STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	)	
	)	
Formula rate tariff and charges authorized by	)	Docket No. 11-0721
Section 16-108.5 of the Public Utilities Act	)	On Rehearing

DIRECT TESTIMONY OF DAVID J. EFFRON
ON REHEARING
ON BEHALF OF
THE PEOPLE OF THE STATE OF ILLINOIS
AND
AARP

AG/AARP Exhibit 6.0

JULY 26, 2012

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. Have you previously submitted testimony in this docket?

A. Yes. I submitted direct testimony on January 13, 2012, marked as AG/AARP Exhibit 2.0 and rebuttal testimony on February 24, 2012 marked as AG/AARP Exhibit 4.0. My qualifications and experience are included with my direct testimony.

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

A. On June 22, 2012, the Commission granted rehearing of its conclusions on certain issues in its Order of May 29, 2012. I am presenting testimony on two of the issues that the Commission designated for rehearing: 1) the Method of Calculating Interest on Reconciliation Adjustments, and 2) the use of Average vs. Year-End Rate Base in Reconciliations.

1. Method of Calculating Interest on Reconciliation Adjustments

Q. What are the reconciliation adjustments on which interest is calculated?

A. Section 16-108.5(d)(1) of the Energy Infrastructure Modernization Act ("EIMA") provides that the formula rate filings shall "include a reconciliation of the revenue requirement that was in effect for the prior rate year (as set by the cost inputs for the prior rate year) with the actual revenue requirement for the prior rate year (as reflected in the applicable FERC Form 1 that reports the actual costs for the prior rate year). Any over-collection or under-collection indicated by such reconciliation shall be reflected as a credit against, or recovered as an additional charge to, respectively, with interest, the charges for the applicable rate year."

Although the EIMA specifies that any over-collection or under-collection will be credited or charged with interest, it does not specify the interest rate to be used or the method of calculating interest. In the open meeting of June 22, 2012, in granting rehearing on the methodology for calculating interest on reconciliation adjustments, the Commission stated that it wants "the record as complete as possible to gather further testimony and expertise from all parties in this case." Public Utility Special Open Meeting, June 22, 2012, Tr. 5-6.

Q. What element of the method for calculating interest on reconciliation adjustments are you addressing?

A. I am not addressing the appropriate interest rate to be used. I am addressing the base to which the interest should be applied.

Q. To what base should the approved interest rate be applied in calculating the interest on any over-collection or under-collection of the actual revenue requirement for a given year?

A. The interest rate should be applied to the net source of cash provided by any over-collection or to the net cash required by any under-collection.

Q. Is the net source of cash provided by an over-collection of the revenue requirement equal to the amount of the over-collection?

A. No. If there is an over-collection of the revenue requirement, that over-collection will be subject to income taxes. Thus, the net source of cash provided by an over-collection (that is, the net ratepayer supplied funds) is the amount of the over-collection net of applicable income taxes. This net source of cash is equal to the amount of the over-collection times the complement of the income tax rate. For example, if there is an over-collection of the revenue requirement of $1,000,000 and the combined income tax rate is 40%, then the net source of cash is $1,000,000*(1-40%), or $600,000.

Q. Is the net cash required by an under-collection of the revenue requirement equal to the amount of the under-collection?

A. No. If there is an under-collection of the revenue requirement, the under-collection reduces the income tax expense to the utility below what it would have been in the absence of the under-collection. Thus the net cash required by an under-collection (that is, the net cash required from investors) is the amount of the under-collection net of applicable income taxes. This net cash requirement is equal to the amount of the under-collection times the complement of the income tax rate. For example, if there is an under-collection of the revenue requirement of $1,000,000 and the combined income tax rate is 40%, then the net cash requirement is $1,000,000*(1-40%), or $600,000.

Q. How should the interest on over-collections or under-collections be calculated?

A. The over-collection or under-collection net of income taxes should be calculated by applying the complement of the income tax rate to the over or under collected balance. Interest should then be calculated by applying the approved interest rate to the over-collection or under-collection net of income taxes. For example, if there is a gross under-collected balance of $1,000,000, then the under-collected balance net of income taxes is $600,000, and that is the balance to which the applicable interest rate should be applied. The same end result can be achieved by applying the interest rate net of income taxes (i*(1-t), where i = the interest rate and t = the tax rate) to the under-collected balance of $1,000,000.

2. Average vs. Year-End Rate Base in Reconciliation

Q. Did the Commission also grant rehearing on the issue of whether the average rate base or year-end rate base should be used to calculate the actual revenue requirement in the reconciliation?

