IIEC Exhibit 4.0

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	**:**	
	:	**Docket No. 10-0467**
Proposed general increase in electric rates	**:**	
	:	

Rebuttal Testimony and Exhibit of

Michael P. Gorman

On behalf of

Illinois Industrial Energy Consumers

Project 9351
December 23, 2010

BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	**:**	
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Rebuttal Testimony of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael P. Gorman and my business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017.

Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A Yes, I am.

Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A I will respond to certain positions taken in the rebuttal testimony of Commonwealth Edison Company ("ComEd" or "Company") witnesses Dr. Samuel Hadaway, Steven Fetter, Carl Seligson, Kathryn Houtsma and Dr. Susan Tierney.

I. RETURN ON EQUITY

Response to ComEd Witness Dr. Samuel Hadaway

Q PLEASE IDENTIFY THE PORTIONS OF DR. HADAWAY'S REBUTTAL TESTIMONY TO WHICH YOU WILL RESPOND IN YOUR REBUTTAL TESTIMONY.

A Dr. Hadaway makes arguments that contest the reasonableness of my return on equity ("ROE") recommendation. He also updates his DCF analysis. I will respond to Dr. Hadaway's assertions and show that they are erroneous or unreasonable. I will also comment on his updated DCF analysis, revise it by using more reasonable data, and show that a return on equity of approximately 9.6% is reasonable for ComEd in this case.

Q WHAT ELEMENTS OF YOUR RETURN ON EQUITY STUDY DID DR. HADAWAY DISPUTE?

A At page 20 of Dr. Hadaway's rebuttal testimony (ComEd Ex. 37.0), he summarizes his disagreement with my return on equity studies as follows:

1. he states that I generally biased my constant growth DCF return studies by selecting data or results that decreased the ROE estimate;

2. for my multi-stage DCF study, he contends I was wrong to use a consensus GDP growth rate that takes account of current economic conditions; in his view that biased downward the determination of an appropriate return on equity because it should reflect his own longer term GDP growth outlooks, which he derives from historical data; and

3. he asserts that my CAPM return estimate was biased downward because I "cherry picked" certain data related to the market risk premium and estimate of the risk-free rate.

For the reasons outlined below, all of Dr. Hadaway's argument are without merit and should be disregarded.

Q WHY DOES DR. HADAWAY BELIEVE THAT YOU UNDERSTATED A FAIR RETURN ON EQUITY USING YOUR CONSTANT GROWTH DCF STUDY?

A My constant growth DCF used consensus analysts' growth rates from three publications. For one of the utilities in my sample of comparable firms, Empire District, consensus analysts' growth rates were not available from those sources. Dr. Hadaway asserts in his rebuttal testimony (ComEd Ex. 37.0 at 21) that I should not have excluded Empire District from my results, even though consensus analysts' growth rate estimates from the same sources used for every other company in the study were not available for that firm. He asserts that I should have simply plugged in a growth rate from his preferred source (*Value Line*) for that firm.

Q IS DR. HADAWAY'S PROPOSAL REASONABLE?

A No. This argument is without merit. My constant growth DCF model is based on consensus analysts' growth rates. *Value Line* does not publish consensus analysts' growth rate estimates. Therefore, it is not an appropriate source of inputs for this DCF model.

As explained in my direct testimony (IIEC Ex. 1.0 at 17-18), I used consensus analysts' growth rate estimates because it is not known whether any particular analyst has the most influence in the market. Therefore, it is reasonable to use the consensus of security analysts as the best measure of consensus investor outlooks over the period the growth rates were designed to reflect. In this DCF model, based on consensus analysts' growth rate estimates, growth rates from a single analyst like the *Value Line* data are not proper inputs.

Q DID YOU AVOID THE USE OF *VALUE LINE* DATA IN YOUR DCF STUDIES?

A No. I used *Value Line* data, consistently for all my sample companies, in my sustainable growth rate DCF study. Therefore, I did not ignore *Value Line* data in a DCF study. Rather, I used *Value Line* data appropriately, in a DCF study that was designed to use that type of data. I used *Value Line* data in my sustainable growth DCF analysis because it is the only data source that I am aware of that provides the proxy group information needed to forecast data from which one derives a sustainable growth rate.

Q DID DR. HADAWAY HAVE ANY COMMENTS RELATED TO THAT SUSTAINABLE GROWTH RATE DCF STUDY?

