

List of Issues & Major Conclusions

Cost of Equity

- Electric utilities have a significant external capital dependency as they spend a significantly higher amount of their cash flow on capital expenditures than industrial firms.
- Authorized returns on equity for utilities have been at extremely low levels for a number of years, prompted in part by a decline in interest rates to historically low levels.
- Current and prospective investors are looking for assurance that allowed returns on equity, and the actual earnings that they produce, will be sufficient to attract new capital on reasonable terms. What investors value most in utilities are stable earnings and regular dividends supported by consistent and fair regulation.
- Higher risks facing utilities for major construction initiatives; the mounting need for external financing; increasing costs for medical, post-retirement, and pension benefits, and other factors warrant higher allowed returns on equity for utilities than have been authorized in many jurisdictions in the recent past.
- Based on nearly 50 years of studying utilities and regulation and supported by two recognized methodologies, determines that a reasonable return on common equity for ComEd is 12.2%.

1 Q. **Please state your name, address and current position.**

2 A. My name is Carl H. Seligson. My address is 40 East 94th Street, New York, NY 10128. I
3 am an independent, self-employed consultant specializing in financial matters related to
4 the utility industry.

5 Q. **Please summarize your professional experience.**

6 A. I began my financial career in 1961 and served two firms as a utility equity (stock)
7 analyst until 1971 when I joined Merrill Lynch as a senior utility investment banker. In
8 1987 I joined Kidder Peabody in a similar capacity. In 1990 I became Senior Consultant -
9 Regulated Industries for Deloitte & Touche and in 1992 I returned to investment banking
10 as Managing Director and Manager of the Public Utility Financing Group of Prudential
11 Securities. In 1996 I joined Andersen Consulting (now Accenture) as a Senior Advisor.
12 Since retiring from Andersen Consulting in 2000, after reaching age 65, I spent about
13 nine months as a Senior Vice President of a start-up internet based business,
14 energyLeader.com, which attempted to become a purchasing agent for utilities. Since
15 2001, I have been a self-employed consultant and spent time at Prospect Street Ventures
16 attempting to raise funds for a Venture Capital effort directed to investing in electro-
17 technologies and then at K Road Ventures and K Road Power examining investment
18 opportunities in non-regulated generation of electricity. For the 7 1/2 years ending Dec.
19 31, 2009 I was on retainer to the Edison Electric Institute developing and implementing
20 an action plan to assure investor confidence in the electric power industry and providing
21 advice for member companies on issues of concern to the financial community. This
22 assignment has included supervising and participating in Regulatory Dialogues between
23 the Financial Community and State Regulatory Commissioners and Staff.

24 Q. **Have you appeared as an expert financial witness before regulatory agencies?**

25 A. Yes. A description of my prior testimony is included in the attached appendix.

26 Q. **Have you made presentations on financial matters to regulatory audiences?**

27 A. Yes. I have made presentations to many such audiences, beginning with presentations on
28 rate of return to the Annual Convention of the National Association of Regulatory
29 Commissioners (NARUC) in October, 1969. I also addressed this convention in 1976,
30 1982, 1987, 1991 and in 2004 on financing future generation. Similarly I have addressed
31 various regional conferences of utility commissioners on ten separate occasions and I
32 presented a Federal Energy Regulatory Commission Advocacy Lecture in 1978. I also
33 appeared at the invitation of the Secretary of Energy at the Department of Energy's
34 National Energy Policy Plan Public Meeting in September, 1994. More recently, I was a
35 member of a panel opening the 15th Annual Education Conference of the Mid-Atlantic
36 Conference of Utilities Commissioners (MACRUC) on June 28th of this year on
37 "Utilities and the Economy".

38 As mentioned earlier, I have participated in about eight Regulatory Dialogues
39 with the Financial Community organized by Gee Strategies Group, LLC, each of which
40 has a number of State Commissioners and Staff in attendance. I also participated in a
41 similar program presented under the auspices of the NARUC Education Foundation, on
42 whose Advisory Board I sat until it was discontinued.

43 Q. **Are you involved with any other professional organizations?**

44 A. Yes. I am a member of the Wall Street Utility Group and the New York Society of
45 Security Analysts, where I served as program chairman of the utilities section. I am also a
46 member of the Association for Investment Management & Research and the Financial

47 Analysts Federation. I also served as a member of the Board of Directors of the Nuclear
48 Energy Institute and of the National Society of Rate of Return Analysts (now
49 SURFA) and as Chairman of the Regulated Industries Committee of the Securities
50 Industry Association. In August 2006 I completed two terms (eight years) as a member of
51 the Advisory Council of the Electric Power Research Institute (EPRI) where I also served
52 on their Strategic Issues Committee. The Advisory Council has ten members appointed
53 by NARUC in addition to numerous other interested parties.