A. Yes. With regard to this issue, Commissioners stated that they "want to see it fleshed out like we did for the other issues" and that another look "with the goal of really fine-tuning and ensuring that we get it right" would be "beneficial for all of us." Public Utility Special Open Meeting, June 22, 2012, Tr. 9-10.

Q. Should the average rate base or year-end rate base be used to calculate the actual revenue requirement in the reconciliation?

A. The average rate base should be used. In short, the Commission did get it right in its Order of May 29, 2012.

Q. Why should the average rate base for the year rather than the end-of-year rate base be used in the calculation of the actual revenue requirement?

A. Very simply, the rate of return times the average rate base is the actual dollar cost to the Company of carrying the net capital investment necessary to provide delivery services for the year. The rate of return times the year-end rate base is not.

As can be seen on the Company's Schedule FR A-1, lines 12-14, the return on rate base is treated as a component of the total revenue requirement, just as expenses like salaries and wages, depreciation, and property taxes are. The return on rate base component (or "return requirement") of the total revenue requirement is calculated by multiplying the Company's weighted average cost of capital by its rate base. This converts the cost rate into a dollar cost, just as depreciation expense is calculated by multiplying the applicable depreciation rate by the relevant depreciable plant.

When a unit of plant is put into service in December of a given year, the Company does not incur a capital cost on that plant for the full twelve months of the year any more than it incurs depreciation expense on that plant for the whole year or any more than it incurs a year of payroll expense for an employee hired in December. The Company does not incur a full year of capital cost on plant that is put into service at the end of the year, and we should not make believe that it does.

The use of the average rate base to calculate the return requirement included in the revenue requirement is similar to calculating the return requirement for the year by calculating the return requirement for each of the twelve months and then summing those monthly return requirements. The return on the average rate base represents the actual dollar cost of capital incurred by the Company over the course of the year, and that is what should be included in the Company's total revenue requirement in the reconciliation.

Q. Do you agree with Ms. Houtsma that the asset balance that is used (average vs. end-of-year balance) and the interest rate that is applied are "two sides of a coin" in the determination of the actual reconciliation revenue requirement and reconciliation adjustment (ComEd Ex. 32.0, at 11:210-212)?

A. No. The two matters are entirely independent. The use of an average or year-end rate base in the calculation of the actual revenue requirement has nothing to do with whether the appropriate interest rate is the customer deposit rate, interest rate on long term debt, weighted average cost of capital, or any other interest rate.

Q. Do you agree with Ms. Houtsma's assertion that "the formula interest calculation on Schedule FR A-4 as it stands only provides in effect one-half year's interest for the rate year, which was done to address the fact that rate base and hence the revenue requirement grows over the course of the year" (Id. at 11:227-231)?

A. No. This is an especially egregious misrepresentation. The "half year's interest" in the formula interest calculation on Schedule FR A-4 has no relevance to whether the rate base grows (or, for that matter, decreases) over the course of the year (and also no relevance to whether the average rate base or year-end rate base is used in the reconciliation). The interest calculation on Schedule F-4 assumes that any under-collection is the same in each month, not that the monthly under-collection increases over the course of the year as it would if the pattern of monthly under-collections were driven by an increasing rate base. In fact, if the interest calculation on Schedule FR A-4 were done to address the fact that the revenue requirement grows over the course of the year, the under-collection would be lower in the earlier months and higher in the later months. Such a pattern of monthly under-collections would reduce the amount of interest for the year as compared the interest calculated pursuant to the assumption of equal monthly under-collections.

The formula interest calculation on Schedule FR A-4 only reflects one-half year's interest for the rate year because any under-collection (or over-collection) is experienced over the course of the year, not on day one of the year. For example, an under-recovery of $12,000,000 for a given year would not be outstanding for the entire year, and the recovery of a full year of interest on that amount would not be appropriate. Rather, the under-recovery is assumed to take place evenly over the course of the year, so that one-twelfth of the under-recovery ($1,000,000) would take place in January, one-twelfth in February, and so on for the remainder of the year. The calculation of the interest must reflect the fact that under-recovery accumulates over the year, rather than taking place instantaneously at the beginning of the year.

As a matter of mathematics, with the assumption that the monthly under-recoveries are equal, the interest calculated on the accumulating under-recovery over the course of the year will equal the annual interest rate times one-half of the total under-collection for the year. Thus, the interest recovery equals the interest on the average under-collected balance for the year, as it should. However, none of this bears any relationship to whether the rate base increases or decreases over the course of the year or whether the average rate base or year-end rate base is used in the reconciliation.