A Yes. At page 21 of ComEd Exhibit 37.0, he took issue with my decision to rely on the median (middle of the range) group estimate rather than the group mean (average) growth estimate. Dr. Hadaway does not take issue with my conclusion that the DPL Inc. DCF return of 20.11% is an outlier. Rather, he says that, instead of using a more representative statistical measure to remove the distortion an outlier would cause, I should have refused to consider that firm's data at all. (This is an approach Dr. Hadaway criticized when, in my constant growth DCF study, I excluded a firm for which no data were available for a group analysis.) Here, Dr. Hadaway recalculated the group average DCF return, excluding the unfavorable (to ComEd) outlier DPL Inc. return. According to Dr. Hadaway, the study thus would have yielded an average proxy group DCF return estimate of 9.45%, rather than the median group estimate including DPL Inc. of 9.19%.

Q IS DR. HADAWAY CORRECT IN HIS ASSERTION THAT USE OF A PROXY GROUP MEDIAN REDUCED YOUR DCF ESTIMATE?

A I do not contest Dr. Hadaway's math. I do disagree with his logic. My use of the group median gives consideration to all DCF estimates in the sample group Dr. Hadaway defined. Dr. Hadaway simply ignores the result for DPL Inc. Regardless, the DCF return estimates produced from Dr. Hadaway's recalculation of results for this DCF study (in a manner I reject) produces, as he acknowledges (ComEd Ex. 37.0 at 21) "not a large effect" in the models and only "a slightly lower overall DCF estimate." The range of DCF estimates from Dr. Hadaway's unwarranted modification of my study -- approximately 9.2% to 9.5% -- supports my 9.6% return on equity recommendation for ComEd in this case.

Q WHAT IS DR. HADAWAY'S DISAGREEMENT WITH YOUR MULTI-STAGE DCF ANALYSIS?

A Dr. Hadaway asserts at page 22 of his rebuttal testimony that I should not have relied on the consensus published economists' GDP growth forecast over the next 5 and 10 years. He states the consensus forecast of the GDP growth rate published and available to investors today, understates long-term outlooks for future inflation. Therefore, he believes the consensus *Blue Chip Economic Forecasts*' outlook of GDP growth rate out over the next 10 years is too low. Instead, he continues to support use of the GDP growth rate forecast he developed especially for this case in a long-term multi-stage growth DCF study, because he believes it reflects a higher inflation outlook, which, in his view, is more likely to prevail over time.

Q DOES DR. HADAWAY MAKE REASONABLE ASSERTIONS IN SUPPORT OF HIS USE OF A HIGHER GDP GROWTH OUTLOOK IN A MULTI-STAGE GROWTH DCF STUDY?

A No. The information that should be used in such a DCF study should be information that is available to investors, since it likely reflects consensus investors' outlooks. Dr. Hadaway has not provided any information that refutes my conclusion that such published analyst growth rate data is more likely influential and reflective of investors' outlooks than his growth rate data derived from historical data by Dr. Hadaway and specifically for this proceeding. My GDP growth rate forecast reflects published consensus economists' projections of future long-term GDP growth. In significant contrast, the GDP growth forecast recommended by Dr. Hadaway reflects his singular assessment of historical GDP growth rates and is based on his private calculations and outlooks.

Dr. Hadaway has provided no evidence that any market participant, much less a consensus of market participants, shares his belief that the GDP growth rate will increase over the long-term to reflect an increase in inflation outlooks relative to that included in published consensus economists' projections of future inflation.

Dr. Hadaway's GDP growth rate forecast is a self-serving projection designed to inflate the DCF return estimate. For this reason, it should be rejected.

Q PLEASE DESCRIBE DR. HADAWAY'S CRITICISMS OF YOUR CAPM ANALYSIS.

A Dr. Hadaway asserts that the market risk premium I used was based on historical Treasury bond yields, which is inconsistent with the Treasury bond yield I used as a risk-free rate in my CAPM. He asserts that had I used historical Treasury bond yields the market risk premiums would have been higher which would have increased my CAPM return estimate.

Q ARE DR. HADAWAY'S CRITICISMS OF YOUR CAPM RETURN ESTIMATE ACCURATE?

A No. Dr. Hadaway's arguments are erroneous. First, I incorporated two measures of a market risk premium in my CAPM analyses. One measure of the market risk premium was derived from historical data and is based on the premium investors actually achieved by investing in the stock market rather than Treasury bonds. Hence, from a historical perspective, market investors have earned a premium of approximately 5.2% to 6.7% by investing in the stock market rather than Treasury bond investments over the period 1929-2009. Incorporating this historical perspective mitigates the effect of what Dr. Hadaway describes as "the current, artificially low government interest rates."