54 **Q. What is the purpose of your testimony in this proceeding?**

55 A. The purpose of my testimony is to determine the appropriate allowed return on common
56 equity capital for Commonwealth Edison Company (“ComEd”). In addition, I will
57 explain the potential negative financial impacts on ComEd from what the financial
58 community would consider to be an adverse rate action.

59 **Q. Please provide an overview of your testimony.**

60 A. One of the long-standing hallmarks of utility regulation is that utilities ought to be
61 permitted the opportunity to earn returns comparable to similar enterprises, and later I
62 will discuss this earnings level as it relates to Commonwealth Edison.

63 **Q. Why is the cost of common equity important?**

64 A. The cost of common equity is the heart of most utility rate cases since it is the earnings
65 on the common stock that not only provide for a return to the owners of the business for
66 their investment but also provides for dearly needed coverage of debt interest. In other
67 words, a regulatory body allows rates to provide for interest on debt and other senior
68 capital and the remaining earnings (the return on common equity) provide all of the

69 interest coverage above one times. For obvious reasons, the return that is actually earned,
70 or which can be earned, is far more important to all investors than a return that is
71 nominally allowed and that may not be realized. If an investor-owned utility is unable to
72 recover the costs of its invested capital, it will not be able to continue to survive
73 indefinitely, and its customers will ultimately have to absorb the costs and consequences.

74 **Q. Are there factors in the current economic environment that make recovery of the**
75 **costs of invested capital particularly important?**

76 A. Yes. It should be noted that the capital markets have experienced dramatic changes since
77 mid 2007, with global investors experiencing large losses, high volatility and significant
78 risk in pricing. While virtually all analysts and media focused on how the financial and
79 economic crisis affected the housing, finance and automobile sectors, few reports
80 mentioned the impact on the electric utility sector. Regulated firms in this sector had
81 been known as high dividend payers with relative stability – more defensive and more
82 stable than most other sectors. In fact after the wave of market turmoil, A rated utilities
83 and AAA rated industrials were the first to access the market when it reopened, and BBB
84 utilities were the first BBB rated issues to do so. On the other hand, utilities face a
85 unique set of risk factors. It is necessary therefore to examine the risk characteristics that
86 utilities face and how the cost of capital is likely to be affected as a result.

87 **Q. What are some of the risk factors facing utilities?**

88 A. Electric utilities have a significant external capital dependency as they spend a
89 significantly higher amount of their cash flow on capital expenditures (“capex”) than
90 industrial firms. A utility may spend nearly 100% or more of operating cash flow on new
91 capital expenditures as opposed to some 35% spent in other sectors. As a result, a

92 utility's operating cash flow rarely covers its capex and dividend expenditures whereas a
93 typical industrial firm covers capex and dividends by about 175%. While utilities spend
94 more on capex than other firms, their liquidity positions tend to be more fragile than non-
95 utilities'. They have a lower percentage of their firm's value in cash, and they rely on
96 bank-provided liquidity for more of their total liquidity than do large industrial firms.
97 This demand for capital has been accentuated by rising pension deficits and hedging
98 instrument collateral requirements across the sector.

99 **Q. What in general is the present financial condition of the industry?**

100 A. Utilities generally have weakened balance sheets that tend to depress their credit ratings
101 and raise their cost of capital. Under present conditions, the cost of capital for utilities
102 appears to be minimized only with at least an A rating. Achieving the A rating level
103 would require immediate and ongoing improvement in cash flows, allowing companies to
104 strengthen the equity component of their capital structure. As the rating agency Standard
105 & Poor's states in their "Closer Look at Ratings Methodology", "Cash flow analysis is
106 the single most critical aspect of all credit rating decisions." Strong cash flow and
107 competitive returns would allow, and encourage, companies to invest in capital
108 expenditures with regulatory oversight of the decision making procedure. The key to a
109 company reaching the A category from a current BBB one is sustained and constructive
110 regulatory support in an ongoing manner. The major impediment to achieving progress
111 towards an A rating is the allowed ROE and the ability to actually earn that figure, as it is
112 the achieved ROE that provides the dollars that are considered "coverage" of interest
113 expenses.

