

**STATE OF ILLINOIS**

**ILLINOIS COMMERCE COMMISSION**

COMMONWEALTH EDISON COMPANY	:	
	:	No. 11-0721
Formula Rate Tariff and charges authorized by	:	Rehearing
Section 16-108.5 of the Public Utilities Act	:	

Rebuttal Testimony on Rehearing of

**SAMUEL C. HADAWAY**

Principal,  
FINANCO, Inc.

On Behalf of

Commonwealth Edison Company

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1 **I. INTRODUCTION AND PURPOSE OF TESTIMONY**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Samuel C. Hadaway. I am a principal in FINANCO, Inc., Financial Analysis  
4 Consultants. My business address is 3520 Executive Center Drive, Austin, Texas 78731.

5 **Q. Are you the same Samuel C. Hadaway who submitted direct testimony on rehearing  
6 on behalf of Commonwealth Edison Company (“ComEd”) in this case?**

7 A. Yes.

8 **Q. What is the purpose of your rebuttal testimony on rehearing?**

9 A. The purpose of my rebuttal testimony is to respond to the Staff of the Illinois Commerce  
10 Commission’s (“Staff”) and certain intervenors’ alternative “interest rate” proposals for  
11 financing the portion of ComEd’s overall investment that is reflected in the annual  
12 reconciliation or “true up” amounts under the Energy Infrastructure Modernization Act  
13 (“EIMA”). I will respond specifically to the recommendations offered by Staff witness  
14 Alan Pregozen, Attorney General/AARP (“AG/AARP”) witness Michael L. Brosch,  
15 Citizens Utility Board (“CUB”) witness Ralph C. Smith, and Illinois Industrial Energy  
16 Consumers (“IIEC”) witness Michael P. Gorman.

17 In my responses, I will explain why Staff’s and intervenors’ reconciliation interest  
18 rate proposals are not adequate. Under EIMA, ComEd should be made whole (subject to  
19 the traditional prudence and reasonableness criteria), including the recovery of its cost of  
20 capital. If ComEd’s actual delivery services costs, including those incurred to undertake  
21 the investments described in EIMA, are to be fully recovered as if there were no under-  
22 or over-recovery balances, ComEd’s weighted average cost of capital (“WACC”) must be

23 the allowed interest rate. Otherwise, for over-recovery balances, ComEd's customers  
24 will be deprived of earning interest at ComEd's WACC, and for under-recovery balances,  
25 ComEd's shareholders will be deprived of an equity return on the capital that they  
26 provide. Contrary to Staff's and intervenors' positions, ComEd cannot obtain debt  
27 funding without equity support, and equity cannot be parsed into short-term and long-  
28 term holdings. Equity shareholders support all of ComEd's financing alternatives, and  
29 the rate of return for that financing cannot be differentiated by the maturity of the subject  
30 investment. Under these conditions, ComEd cannot be made whole unless it recovers its  
31 WACC on EIMA reconciliation balances.

32 **Q. Has Staff or any intervenor changed its position with respect to the appropriate**  
33 **interest rate?**

34 A. Yes. Staff has modified its position and now recommends a WACC approach, but with a  
35 reduced rate of return on equity ("ROE") in the WACC calculation. Pregozen Reh. Dir.,  
36 Staff Ex. 25.0, 11:178-12:185; *Id.*, Sched. 25.1. AG/AARP continues to support a short-  
37 term and debt-only rate for calculating the refunds or surcharges in the reconciliation  
38 procedures. Brosch Reh. Dir., AG/AARP Ex. 5.0, 3:49-54. AG/AARP also  
39 acknowledges the Commission's "hybrid" interest rate blend, but suggests that a lower  
40 marginal cost of debt should be used in calculating that rate. *Id.*, 14:330-34. CUB  
41 continues to support an asymmetrical "WACC for refunds/debt rate for under-  
42 collections" approach.<sup>1</sup> Smith Reh. Dir., CUB Ex. 5.0, 8:204-10. IIEC also continues to  
43 recommend a debt-only cost recovery rate, with IIEC witness Gorman arguing that the

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<sup>1</sup> Mr. Smith has continued to modify the recommended rate he would apply for the cost of debt from a short-term debt rate in his initial testimony, to the Staff's customer deposits rate in his rebuttal testimony, now to the Commission's hybrid rate.