In my other CAPM study, I derived a forward-looking expected return on the market of 10.77%. I used this projected market return to derive an expected market risk premium by subtracting my risk-free rate from the projected market return. This produced a market risk premium of 6.27% (10.77% - 4.5%). Contrary to Dr. Hadaway's erroneous contention, this market risk premium was derived using the same risk-free rate that I used as the risk-free input to my CAPM analysis. This market risk premium is developed in a manner very similar to Staff witness McNally's development of his market risk premium, which Dr. Hadaway adopts in his inappropriate revision of my CAPM study. Dr. Hadaway's criticism appears more result-oriented than focused on my study's analytical approach.

Dr. Hadaway's suggestion that my use of historical data to measure a market risk premium was the result of an intentional downward bias of the market risk premium is unfounded.

Q ARE DR. HADAWAY'S ADJUSTMENTS TO YOUR RETURN ON EQUITY ESTIMATES, SHOWN AT PAGE 24 OF HIS REBUTTAL TESTIMONY, BASED ON REASONABLE APPLICATIONS OF DCF AND CAPM STUDIES?

A No. His adjustments to my consensus analysts' growth rate DCF study included *Value Line* data for Empire District Company. *Value Line* is not a consensus analyst growth rate estimate, and therefore is not appropriate to include in this particular study. His adjustments to my consensus growth rate DCF study do not support his overall assertion that my DCF estimates are understated. As shown on page 24, his adjustments to my DCF (sustainable growth) results actually decreased my DCF estimate.

Dr. Hadaway's adjustment to my multi-stage DCF study to increase the 4.7% consensus economists GDP growth outlook published in the *Blue Chip Economic Indicators* up to his historical data derived GDP growth outlook of 6.0% is a more significant error. His assessment is not reflective of current market expectations, nor investors' outlooks, and as a result overstates investors' return requirements.

Finally, Dr. Hadaway's proposal to reject my CAPM return estimate in favor of Staff's is without merit and unsupported. Indeed, his arguments to reject my CAPM return estimates are based on the erroneous evaluations of my CAPM study discussed above.

Q DID DR. HADAWAY UPDATE HIS DCF STUDIES IN THIS CASE?

A Yes, his rebuttal testimony presents updated elements of his earlier ROE studies in his ComEd Exhibit 37.4 and ComEd Exhibit 37.5.

Q DID YOU CORRECT DR. HADAWAY'S UPDATED STUDIES?

A Yes. I reproduce his updated results in the following table. I also show the results of revising Dr. Hadaway's DCF studies to reflect the consensus economists' outlook of GDP growth, rather than the use of Dr. Hadaway's derivation of a GDP growth rate estimate strictly from historical data. My revised results, I believe, are more accurate than Dr. Hadaway's updated results because they better reflect investor outlooks.

TABLE 1

Update to Dr. Hadaway's Updated DCF Studies

Description	Hadaway Updated DCF Estimates	Revised Hadaway Updated DCF Estimates
Constant Growth (Analysts' Growth)	10.3% - 10.3%	10.3% - 10.3%
Constant Growth (Long-Term GDP Growth)	10.9% - 10.8%	9.6% - 9.5%
Three-Stage Growth DCF	10.7% - 10.7%	9.7% - 9.8%
Range	**10.6% - 10.6%**	**9.9% - 9.9%**

Source: IIEC Exhibit 4.1.

This one data adjustment (GDP) reduces Dr. Hadaway's DCF return from 10.6% to 9.9%, and supports my DCF study results.

Q DO DR. HADAWAY'S UPDATED RISK PREMIUM STUDIES YIELD REASONABLE RESULTS?

A No. While I recognize the Illinois Commerce Commission's ("ICC") practice of not placing heavy reliance on risk premium studies, I nevertheless updated these studies to produce more reasonable results. Dr. Hadaway's chosen inputs for his risk premium studies continue to produce unreasonably high return on equity estimates for ComEd. The equity risk premiums Dr. Hadaway uses to derive his return on equity (as shown on his ComEd Exhibit 37.5) range from 4.8% to 4.67%. However, a review of that same exhibit shows that risk premiums over the last five years fall in the range of approximately 3.8% up to 4.8%, and reasonably reflect current capital market costs. Using the midpoint of this range, or 4.3%, along with Dr. Hadaway's current and forecasted "BBB" bond yields of 5.25% and 5.57%, respectively, would indicate a return on equity in the range of 9.05% up to 10.37%. This range supports my recommended return on equity of 9.6% for ComEd.