114 A report from J.P. Morgan Securities, Inc. written by Ian Connor, Marc Zenner
115 and Evan Junek entitled “Challenges Ahead: Building a New Power Infrastructure in
116 Today’s Financial Paradigm” addressed these issues in detail and the “Executive
117 Takeaway” at the end of this report states:

118 “The current historic credit crisis has generated capital Market
119 pressure for virtually all industries. Boards of Directors of utilities should,
120 however, be aware that the industry’s significant credit and external
121 funding challenges, accentuated by its other unique risk factors,
122 potentially place the industry in a challenging and exposed position.
123 Decision makers would be well advised to take prudent defensive and
124 proactive measures.”

125 **Q. Do the factors you describe affect the role of utility commissions setting rates?**

126 **A.** Yes. Regulators should take note and recognize that in addition to the board of directors
127 and management of the regulated companies the commissioners and staffs of the
128 regulators are among these “decision makers” referenced in the above-cited J.P. Morgan
129 report and bear responsibility toward not only the customers but also to the financial
130 stakeholders. In addition to responsive action on rate increase requests, supportive
131 commission activities include pre-approved costs and financing agreements for specific
132 new plants, a new plant adjustment clause to minimize regulatory lag for new plant
133 investment, allowing for recovery of prospective environmental costs, an environmental
134 compliance plan that provides for recovery of approved environmental costs, and similar
135 adjustment mechanisms.

136 Q. **Have recent utility commission decisions in rate cases provided the type of**
137 **regulatory support you describe?**

138 A. No. Authorized ROEs have been at extremely low levels for a number of years,
139 prompted in part by a decline in interest rates to historically low levels. However, there
140 are some signs that declining trend is beginning to reverse, reflecting regulatory
141 recognition of increasing industry risk. This mounting utility risk stems from a number of
142 sources: major construction initiatives; increasing costs for medical, post-retirement, and
143 pension benefits, as well as expenses connected with standard operations; environmental
144 and renewable energy compliance mandates; Smart Grid-related expenditures; the
145 looming cost of carbon reduction; the mounting need for external financing; and
146 heightened exposure to the regulatory arena. Higher risks facing utilities warrant the
147 consideration of implementing some mitigating policies as well as higher allowed ROEs.
148 Importantly, as Fitch Ratings has stated, the credit impact will be greatest for those
149 companies faced with a combination of these factors and the least regulatory support.

150 Q. **Given all of these factors, what is your approach to determining the cost of common**
151 **equity?**

152 A. My approach is based on two widely accepted methodologies – risk premium and
153 comparable earnings. There is no question that risk, both business and financial, is an
154 important determinant of the cost of equity capital. There is a very close relationship
155 between the cost of capital and the risk associated with investment, since investors
156 understandably require a greater return as risk and uncertainty increase. Risk is generally
157 perceived by investors to consist of two integrated elements - the business risk and the
158 financial risk. Business risk involves not only variability of revenue but also variability of

159 return on investment, which is influenced in large part by the ability (or inability) of the
160 enterprise to adjust prices, or to exercise control over costs, or both. Financial risk is
161 directly related to the nature of the capital employed in financing the business. The
162 existence of senior capital increases the risk associated with the ownership of common
163 stock. Inasmuch as senior securities have a prior claim to the earnings and assets of the
164 business, the common stockholder benefits from a leveraged capital structure only when
165 the return on the equity exceeds the cost rate of the senior capital employed in the
166 business. In a highly leveraged capital structure, the possibility of adversity affecting the
167 equity return is greatly enhanced due to the greater fixed costs associated with a higher
168 level of senior capital.

169 **Q. In simple terms, how does the risk premium method estimate the cost of common**
170 **equity capital?**

171 A. The essence of the risk premium theory holds that the common stockholder is entitled to
172 a premium in return for the assumption of this risk. In making a determination of a fair
173 return on common equity, the premium is added to the cost of relatively “risk free”
174 investments, such as U.S. Treasury securities.

175 **Q. Can you also provide a simple explanation of the comparable earnings method?**

176 A. Under the comparable earnings method, I believe it is fair and reasonable to determine
177 the cost of common equity by looking at the earned returns of a broad range of regulated
178 utilities.

179 **Q. Are these mechanical methods requiring no judgment?**

180 A. No. I strongly believe that determining a fair rate of return is not a wholly mechanical
181 approach. While statistical, financial and mathematical models are appropriate,
182 professional judgment is also an essential ingredient in a final determination.