44 clear mismatch of such an approach could be corrected (in other unspecified base rate  
45 proceedings) by removing short-term debt from ComEd's regulatory capital structure.  
46 Gorman Reh. Dir., IIEC Ex. 3.0, 19:435-42.

47 However, to the extent that under-recoveries may occur in the EIMA process,  
48 each of these alternative interest rate recommendations would directly prevent ComEd  
49 from recovering its allowed rate of return on the equity capital that supports its EIMA  
50 investments. As noted by Dr. Hemphill in his rebuttal testimony, because the  
51 reconciliations are not a one-time event and will occur every year for a number of years,  
52 the process will reflect two years of delayed recovery over and over. *See* Hemphill Reh.  
53 Reb., ComEd Ex. 34.0, 5:90 – 6:128 (describing the process for each rate year). In this  
54 context, the Staff's and intervenors' interest rate recommendations would consistently  
55 deprive ComEd of its authorized rate of return on its EIMA investments. From a  
56 financial perspective, this result is not consistent with the EIMA undertaking.

57 **II. RESPONSE TO ICC STAFF WITNESS ALAN PREGOZEN**

58 **Q. What is the basis for Staff's modified interest rate recommendation?**

59 A. Mr. Pregozen admits that Staff's position during the initial phase of this case was based  
60 on "the mistaken understanding" of the EIMA reconciliation adjustment. Pregozen Reh.  
61 Dir., Staff Ex. 25.0, 2:35-3:50. He now acknowledges that the size of the EIMA  
62 reconciliation adjustment is a function of the same risk considerations as the preliminary  
63 EIMA revenue requirement and the final EIMA revenue requirement, both of which are  
64 subject to Commission determinations of prudence and reasonableness. Mr. Pregozen  
65 further states that since the reconciliation adjustment is combined with the revenue  
66 requirement (and the ROE collar adjustment) into a net revenue requirement, the

67 reconciliation adjustment is also subject to the same degree of sales risk. Based on these  
68 considerations, Mr. Pregozen recommends that the interest rate in the reconciliation of  
69 EIMA under- and over-recovery balances should be a modified WACC.

70 **Q. How does Staff calculate its modified WACC?**

71 A. Mr. Pregozen offers the following explanation for Staff's modified WACC proposal:

72 [T]he formula for Staff's recommendation is (1) the product of the rate of  
73 return on common equity calculated using the procedure shown in ICC  
74 Staff Exhibit 25.1 and the common equity ratio included in the authorized  
75 rate of return on rate base; plus (2) the weighted costs of the remaining  
76 (i.e., non-common equity) components of the capital structure included in  
77 the authorized rate of return on rate base

78 Pregozen Reh. Dir., Staff Ex. 25.0, 11:180-12:185.

79 **Q. Does Mr. Pregozen's modified WACC proposal result in an appropriate interest**  
80 **rate?**

81 A. No. While his movement to a WACC approach is correct, his attempt to construct an  
82 artificial ROE that is part of the WACC is not. In effect, Mr. Pregozen has created his  
83 own "hybrid" approach and his own cost of equity by inserting a modified ROE (of only  
84 4.48% to 5.14%) into the WACC calculation. His modified ROE proposal, which ends  
85 up being lower than ComEd's cost of long-term debt (6.42%), is wrong because it is  
86 based on faulty logic and it produces an extreme result that has no economic basis in any  
87 equity security that exists. When viewed in detail, Mr. Pregozen's proposal is effectively  
88 a disguised debt-only "WACC" approach. His proposed "debt-like" modified equity  
89 return should be rejected.

90 **Q. What are the flaws in Mr. Pregozen's modified ROE calculation?**

91 A. Mr. Pregozen's concept is to assume an artificial, 2-year maturity, equity security and to  
92 estimate the required rate of return on that security. Pregozen Reh. Dir., Staff Ex. 25.0,  
93 4:73-76. Mr. Pregozen's logic is wrong because no such security exists and there is no  
94 way for ComEd to offer such a security. As Mr. Pregozen correctly notes at the  
95 beginning of his discussion (*Id.*, 3:53-54), equity investments technically have a perpetual  
96 life. In this context, the required equity return cannot be parsed across alternative  
97 investment horizons. Put another way, Mr. Pregozen attempts to transform what is  
98 indisputably an equity security into a type of term note, which he assumes might provide  
99 a two-year investor horizon. However, Mr. Pregozen's attempt to mix and match  
100 incompatible characteristics of what are very different debt and equity investments is  
101 unsupported by any economic theory or financial literature, as evidenced by Mr.  
102 Pregozen's failure to cite to any support for his approach.