Response to ComEd Witness Steven Fetter

Q DID COMED WITNESS MR. FETTER OFFER AN OPINION ON THE REASONABLENESS OF YOUR 9.6% RETURN ON EQUITY?

A Yes. At page 16 of his rebuttal testimony (ComEd Ex. 45.0), he states that he disagrees with my return on equity recommendation. He urges the Commission to reject my conclusion that my 9.6% return on equity recommendation is adequate to maintain ComEd's investment grade bond rating. In support of his contrary position, he states his opinion that credit rating agencies and analysts would not look on this return on equity favorably, noting that it would be amongst the lowest return on equity authorizations awarded, back to 1989.

Q DO YOU ACCEPT MR. FETTER'S APPARENT POSITION (AT PAGE 16) THAT A 9.6% RETURN ON EQUITY WOULD NOT SUPPORT COMED'S INVESTMENT GRADE BOND RATING?

A No. The major flaw in Mr. Fetter's reasoning is that he appears to disregard the need to set the authorized return on equity based on current market capital cost, rather than matching past return awards or pleasing analysts. In fact, the Commission has sternly rejected the use of awards in other states as a basis for an Illinois utility's return.

Q WHERE DID THE ICC REJECT USING PREVIOUS RETURNS ON EQUITY TO FORM THE BASIS FOR ITS DECISION?

A In a recent Peoples Gas Light and Coke Co./North Shore Gas Company rate case, the ICC stated as follows:

> At several places in their evidence and briefs, the Utilities compare the ROE's recommended here with the ROEs approved in previous cases by this and other commissions. E.g., NS-PGL Ex. PRM-2.0 at 3-6. They assert that previously approved ROEs serve as "guideposts" for our analysis in these cases and insist that they "are not arguing that their returns should be based on the authorized returns of other utilities." NS-PGL BOE at 25. The Commission doubts that the Utilities' return comparisons were offered without the expectation that our decision-making would be affected by them. The Utilities are presumably reluctant to directly press for comparison-based ratemaking because of our previous rejection of that approach. In Commonwealth Edison's most recent rate case, we said:
>
>> ComEd asserts its cost of equity should reflect the costs of equity recently approved for electric utilities in the United States. The cost of equity appropriate to ComEd, however, is specific to that utility. ComEd may not simply adopt the cost of equity set for other utilities scattered around the country, for which the factors and circumstances are not necessarily similar. Rather, pursuant to Section 9-201 of the Act, ComEd must prove that its proposed cost of equity is just and reasonable. Commonwealth Edison, Docket. No. 05-0597, 1181 Order, at 153 (June 6, 2006).[1]

Q DOES MR. FETTER RESPECT ESTABLISHED ICC PRACTICE IN JUDGING THE REASONABLENESS OF YOUR RETURN ON EQUITY RECOMMENDATION?

A No. Mr. Fetter's approach is at odds with the long-established practice for measuring a fair return on equity, *i.e.,* that it should be based on current market conditions. Setting the equity return to the current cost of capital supports a utility's financial

[1]Final Order, Peoples Gas Light and Coke Co. and North Shore Gas Company, Proposed General Increase in Delivery Service Rates, ICC Dockets No. 07-0241/07-0242 (consolidated), February 25, 2008, at 89-90.

integrity. In fact, the authorized return on equity must be set to current capital market costs, in order to preserve a utility's financial integrity. Otherwise, that is, without that objective standard, the authorized return on equity would be set either unreasonably high or unreasonably low. In markets where it is set unreasonably low, the financial integrity of the Company would be at risk. Such a practice would not stabilize utility investment risk.

For example, consider how Mr. Fetter's or analysts' test of other states' awards would apply in various market conditions. Notwithstanding the recent overall decline in capital market costs, Mr. Fetter suggests that an authorized return on equity today that is lower than those established over the last few decades would not support an investment grade bond rating. That position essentially implies that the historical levels of authorized return on equity determinations should not be decreased, even in the event of declining capital market costs. If that standard were adopted, authorized returns on equity in this case would be set above current market costs. While that would almost certainly support ComEd's credit rating, it would represent an unreasonable return that overstates the capital costs properly recovered from ratepayers.

The flaw in Mr. Fetter's logic is even more clearly evident in the context of an increasing capital cost market. For example, if capital market costs are increasing and a utility's return on equity is not set above historical levels, then the authorized return could be below market, which would likely erode the utility's financial integrity.