183 Q. **How do you determine the cost of common equity by use of the comparable earnings**
184 **method?**

185 A. I have looked at the earnings levels of utility operating companies reported by the highly
186 reputable firm Regulatory Research Associates, which tracks closely the regulatory
187 actions and results of utilities in the United States. Their report ELECTRIC UTILITY
188 QUALITY MEASURES: Rankings and Trends of April 1, 2010 presents a table of 34
189 companies whose earned return on equity in 2009 averaged 12.2% (see my Exhibit 12.1,
190 page 1). Some 15 of these companies (excluding Commonwealth Edison's parent, Exelon
191 Corp.) had returns above the 12.5% level, averaging 15.3%, while the remaining 18
192 companies had returns averaging 9.1%. (see ComEd Exhibit 12.1, pages 2 and 3)) The
193 median return for the two groups was 11.8%.

194 Q. **How do you determine the cost of common equity by use of the risk premium**
195 **method?**

196 A. The risk premium method is based on the premise that investors are averse to risk and
197 require a higher return to be compensated for assuming additional risk. Among long-term
198 investments, United States government bonds are the least risky and, therefore, their
199 return can be used as the basis for calculating risk premiums attributable to alternative
200 investments. Numerous studies have compared the returns realized over various time
201 frames by investments in government bonds with investments in a cross-section of
202 common stocks.

203 A landmark in such studies is the work originally done by Ibbotson Associates, a
204 division of Morningstar, Inc., entitled Stocks, Bonds and Inflation. The most recent such
205 study, taken from 2010 Valuation Yearbook, Appendix C, Table C-1 concluded that from
206 the beginning of 1926 to the end of 2009, common stock investors have historically
207 realized a premium of 6.7% over the return available on risk-free alternative investments,
208 using long-term U.S. Treasury Bonds to represent that category.

209 **Q. What time period do you use in this proceeding for determining the appropriate**
210 **base risk-free rate to which an appropriate risk premium should be added?**

211 A. I believe that the appropriate period to use for the Treasury Bond yield in a risk premium
212 determination of the cost of common equity in this proceeding is the estimated yield
213 for 2011. I believe that it is perfectly fair and appropriate to use such a future period
214 seeing as any new rates set in this proceeding will apply in 2011 and beyond. The
215 average of three widely available independent sources projecting rates for 30 year
216 Treasury Bonds in 2011 is 5.90%. (See my Exhibit 12.1) The resultant Return on
217 Common Equity then is the sum of the 6.7% premium and the 5.9% risk free (Treasury
218 Bond) yield, or 12.6%.

219 **Q. Please discuss what you consider to be a reasonable return on common equity**
220 **for Commonwealth Edison.**

221 A. As indicated above, in my opinion, based on the risk premium analysis that I have
222 consistently used in nearly 50 years of studying utilities and regulation, current return on
223 equity requirements for an “average” company are a minimum of 11.8%, based on
224 comparable earnings achieved by other utilities and 12.6%, based on my risk premium
225 analysis. I would consider a middle ground of these two findings, or 12.2% .

226 Q. **Are you aware that in a recent rate Order the ICC granted substantially lower**
227 **allowed returns to the Ameren electric utilities?**

228 A. Yes, I am aware that on April 29th, in rate orders covering the three Illinois subsidiaries
229 of Ameren (Central Illinois Light, Central Illinois Public service and Illinois Power), the
230 returns on equity as reported by Regulatory Research Associates were 9.90%, 10.06%
231 and 10.26% respectively, after significant reductions in rate base from what the
232 companies filed. I am also aware that those decisions were immediately termed a
233 "negative order" by one of the leading financial analysts following electric utilities.
234 Another analyst, maintaining his "Sell" recommendation on Ameren, noted "We expect
235 Ameren's shares to underperform peers, given the low authorized RoEs...and the sizable
236 difference in requested versus authorized rate increases."

237 Q. **Is regulatory risk of particular concern to investors in today's environment?**

238 A. Yes. Coming off a period of recent years when most utilities have been actively cutting
239 costs in order to maintain or increase earnings without seeking to increase rates,
240 regulatory risk has once again become an increasingly important attribute in making
241 investment decisions. Current and prospective investors are looking for some form of
242 assurance that allowed returns on equity (ROE), and the actual earnings that they
243 produce, will be sufficient to attract new capital on reasonable terms. Investors have
244 multiple choices as to where to invest and will seek the highest available returns
245 consistent with their individual risk tolerance – possibly in other states – if they desire the
246 traditional stability of utilities. Finding ways to increase both the certainty of the
247 earnings stream and a company's opportunity to earn its allowed return will be
248 increasingly important as the industry's capex cycle deepens. Moreover, fairness to

249 investor owners of the utility business and fairness to the customers of the utility are not
250 mutually exclusive, but actually go hand-in-hand. As stated in a paper distributed by the
251 Edison Electric Institute (EEI) last December, “A fair measure of stability has returned to
252 the capital markets...”, however “challenges will remain for the (regulated) electric
253 utility industry because of the capital expenditures required to build new assets and
254 maintain existing ones, meet evolving renewable and carbon reduction goals, and
255 implement ‘smart grid’ technologies”.