103 Q. **How does Mr. Pregozen attempt to estimate the required ROE for his postulated 2-**  
104 **year investment horizon?**

105 A. Mr. Pregozen begins his exercise with the formula ROE methodology prescribed in  
106 Section 16-108.5(c)(3) of the Public Utilities Act. In that formula, the allowed ROE for  
107 each year is the average monthly yield on 30-year U.S. Treasury bonds plus an equity  
108 risk premium of 580 basis points (5.80%). In his exercise, Mr. Pregozen adjusts the ROE  
109 formula in two ways. First, he replaces the 30-year Treasury rate with a much lower 2-  
110 year rate. Second, he adjusts the 580 basis point equity risk premium downward based  
111 on his assumed shorter equity investment horizon. As shown in Mr. Pregozen's table on  
112 page 8 of his testimony, the net result of his calculations is a reduction of ROE from  
113 10.05 percent to 5.14 percent for 2010 and from 9.71 percent to 4.48 percent for 2011.

114 Pregozen Reh. Dir., Staff Ex. 25.0, 8:138-39. These rates do not fall within the range of  
115 returns equity investors demand, but are near or below the current, historically low cost  
116 of debt.

117 **Q. Why does Mr. Pregozen’s methodology produce such an extreme result?**

118 A. As I have explained, there is no economic basis to support Mr. Pregozen’s parsing of  
119 equity across alternative investment horizons. Equity investors have only one purchase  
120 option – an investment in perpetuity. Accordingly, the fiction of a two-year investment  
121 horizon proposed by Mr. Pregozen is not an investment option that is available to equity  
122 investors. Moreover, there is readily available data that show that Mr. Pregozen’s  
123 methodology is particularly susceptible to current, abnormal market conditions. The  
124 government’s stated policy of keeping short-term interest rates near zero and longer-term  
125 rates at record low levels<sup>2</sup> creates artificially low results from Mr. Pregozen’s  
126 calculations. The 2-year Treasury rate used by Mr. Pregozen is only 0.70 percent for  
127 2010 and only 0.45 percent for 2011. Similarly, his adjusted risk premium, based on

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<sup>2</sup> On January 25, 2012 the Federal Open Market Committee of the Federal Reserve System ("Fed") issued the following policy statement:

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. ... To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

On June 20, 2012, the Fed further announced that it is extending “Operation Twist” to the end of the year. In its review of that announcement, Bloomberg offered the following assessment: The Federal Reserve will expand its Operation Twist program to extend the maturities of assets on its balance sheet and said it stands ready to take further action to put unemployed Americans back to work. The central bank will prolong the program through the end of the year, selling \$267 billion of shorter-term securities and buying the same amount of longer-term debt in a bid to reduce borrowing costs and spur the economy. Jeff Kearns and Joshua Zumbrun, *Fed Expands Operation Twist by \$267 Billion Through 2012*, Bloomberg (June 20, 2012), <http://www.bloomberg.com/news/2012-06-20/fed-expands-operation-twist-by-267-billion-through-year-end.html>.

128 shorter-term relative to longer-term yield spreads, is 140 to 180 basis points lower than  
129 the 580 basis point level in the prescribed ROE formula. The relative effect of these  
130 near-term abnormal market conditions can also be seen in the table on page 8 of Mr.  
131 Pregozen's testimony. For example, according to his calculations, the prescribed formula  
132 ROE for 2009 would have been 9.88 percent and his modified ROE for 2009 would have  
133 been 9.05 percent. While, in Mr. Pregozen's table, the relationship between the  
134 prescribed and modified ROE varies from year-to-year, there are no other years in which  
135 the reductions to ROE are nearly as large as Mr. Pregozen recommends for 2010 and  
136 2011. In summary, Mr. Pregozen's modified ROE proposal is not consistent with sound  
137 economic theory or with the practical aspects of equity ownership, which is further  
138 demonstrated by the resulting ROEs that are also inconsistent with Section 16-  
139 108.5(c)(3).