Aside from its effects on the Commission's determination of an appropriate return, Mr. Fetter's proposal to set authorized returns on equity at levels no lower than those authorized in the past would also deprive customers of the benefits of a declining capital market environment. For example, as shown on Dr. Hadaway's

ComEd Exhibit 37.5, page 2, authorized returns on equity have ranged from in excess of 15% during the period 1980 through 1985, in excess of 12% to 15% from 1986 through 1992, dropping down into the 11% range during most of the 1990s, and dropping into the 10% area since the turn of the century. These declines in authorized returns on equity would not have been approved if commissions had accepted Mr. Fetter's recommendation to ignore the current market cost of capital, and had, instead, authorized returns on equity at a level that had been awarded in the past. In essence, Mr. Fetter's approach would deprive customers of benefits from declining capital market cost by encouraging commissions to continue to award returns on equity at levels that had been authorized in the past, rather to reflect the current market cost of capital.

Response to ComEd Witness Carl H. Seligson

Q IN HIS REBUTTAL TESTIMONY, DID MR. SELIGSON DISPUTE YOUR CONTENTION THAT THE RECOMMENDED RETURN FROM THE RISK PREMIUM STUDY PRESENTED IN HIS DIRECT TESTIMONY IS OVERSTATED?

A Yes. Mr. Seligson asserted that ComEd and regulated electric utilities in general do not have below market risk. He believes that a fair return on equity for ComEd is 12.6%, which is even higher than the 12.2% offered in his direct testimony, and that this high return is appropriate for a regulated utility.

Q DID MR. SELIGSON OFFER NEW CONVINCING EVIDENCE IN SUPPORT OF HIS RETURN ON EQUITY FOR COMED?

A No. Mr. Seligson's proposed return on equity is far out of line with the current market cost of common equity for low-risk regulated utility operations. Indeed, Mr. Seligson has not provided any evidence that his belief that utilities have risk comparable to the overall market is shared by any market participant or has any validity. Rather, Mr. Seligson's arguments seem to be based purely on his own subjective determination that a return on equity for ComEd should be above 12%. He has not provided any credible support for this recommendation.

II. POST-TEST YEAR PLANT ADDITIONS

Response to ComEd Witness Kathryn Houtsma

Q ARE THERE PORTIONS OF THE REBUTTAL TESTIMONY OF COMED WITNESS KATHRYN M. HOUTSMA THAT WARRANT A RESPONSE?

A Yes. In ComEd Exhibit 29.0 at page 8, Ms. Houtsma responds to Staff witness Ms. Ebrey's testimony that ComEd's proposed *pro forma* adjustment for post-test year plant additions would overstate ComEd's rate base and its rates. I would like to respond to the assertions Ms. Houtsma makes in response to Ms. Ebrey that ComEd's proposed test year rate base, which does not reflect an offset to post-test year plant additions to recognize the buildup of accumulated depreciation reserve during the same post-test year period, will not result in an overstatement of ComEd's revenue requirement, rate base, or rates. In support of these assertions Ms. Houtsma refers first to the future test year revenue requirement comparison presented in her direct testimony (ComEd Ex. 6.0 Revised) and ComEd Exhibit 6.3.

Q WHAT IS THE GIST OF MS. HOUTSMA'S REVENUE REQUIREMENT ARGUMENT?

A Ms. Houtsma asserts that the revenue requirement developed for the historical test year chosen by ComEd is very similar to the revenue requirement ComEd would have requested had it filed a 2011 future test year case. Ms. Houtsma then concludes that this comparison suggests that ComEd's revenue requirement is not overstated.

Q DOES THE PRESENTATION MS. HOUTSMA REFERENCED ADDRESS THE ISSUES IDENTIFIED BY STAFF WITNESS EBREY?

A No. Indeed, Ms. Houtsma's revenue requirement argument completely ignores the assertions made by Staff witness Ebrey, which are similar to the assertions I made in my direct testimony. The central points of our testimony related to the overstatement of rate base and the resulting excessive rates to customers, not revenue requirement.

Q DOES MS. HOUTSMA DIRECTLY ADDRESS THOSE ISSUES AT ALL?

A Yes, but only briefly. At page 8 of her rebuttal testimony (ComEd Ex. 29.0), she argues that ComEd's historical test year rate base will not be overstated "because ComEd will continue to make significant capital investments" after its chosen test year. However, in reaching this conclusion she appears to ignore entirely Sec. 287.40 of the Commission's rules; that section sets out certain requirements for post-test year investments to be considered in setting rates in a historical test year rate case. Instead, she treats her investment forecasts as though ComEd had selected a future test year. As to rates, Ms. Houtsma observes that on past occasions when ComEd's rates were set without recognizing both post-test year increases and post-test year decreases to rate base, ComEd's earnings did not surpass its authorized return. From this, and ignoring every other factor that might affect ComEd's earnings, she concludes that rates in this case will not be overstated if decreases to rate base over the period of post-test year rate base increases are ignored again. The flaws in her logic are confirmed by an examination of Ms. Houtsma's ComEd Exhibit 6.3, which undercuts her arguments and conclusions respecting ComEd's rate base and rates.