256 **Q. Why is regulatory risk so important to investors?**

257 A. What investors value most in utilities are stable earnings and regular dividends supported
258 by consistent and fair regulation. Where regulation is seen as providing such stability,
259 investors are comfortable in making capital available to utilities on reasonable market-
260 based terms and conditions, and such reasonably priced capital will benefit the utility’s
261 customers in the form of reduced capital costs.

262 **Q. Given your analysis and the reactions you attribute to the financial community,**
263 **what is your conclusion?**

264 A. I conclude that the Commission should attempt to reverse the negative opinions of
265 investor representatives in order to permit Commonwealth Edison to compete in the
266 marketplace for funds necessary to further capital expenditures and provide a fair and
267 reasonable return to its shareholders. Based on my analysis, a 12.2% return on equity for
268 ComEd is fair and reasonable.

269 **Q. Does this conclude your testimony?**

270 A. Yes, it does.

271 **Appendix Concerning Prior Testimony**

272 I prepared testimony on rate of return before the Federal Power Commission on behalf
273 of Florida Power Corporation, Jersey Central Power & Light, Metropolitan Edison Company,
274 Panhandle Eastern Pipeline and Pennsylvania Electric Company and before the Federal
275 Energy Regulatory Commission on behalf of Florida Power Corporation and Duke Power
276 Company (rebuttal). I have also presented such testimony before the following Commissions:
277 Arkansas Public Service Commission on behalf of Arkansas Power & Light Company;
278 District of Columbia Public Service Commission on behalf of Potomac Electric Power
279 Company; Florida Public Service Commission on behalf of Florida Power Corporation,
280 Florida Telephone Company, Gulf Power Company, Southern Bell Telephone & Telegraph
281 Company and Winter Park Telephone Company; Georgia Public Service Commission on
282 behalf of Georgia Power Company; Illinois Commerce Commission on behalf of Peoples'
283 Gas, Light & Coke Company; Indiana Utility Regulatory Commission on behalf of Northern
284 Indiana Public Service Company; Kentucky Public Service Commission on behalf of
285 Kentucky Power Company; Maryland Public Service Commission on behalf of Potomac
286 Edison Company; Department of Public Utilities of Massachusetts on behalf of Boston
287 Edison Company; the Board of Regulatory Commissioners of the State of New Jersey on
288 behalf of Jersey Central Power & Light Company, New Jersey Power & Light Company and
289 South Jersey Gas Company; New York Public Service Commission on behalf of
290 Consolidated Edison Company of New York, Long Island Lighting Company, National Fuel
291 Gas Distribution Company, Niagara Mohawk Power Corporation, Orange and Rockland
292 Utilities and Pennsylvania Electric Company; North Carolina Utilities Commission on behalf
293 of Virginia Electric & Power Company; Public Utilities Commission of Ohio on behalf of

294 Cleveland Electric Illuminating, Columbus & Southern Ohio Electric and Toledo Edison
295 Company; Corporation Commission of the State of Oklahoma on behalf of Public Service
296 Company of Oklahoma; Pennsylvania Public Utilities Commission on behalf of Metropolitan
297 Edison Company, Pennsylvania Electric Company and West Penn Power Company; Virginia
298 State Corporation Commission on behalf of Virginia Electric & Power and Public Service
299 Commission of West Virginia on behalf of West Virginia Water Company and Huntington
300 Water Company.

301 I also testified before the Federal Power Commission in its Phase II electric utility
302 hearings; before the Nuclear Regulatory Commission's Atomic Safety and Licensing Board
303 on behalf of Alabama Power Company and Carolina Power & Light Company; before the
304 Federal Power Commission on Construction Work in Progress; before the National
305 Association of Regulatory Commissioners ad hoc Committees on Utility Diversification and
306 on the financial health of Electric Utilities; before the House of Representatives' Committee
307 on Ways and Means on deferred taxes, and the sub-committee on Energy and Environment
308 of the Committee on Interior and Insular Affairs on nuclear licensing reform; before the
309 Department of Energy at its National Energy Strategy hearings; and before State Legislative
310 Committees in Arizona, Connecticut, Michigan and New Jersey.