ComEd Ex. 37.0

STATE OF ILLINOIS

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Rebuttal Testimony on Rehearing of

SAMUEL C. HADAWAY

Principal,
FINANCO, Inc.

On Behalf of

Commonwealth Edison Company

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I. INTRODUCTION AND PURPOSE OF TESTIMONY

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

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

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

A. Yes.

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

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

In my responses, I will explain why Staff's and intervenors' reconciliation interest rate proposals are not adequate. Under EIMA, ComEd should be made whole (subject to the traditional prudence and reasonableness criteria), including the recovery of its cost of capital. If ComEd's actual delivery services costs, including those incurred to undertake the investments described in EIMA, are to be fully recovered as if there were no under- or over-recovery balances, ComEd's weighted average cost of capital ("WACC") must be the allowed interest rate. Otherwise, for over-recovery balances, ComEd's customers will be deprived of earning interest at ComEd's WACC, and for under-recovery balances, ComEd's shareholders will be deprived of an equity return on the capital that they provide. Contrary to Staff's and intervenors' positions, ComEd cannot obtain debt funding without equity support, and equity cannot be parsed into short-term and long-term holdings. Equity shareholders support all of ComEd's financing alternatives, and the rate of return for that financing cannot be differentiated by the maturity of the subject investment. Under these conditions, ComEd cannot be made whole unless it recovers its WACC on EIMA reconciliation balances.

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

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

[1] 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.

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

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

II. <u>RESPONSE TO ICC STAFF WITNESS ALAN PREGOZEN</u>

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

A. Mr. Pregozen admits that Staff's position during the initial phase of this case was based on "the mistaken understanding" of the EIMA reconciliation adjustment. Pregozen Reh. Dir., Staff Ex. 25.0, 2:35-3:50. He now acknowledges that the size of the EIMA reconciliation adjustment is a function of the same risk considerations as the preliminary EIMA revenue requirement and the final EIMA revenue requirement, both of which are subject to Commission determinations of prudence and reasonableness. Mr. Pregozen further states that since the reconciliation adjustment is combined with the revenue requirement (and the ROE collar adjustment) into a net revenue requirement, the reconciliation adjustment is also subject to the same degree of sales risk. Based on these considerations, Mr. Pregozen recommends that the interest rate in the reconciliation of EIMA under- and over-recovery balances should be a modified WACC.

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

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

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

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

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

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

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

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

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

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

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

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

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

[2] 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.

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

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

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

A. Other than Staff, the other parties continue to advocate a debt-only rate of return for EIMA under-recovery balances. None of these proposals would allow ComEd to be made whole in the EIMA process. AG/ARRP and IIEC would apparently have the Commission apply the same debt-only rate to both under- and over-recovery balances. CUB would have the Commission penalize ComEd with a debt-only rate for under-recovery and require ComEd to pay WACC on any over-recovery. The Commission, in its "hybrid" approach, using a blend of short- and long-term debt costs for both under-and over-recovery balances, clearly rejected these recommendations. The parties' reiteration of their prior positions should be similarly rejected.

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

A. AG/AARP witness Brosch states:

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

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

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

A. As part of a "hybrid" approach, Mr. Brosch's recommendation is poorly founded and, even if a marginal debt approach were used, the data he provides would not be the proper rates to use. Contrary to Mr. Brosch's recommendations, the Commission's approach in its hybrid calculation is an effort toward compromise. Mr. Brosch would simply have the compromise moved more nearly toward his position. Additionally, the rates reported in the Federal Reserve System ("Fed") H-15 Series, which Mr. Brosch provides, are not the rates for utility debt. While utility borrowing rates are reported by Moody's, along with industrial rates and the corporate rates provided by Mr. Brosch, the only Moody's series reported by the Fed are the corporate averages. While the differences are generally small between reported corporate and utility interest rates, Mr. Brosch's effort to a lower rate is neither properly conceived nor correctly supported. Therefore, Mr. Brosch's proposed modification to the Commission's hybrid approach should be rejected accordingly.

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

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

I have now also reviewed the 2010 FPL Order that Mr. Smith would have the Commission use as his proposed "model." There are two reasons why Mr. Smith's proposed "model" is not supported by the FPL Order. First, the portion of the Order on pages 94 and 95 that Mr. Smith cites is clearly dealing only with under- and over-recovered fuel cost balances. In that particular context, the Florida Commission concluded that an asymmetric interest rate approach was needed to incent FPL to reasonably project fuel costs so that customers are not over charged. However, Mr. Smith's attempt to broadly expand this narrowly applied asymmetric interest rate approach to the entirety of ComEd's reconciliation balances has absolutely no support and is inconsistent with EIMA. In Illinois, the EIMA framework specifically prescribes how rates are set for an annual period using historic data based on the most recently filed FERC Form 1 and capital projections for the current year. Moreover, with respect to the capital projections, EIMA itself describes many of the projects and identifies estimated expenditures, as well as provides for an extensive regulatory, planning and reporting structure that ensures careful and detailed annual planning and reporting. For example, as required by Section 16-108.5(b), ComEd filed its comprehensive Infrastructure Investment Plan with the Commission in early January 2012, which detailed the investments it proposed to make under EIMA. ComEd's AMI deployment is further governed by an AMI deployment plan that was filed with and approved by the Commission. *See Commonwealth Edison Co.*, ICC Docket No. 12-0298, Final Order (June 22, 2012). In sum, Mr. Smith has provided no justification that an asymmetric interest rate is either appropriate or needed in the unique context of EIMA.

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

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

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

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

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

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

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

A. Yes.