The following contrary conclusions can be accurately drawn from Ms. Houtsma's ComEd Exhibit 6.3:

1. Using the historical test year, ComEd's rate base would be $7.7 billion. This is nearly $250 million higher than the $7.5 billion rate base that Ms. Ebrey shows for a future test year using calendar year 2011, where all rate base components are stated as of the same point in time. ComEd's incomplete adjustments to the historical test year rate base (post-test year plant additions, but not the post-test year change in accumulated depreciation) will result in an overstatement of the ComEd rate base used to set rates, even in comparison to a future test year.

2. The exhibit shows that Ms. Houtsma's contention that the revenue requirement the Company is seeking in this case is "similar" to the <u>revenue requirement</u> that would be produced with a historical test year is supported by her calculations. However, despite similar revenue requirements, the impact on customer rates of using a historical test year as the basis for setting rates to recover this revenue requirement may not be the same as the <u>rate impact</u> of using a future test year. The rate impact to recover the same revenue requirement may be different because of test year-specific rate-setting factors that are not shown in Ms. Houtsma's comparison. For example, ComEd's number of customers and kWh sales in the historical test year may not be the same as the billing units in a future test year. As a result, overstating the historical test year rate base and revenue requirement as Ms. Houtsma is doing in this case, will result in an unjust increase in the rates charged to its retail customers – even where historical and future test year revenue requirements are "similar."

Q CAN YOU PROVIDE AN EXAMPLE THAT ILLUSTRATES WHY MS. HOUTSMA'S HISTORICAL TEST YEAR RATE BASE ADJUSTMENT WILL UNJUSTLY INCREASE RATES?

A Yes. The erroneous impact on rates can be illustrated by spreading the historical test year revenue requirement and future test year revenue requirement projections made by Ms. Houtsma, over the number of customers and kWh sales in the historical test year, relative to the estimated number of customers and kWh sales in the forecasted test year. This is done in Table 2 below. As shown in this table, even though the revenue requirement in the historical test year is comparable to that in the future test year, because the number of customers and kWh sales increase over time, the rate developed using a historical test year is higher than the rate that would be developed using the future test year period.

TABLE 2

Rate Impact
(Millions)

Description	Historical Test Year[1]	2011 Future Test Year[2]
Revenue Requirement	$2,314	$2,337
Number of Customers (000)	3,797	3,873
GWh Sales	88,914	90,692
Rev. Req./MWh	$26.03	$25.77

Sources:
[1]ComEd Ex. 6.3.
[2]Assumes 1% annual customer growth and constant use per customer.

The hypothetical example illustrated in Table 2 above shows the potential for distortions of relationships among test year data used to set rates with piecemeal adjustments, as well as why it is important that rates be set using data from the same test year. Mismatching cost of service data, as Ms. Houtsma proposes, will result in flawed rate adjustments, an erosion of customer protection, and an overstatement of retail rates.

III. REGULATORY RISK

Q DOES COMED WITNESS MR. FETTER IMPLY THAT IIEC'S POSITIONS IN THIS PROCEEDING MAY CREATE INSTABILITY IN THE ILLINOIS REGULATORY ENVIRONMENT?

A Yes. For example, at page 5 of his rebuttal testimony (ComEd Ex. 45.0), Mr. Fetter urges the Commission to reject my conclusion that my recommended 9.6% return on equity can maintain ComEd's credit ratings. Further, at pages 13 and 14 of his rebuttal testimony, Mr. Fetter cites a Standard & Poor's credit report for ComEd that notes an unfavorable aspect of an Ameren Order in March 2010, and states the need for constructive regulatory treatment for ComEd in this case. Mr. Fetter then alludes to the Commission's "depart[ure] from a rule of decision that was favorable to utilities that it had adhered to in many recent cases" in that order. I interpret this to refer to the Commission's rejection of the Ameren position that recognition of the change in accumulated depreciation for the post-test year period of plant additions is not appropriate. ComEd is making the same argument in this case.

My revenue requirement recommendations on behalf of IIEC focus on the determination of a fair return on equity that reflects current market cost, and on accurate measurements of post-test year changes to historical test year rate base. These well-established objectives should not be cause for alarm.