140 **III. RESPONSE TO THE OTHER PARTIES' EIMA INTEREST RATE PROPOSALS**

141 **Q. What is your general response to the EIMA interest rate recommendations of**  
142 **AG/AARP, CUB, and IIEC?**

143 **A.** Other than Staff, the other parties continue to advocate a debt-only rate of return for  
144 EIMA under-recovery balances. None of these proposals would allow ComEd to be  
145 made whole in the EIMA process. AG/ARRP and IIEC would apparently have the  
146 Commission apply the same debt-only rate to both under- and over-recovery balances.  
147 CUB would have the Commission penalize ComEd with a debt-only rate for under-  
148 recovery and require ComEd to pay WACC on any over-recovery. The Commission, in  
149 its "hybrid" approach, using a blend of short- and long-term debt costs for both under-

150 and over-recovery balances, clearly rejected these recommendations. The parties'  
151 reiteration of their prior positions should be similarly rejected.

152 **Q. What was the AG/AARP response to the Commission's "hybrid" interest rate**  
153 **approach?**

154 A. AG/AARP witness Brosch states:

155 [A] reasonable balance that is quite generous to ComEd was struck by the  
156 Commission in adopting a blended debt cost rate. Because future  
157 reconciliation balances, either positive or negative, may extend over more  
158 than 12 months, some consideration and blending of longer-term debt cost  
159 rates may be appropriate.

160 Brosch Reh. Dir., AG-AARP Ex. 5.0, 13:327-14:331. Mr. Brosch, however, goes on to  
161 recommend that the marginal cost of debt, rather than the embedded cost should be used  
162 in the hybrid calculation. According to Mr. Brosch, this approach would reduce the  
163 Commission's hybrid rate to 2.53 percent.

164 **Q. What is your response to Mr. Brosch's marginal cost recommendation?**

165 A. As part of a "hybrid" approach, Mr. Brosch's recommendation is poorly founded and,  
166 even if a marginal debt approach were used, the data he provides would not be the proper  
167 rates to use. Contrary to Mr. Brosch's recommendations, the Commission's approach in  
168 its hybrid calculation is an effort toward compromise. Mr. Brosch would simply have the  
169 compromise moved more nearly toward his position. Additionally, the rates reported in  
170 the Federal Reserve System ("Fed") H-15 Series, which Mr. Brosch provides, are not the  
171 rates for utility debt. While utility borrowing rates are reported by Moody's, along with  
172 industrial rates and the corporate rates provided by Mr. Brosch, the only Moody's series  
173 reported by the Fed are the corporate averages. While the differences are generally small

174 between reported corporate and utility interest rates, Mr. Brosch's effort to a lower rate is  
175 neither properly conceived nor correctly supported. Therefore, Mr. Brosch's proposed  
176 modification to the Commission's hybrid approach should be rejected accordingly.

177 **Q. CUB witness Smith says that neither you nor ComEd has demonstrated that the**  
178 **WACC reconciliation rate used for under- and over-recoveries in Texas for**  
179 **advanced metering technology investments should be a model for carrying costs in**  
180 **Illinois. Later in his testimony, he cites extensively to a Florida Power & Light**  
181 **Company ("FPL") case and claims that the Florida decision supports his**  
182 **recommended asymmetric interest rate approach. What is your response to Mr.**  
183 **Smith's claims (Smith Reh. Dir., CUB Ex. 5.0, 15:370-72, 18:433-21:501)?**

184 **A.** In my initial testimony on rehearing, I explained that ComEd will only be made whole on  
185 its EIMA and other investment if it is allowed to recover the WACC on true-up balances.  
186 I cited the Texas cases because I am located in that state and I am more familiar with the  
187 advanced metering technology cases that have been decided there. To my knowledge, the  
188 WACC has been used as the under- and over-recovery interest rate in all those cases.