Q. Is Ms. Houtsma's characterization of the one-half year's interest on Schedule FR A-4 as an "assumption" accurate?

A. No. The one-half year's interest is not an "assumption." It is the amount of interest that results from applying the approved interest rate to the cumulative under-collected or over-collected balance for each month of the year, and it *is* appropriate when used in conjunction with a reconciliation revenue requirement based on an average rate base. The proper calculation of interest on an under-recovery or over-recovery is unrelated to the use of the average rate base to calculate the actual rate year revenue requirement. In no way, shape, or form does the method of calculating interest on Schedule FR A-4 "double count" the use of an average rate base in the calculation of the reconciliation revenue requirement.

Q. Do you agree with Ms. Houtsma that "the reconciliation process and adjustment should properly result in the financial equivalent of 'real time' recovery of costs in the rate year based on ComEd's actual reasonable and prudent costs in the rate year" (Id. at 11:223-225)?

A. Yes, completely. Unfortunately, the reconciliation process being advocated by Ms. Houtsma, which would rely on an end-of-year rate base to calculate the actual revenue requirement, does not accomplish the result that she describes. Ms. Houtsma would treat plant going into service in December as if it were in service for the whole year.

"Real time" recovery of costs over the course of the rate year allows the utility to earn a return on its investment in a given month on its actual investment for that month, not the investment as of the end of the year. Allowing a return on the average rate base for the year accomplishes the financial equivalent of "real time" recovery of costs in the rate year. Allowing a return on the year-end rate base does not, because it overstates costs when rate base increases over the course of the year.

Q. In the Company's reconciliation Docket No 12-0321, the average rate base is greater than the year-end rate base in 2011. Does the use of the average rate base to calculate the actual revenue requirement in 2011 confer a windfall on the Company?

A. No. It would do no more than allow the Company to recover the cost of capital that it actually incurred. Conversely, the use of an average rate base to calculate the actual revenue requirement does not cause the Company to under-recover its actual cost of capital in those years when the average rate base is less than the year-end rate base. However, the use of the year-end rate base to calculate the actual revenue requirement when the average rate base is less than the year-end rate base would confer a windfall on the Company, because the cost of capital recovered through the reconciliation process would exceed the cost of capital actually incurred.

Q. If the year-end rate base were to be used to calculate the actual revenue requirement in the reconciliation process, is there a mechanism available to limit the windfall to the Company?

A. Yes. On Schedule FR A-3 (the Return on Equity (ROE) Collar Computation), the DS Rate Base on Line 1 should be the average rate base for the year, so that the return on equity is calculated based on the average common equity balance for the year. The *only* appropriate method to calculate the actual earned rate of return on common equity is to divide the net income available for common equity by the average balance of common equity for the period under review. Although this mechanism would limit the windfall to the Company from the use of a year-end rate base that is greater than the actual average rate base, it would not eliminate the windfall. However, use of the average common equity balance in the ROE calculation would at least avoid having the Company recover additional revenues when its actual earned ROE is within the collar range and would also require the Company to refund at least a portion of the excess revenue when the windfall results in a return on equity in excess of the top of the collar range.

Q. Does this conclude your direct testimony on rehearing?

A. Yes.

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COMMONWEALTH EDISON COMPANY	)	
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Tariffs and charges submitted pursuant to	)	Docket No. 11-0721
Section 16-108.5 of the Public Utilities Act	)	On Rehearing

AFFIDAVIT OF DAVID J. EFFRON

DAVID J. EFFRON, being duly sworn or affirmed, states as follows:

1. My name is David J. Effron. I am a Certified Public Accountant and consultant specializing in utility regulation. My business address is 12 Pond Path, North Hampton, New Hampshire, 03862.

2. On July 26, 2012, my Direct testimony on Rehearing, identified as AG/AARP Exhibit 6.0, was filed on e-Docket in this proceeding.

3. On Page 6, at Line 135, the reference to "Schedule F-4" should be to "Schedule FR A-4."

4. I have no other corrections or changes to my Direct Testimony on Rehearing, AG/AARP Ex. 6.0. If asked under oath or affirmation the questions posed in AG/AARP Exhibit 6.0, I would provide the answers reflected in that exhibit.

5. The testimony identified above is true and correct to the best of my knowledge and belief. Under penalties as provided by law pursuant to Section 1-109 of the Illinois Code of Civil Procedure, the undersigned certifies that the statements set forth in this instrument are true and correct, except as to matters therein stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he verily believes the same to be true.

Further Affiant sayeth not.

David J. Effron

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