Q WOULD YOUR RECOMMENDED RETURN ON EQUITY CREATE INSTABILITY IN THE RATEMAKING PROCESS IN ILLINOIS?

A No. My return on equity recommendation in this case is based on an analysis that uses largely the same methodologies I used in prior rate cases in Illinois. Further, I have offered rate of return recommendations in many jurisdictions outside of Illinois. In most rate cases, regulatory commissions either rely in whole or in part on my return on equity recommendations, or the commission authorized return on equity is very close to or within my recommended ROE range. My return on equity methodologies are generally consistent with industry standards around the country.

Q WOULD YOUR PROPOSAL TO OFFSET POST-TEST YEAR PLANT ADDITIONS FOR THE CHANGE IN ACCUMULATED DEPRECIATION OVER THE SAME POST TEST YEAR TIME PERIOD CREATE INSTABILITY IN THE RATEMAKING PROCESS FOR ILLINOIS UTILITIES?

A No. Indeed, the practice of making post-test year plant additions and accumulated depreciation adjustment is a common practice in virtually every jurisdiction to my knowledge. This practice properly estimates utility net plant in-service, which is the primary component of rate base.

Indeed, in the Ameren rate case noted by the witnesses, I pointed out that the position Ameren advocated in Illinois contradicts the position Ameren took for setting rates for its Missouri utility affiliate. In Illinois, Ameren argued for post-test year plant additions without an adjustment for accumulated depreciation through the post-test year period. In significant contrast, Ameren in Missouri adjusted the historical test year rate base to include both plant additions and accumulated depreciation reserve adjustments for the same time period. Ameren's position in Missouri is one that is consistent with rate base adjustments in virtually all jurisdictions that I am aware of.

The Regulatory Research Associates ("RRA") ranking of the Missouri jurisdiction (which accepts the adjustment I recommend) is "Average 2."[2]

I also note that I have also worked in rate cases in Iowa where the utility, Interstate Power and Light Company, has reflected test year plant additions, including a roll forward of accumulated depreciation reserve through the test year adjustment period.[3] RRA's regulatory ranking for Iowa is "Above Average 3."[4]

These RRA rankings demonstrate that properly measuring rate base, by reflecting the change in accumulated depreciation reserve during the same post-test year time period as the plant additions are made, will not cause a negative regulatory ranking as the ComEd witnesses imply. Indeed, it is ComEd's unusual proposed treatment of post-test year plant additions in this case that is an outlier, and that adds instability in the ratemaking process.

Q SHOULD THE COMMISSION MODIFY ITS RATE SETTING RULES AND PROCEDURES TO APPEASE RRA OR CREDIT RATING ANALYSTS?

A No. The Commission should follow its test year rules. Those rules are designed to provide a utility an opportunity to earn fair compensation, and to maintain its financial integrity, while also balancing customers' need to receive just and reasonable prices for utility service. RRA and credit analysts are clearly not in a position where they are responsible for protecting retail customers.

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[2] RRA Regulatory Focus, State Regulatory Evaluations, October 8, 2010.
[3] Iowa Utilities Board, Interstate Power and Light Company, Docket No. RPU-2010-0001, Jason Nelson Direct Testimony at 5-6.
[4] *Id.* at 2.

Q DID ANY COMED WITNESS OFFER PRINCIPLES THAT YOU AGREE WOULD BE APPROPRIATE FOR THE COMMISSION TO FOLLOW IN THIS CASE?

A Yes. At page 5, lines 102 through 106 of ComEd Exhibit 26.0, Dr. Philip O'Connor states the following:

> … The single overarching point of traditional ratemaking is to arrive at rates that give the utility a fair opportunity to recover its reasonable and prudent costs of service. It is clearly the policy of Illinois that delivery services rates "shall allow the electric utility to recover the costs of providing delivery services through its charges to its delivery service customers."

I agree with Dr. O'Connor's characterization of appropriate ratemaking principles. Unfortunately, ComEd's proposal with respect to post-test year plant additions fails to meet this standard because its methodology overstates its cost of service in the historical test year case, and will not result in just and reasonable rates for retail customers.

IV. COMED'S PROPOSED ROE ADDER

Response to ComEd Witness Dr. Susan F. Tierney

Q WHAT COMMENTS DID DR. TIERNEY MAKE CONCERNING YOUR REVIEW OF HER TESTIMONY?

