials should be recognized by the Commission and applied as a form of rate mitigation. CUB Initial Br. at 20-21. CUB’s testimony showed that the residential and industrial customer classes are less risky to serve. CUB Ex. 2.0 (corrected) at 15-10; CUB Ex. 4.0 at 11-16. Thus, those customer classes should receive a rate increase that is no more than 90% of the system average. CUB Ex. 4.0 at 17.

Ameren insists that the distribution of inter-class revenue requirements should be based on an equalized rate of return. Ameren Ex. 10.0 at 5. CUB maintains that this method is flawed because each customer class poses a higher or lower risk of service. CUB Ex. 2.0 (corrected) at 15-16. Ameren argued that the residential class is actually more risky to serve than the other classes because uncollectibles and weather related risks are higher for that class. Ameren Ex. 41.0 at 7. Ameren’s argument is wrong because it ignores the fact that Ameren actually limits its residential class risk by mitigating those risks by incorporating them into proposed rates. Ameren witness Jones testified that the companies’ proposed rate increase was computed using weather normalization billing units that mitigate weather related risk. Ameren Ex. 10.0 at 38. Similarly, Ameren’s risk related to uncollectible expenses is also incorporated into the company’s proposed rate increase. Order at 39. In light of the mitigation of these risks, it is inconsistent for Ameren to argue that the residential class is more risky to serve than other classes based on weather and uncollectibles risks.

CUB maintains that the large commercial and industrial classes present a greater risk to serve because of the unpredictability of commercial and industrial sales, which depend in large part on the overall economy. CUB Ex. 1.0 (corrected) at 21. The impact of those same economic risks is not present in residential and governmental sales. *Id.* at 21. Unlike the

normalized risks for weather and uncollectibles, which are mitigated through their incorporation into Ameren's proposed rates, economic trends present significant risks that have the greatest impact on the large commercial and industrial customer classes. *See* Ameren Ex. 10.0 at 39. Ameren's attempts to ignore this unaccounted-for risk does not change the fact that the large commercial and industrial customer classes are more risky to serve than the residential class.

No party to this proceeding has argued that a class risk differential does not exist. The Order does not find that a differential is unreasonable. Instead the Order seems to be confused by the facts when finding that "The Commission is not comfortable adopting such a multiplier [Mr. Thomas' recommendation to limit residential increases to 90% of the system average] without knowing how it was developed." Order at 179. Mr. Thomas testified that: "no one has been able to effectively quantify the class risk differential, but regardless of that fact, it is completely inappropriate to simply assume that class risk differential doesn't exist." CUB Ex. 4.0 at 16. However, Mr. Thomas then went on to explain that his "recommendation to limit the residential and governmental class increase to 90% of the system average increase reflects both the existence of class risk differentials as well as a degree of gradualism in mitigating the impacts that rate increases will have on residential end users." *Id.* While the precise number may be unknown, it is based on the simple fact that residential customers are less risky to serve and on the well-accepted rate design principal of gradualism, which the Commission has employed to mitigate rate increases for the residential class. *Id.* Therefore, making some adjustment is more appropriate than ignoring these principles altogether.

CUB maintains that class risk differentials and gradualism are consistent with the Commission's position on rate mitigation. In fact, the Commission has approved gradualism or other rate mitigation plans in prior cases that have limited the residential classes contribution to

the rate of return. This is exactly the same impact that Mr. Thomas' proposal has on the residential and customer classes. CUB Ex. 4.0 at 11. The Commission's past precedents on this subject are still valid and continue to be followed.

CUB's class risk analysis demonstrated that the risk of serving a customer class varies between classes. Thus, the Commission should adopt CUB's class risk analysis as the basis to mitigate any rate increase to the residential and governmental class to no more than 90% of the system average.

VII. CONCLUSION

For the reasons discussed herein, CUB respectfully request that the Commission grant rehearing on the issues addressed above.

Respectfully submitted,

CITIZENS UTILITY BOARD,

A handwritten signature in black ink that reads "Robert J. Kelter". The signature is written in a cursive, flowing style.

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