189 I have now also reviewed the 2010 FPL Order that Mr. Smith would have the  
190 Commission use as his proposed "model." There are two reasons why Mr. Smith's  
191 proposed "model" is not supported by the FPL Order. First, the portion of the Order on  
192 pages 94 and 95 that Mr. Smith cites is clearly dealing only with under- and over-  
193 recovered fuel cost balances. In that particular context, the Florida Commission  
194 concluded that an asymmetric interest rate approach was needed to incent FPL to  
195 reasonably project fuel costs so that customers are not over charged. However, Mr.  
196 Smith's attempt to broadly expand this narrowly applied asymmetric interest rate

197 approach to the entirety of ComEd’s reconciliation balances has absolutely no support  
198 and is inconsistent with EIMA. In Illinois, the EIMA framework specifically prescribes  
199 how rates are set for an annual period using historic data based on the most recently filed  
200 FERC Form 1 and capital projections for the current year. Moreover, with respect to the  
201 capital projections, EIMA itself describes many of the projects and identifies estimated  
202 expenditures, as well as provides for an extensive regulatory, planning and reporting  
203 structure that ensures careful and detailed annual planning and reporting. For example,  
204 as required by Section 16-108.5(b), ComEd filed its comprehensive Infrastructure  
205 Investment Plan with the Commission in early January 2012, which detailed the  
206 investments it proposed to make under EIMA. ComEd’s AMI deployment is further  
207 governed by an AMI deployment plan that was filed with and approved by the  
208 Commission. *See Commonwealth Edison Co.*, ICC Docket No. 12-0298, Final Order  
209 (June 22, 2012). In sum, Mr. Smith has provided no justification that an asymmetric  
210 interest rate is either appropriate or needed in the unique context of EIMA.

211 The second and more important reason that the Florida Order does not support  
212 Mr. Smith’s “model” is shown on page 96 of the Order. There, specifically discussing  
213 FPL’s Advanced Metering costs, the Florida Commission stated the following:

214 [W]e find that the costs for AMI [Advanced Meeting Infrastructure]  
215 implementation are appropriate and have properly been included in *rate*  
216 *base* for the test year (emphasis added). ... The investment will help  
217 modernize the grid and help the Company provide better service to its  
218 customers. If the savings become too great, and the Company earns a  
219 return outside its authorized rate, we may call FPL in for an earnings  
220 review.

221 *Florida Power & Light Co., Florida Pub. Serv. Comm’n*, PSC Docket Nos. 080677-EI,  
222 090130-EI, Order No. PSC-10-0153-FOF-EI (March 17, 2010), at 96.

223           Contrary to Mr. Smith’s claims about asymmetric treatment of carrying charges in  
224 Florida, when dealing with the same kind of advanced metering investments as those  
225 under consideration in the present case, the Florida Commission did not use an  
226 asymmetric approach. The rate base treatment of FPL’s AMI investments ensures that  
227 the rate of return applied to these investments is FPL’s WACC. Mr. Smith’s attempt to  
228 misdirect the record in the present case by pointing to fuel reconciliation procedures in  
229 Florida, along with his asymmetric approach to the EIMA interest rate issue in the  
230 present case, should be rejected.

231 **Q. IIEC witness Mr. Gorman claims that you exaggerate by claiming a reconciliation**  
232 **balance of hundreds of millions of dollars (Gorman Reh. Dir., IIEC Ex. 3.0, 13:300-**  
233 **14:329). Is this statement correct?**

234 **A.** No. Perhaps Mr. Gorman misunderstood my testimony. In the referenced portions of my  
235 testimony, I was explaining that WACC should be used in the reconciliation because the  
236 EIMA investment is like any other utility investment and that it is large – “hundreds of  
237 millions of dollars of capital investment in 2013”. Hadaway Reh. Dir., ComEd Ex. 33.0,  
238 3:62. I also explained that WACC is the appropriate interest rate because the EIMA  
239 adjustment is “not simply the reconciliation of specific and limited costs that are adjusted  
240 frequently” (*id.*, 5:92-93), and that the EIMA adjustment “consists of delayed *costs of*  
241 *recovery* of hundreds of millions of dollars of *plant investment.*” *Id.*, 5:91-92 (emphasis  
242 added). My point was, and is, that EIMA involves very large amounts of capital  
243 investment (“hundreds of millions of dollars”) and that that investment should have the  
244 opportunity to fully earn ComEd’s authorized weighted average cost of capital. This

245 result will only occur if the WACC is used as the interest rate in the EIMA reconciliation  
246 process.

247 Q. **Does this conclude your rebuttal testimony on rehearing?**

248 A. Yes.