A Dr. Tierney states that she disagrees with several aspects of my testimony where I contest the reasonableness of her proposed 40 basis point adder to ComEd's return on equity and ultimately recommend it be rejected. Dr. Tierney alleges that:

1. I mischaracterized her testimony when I suggested that she acknowledged that ComEd has regulatory mechanisms that provide a high level of assurance of full cost recovery;

2. I failed to address the financial risk and revenue impacts that ComEd faces from energy efficiency programs;

3. she asserts that I made arguments that have no basis (specifically, she disagrees with my position that a 40 basis point ROE adder would erode the efficiency of the ratemaking process and detract from the objective of achieving an optimal utility); and

4. finally, she asserts that my conclusion that her proposed 40 basis point adder would offset energy efficiency gains and economic benefits created on customers' behalf from such programs was without support whatsoever.

Q DID YOU MISCHARACTERIZE DR. TIERNEY'S TESTIMONY CONCERNING COMED'S REGULATORY MECHANISMS?

A No. At pages 4 and 5 of her rebuttal testimony, she acknowledges that ComEd can use a future test year, which would incorporate forecasted sales levels and costs of service in developing rates that provide an opportunity to earn its cost of capital. Her apparent position is that because ComEd chose not to use a future test year in this proceeding, ComEd may not be criticized for any effects of that choice.

Q WHAT ARE THE ALLEGED FINANCIAL AND OPERATING RISKS COMED WILL FACE DUE TO ENERGY EFFICIENCY PROGRAMS?

A The risk identified by Dr. Tierney is that energy efficiency will reduce sales. The bottom line assessment of this risk is whether or not the rates approved in a rate case provide a utility with a reasonable opportunity to earn its authorized rate of return on its investment in utility plant and equipment.

Q DOES THIS SALES LOSS RISK WARRANT A RETURN ON EQUITY ADDER?

A No. Energy efficiency can reduce sales, and can restrict the ability to set compensatory rates using a historic test year. However, utilities can manage sales reduction risk with available regulatory mechanisms.

Q DOES COMED HAVE REGULATORY MECHANISMS THAT WILL HELP IT MANAGE ENERGY EFFICIENCY SALES RISK?

A Yes. As noted above, ComEd has the option of using a future test year in which it can use a forecasted cost of service to supply a forecasted level of sales which can include the effects of energy efficiency programs. Hence, these rates developed from a forecasted test year should mitigate, to a large degree, the uncertainty of whether or not ComEd would implement rates that do not provide it a fair opportunity to earn its authorized return on equity.

Also, ComEd has proposed to implement a rate design which will mitigate the risk to its ability to earn its authorized return on equity in the event of loss of sales. Under ComEd's current rate designs, the customer classes that are billed for delivery service on the basis of energy are its residential and smallest commercial customers. However, as I understand from my colleague, Mr. Robert Stephens, ComEd is proposing a rate design change in this case that would collect a larger percentage of its revenues from residential customers and commercial customers through the fixed customer charges. This would reduce the revenue collected under energy sales and therefore would mitigate the potential income loss from reduced sales caused by energy efficiency.

This new rate design (referred to as a straight fixed variable rate design) is introduced by ComEd witness Ross Hemphill (ComEd Ex. 14.0 Revised at 8-23). As such, a second regulatory mechanism that may be available to ComEd is a rate design that will provide greater assurance of recovery of its costs of service.

Q WHY WILL DR. TIERNEY'S PROPOSAL FOR AN ROE ADDER TO COMPENSATE FOR ENERGY EFFICIENCY ERODE THE EFFICIENCY OF THE RATE-SETTING PROCESS?

A An efficient response to risk is identifying and describing the risk, then determining whether it can be managed, or concluding that the risk is outside management control. ComEd can manage its reduced sales risk using available regulatory mechanisms. Dr. Tierney is proposing to reward ComEd for a risk that can be largely managed. Therefore, her proposal will erode the efficiency of the rate-setting process.

Q WHY DOES DR. TIERNEY BELIEVE THAT THE USE OF ILLINOIS' REGULATORY MECHANISMS CANNOT MITIGATE OR ACCOUNT FOR THE RISK OF ENERGY EFFICIENCY PROGRAMS?

A Dr. Tierney has apparently not seriously considered the full range of regulatory mechanisms available to ComEd to manage any risk associated with sales losses from energy efficiency programs. Hence, her assessment of these risks and the mitigation and management tools available to ComEd is flawed. Her suggestion that ComEd has no responsibility to manage the risks she describes detracts from the legitimacy of her recommendation for a 40 basis point adder to ComEd's return on equity. Therefore, Dr. Tierney's recommendations should be rejected.

Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A Yes.

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