STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY Annual formula rate update and revenue requirement reconciliation authorized by Section 16-108.5 of the Public Utilities Act.	)))))	Docket No. 12-0321

DIRECT TESTIMONY OF MICHAEL L. BROSCH

ON BEHALF OF THE

PEOPLE OF THE STATE OF ILLINOIS AND AARP

DATED JULY 17, 2012

DIRECT TESTIMONY OF MICHAEL L. BROSCH

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EXHIBIT LIST

I. INTRODUCTION / SUMMARY

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is PO Box 481934, Kansas City, Missouri 64148-1934.

Q. By whom are you employed and in what capacity?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to regulatory projects for utility regulation clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses, utility reorganization analyses and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the People of the State of Illinois represented by the Attorney General, ("Attorney General" or "AG") and AARP (formerly the American Association of Retired Persons).

Q. Will you summarize your educational background and professional experience in the field of utility regulation?

A. Yes. AG/AARP Exhibit No. 1.1 is a summary of my education and professional qualifications. I have testified before utility regulatory agencies in Arizona, Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio, Oklahoma, Texas, Utah, Washington, and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities. A listing of my previous testimonies in utility regulatory proceedings is set forth in AG/AARP Exhibit No. 1.2. In Illinois, I have testified in several major proceedings before the Illinois Commerce Commission ("the Commission" or "the ICC"). These include Peoples Gas rate cases in Docket Nos. 90-0007 and 07-0241, North Shore Gas Company Docket No. 92-0242, Illinois Bell Telephone Company in Docket Nos. 92-0448 and 92-0239, ComEd rate case Docket Nos. 07-0566 and 10-0467 and Ameren Illinois Utilities Docket Nos. 07-0585 through 07-0590. I also testified in ComEd Docket No. 09-0263 involving the Advanced Metering Infrastructure Pilot Program and Associated Tariffs and in response to ComEd's alternative regulation proposal that was filed in Docket No. 10-0527. I provided testimony in the first ComEd formula rate case, Docket No. 11-0721 and in the two Ameren Illinois Utilities formula rate filings in Docket Nos. 12-0001 and 12-0293.

Q. What is the purpose of your testimony in this docket?

A. My testimony is responsive to the second formula rate filing of Commonwealth Edison Company ("ComEd" or "Company") in this Docket that is captioned as "Annual formula rate update and revenue requirement reconciliation authorized by Section16-108.5 of the Public Utilities Act." The Commission has established formula ratemaking policies and protocols for ComEd in its Order dated May 29, 2012. In response to the Commission's Order, on June 13, 2012 ComEd submitted a compliance filing that revised its asserted prospective revenue requirement and 2011 reconciliation calculations. My testimony proposes a single new ratemaking adjustment to remove from revenue requirements certain Exelon/Constellation merger-related expenses that were recorded by ComEd in 2011. My testimony also sponsors excerpts from my Direct Testimony in Docket No. 11-0721 regarding the average reconciliation rate base and reconciliation interest issues that are pending rehearing in Docket No. 11-0721, so as to preserve the record on these issues in Docket No. 11-0321.

Q. Please summarize the recommendations that are set forth in your testimony.

A. In 2011, ComEd's parent company, Exelon Corporation, negotiated and announced an agreement to merge with Constellation Energy, another public utility holding company headquartered in Baltimore, Maryland. ComEd identified about $8 million of expenses in 2011 that it included in its prospective and reconciliation revenue requirements. I explain in my testimony several reasons why these expenses should not be borne by ComEd's ratepayers and propose an accounting adjustment to exclude these expenses in determining the Company's formula revenue requirement. Beyond this single new adjustment, I am sponsoring excerpts from my Direct Testimony in Docket No. 11-0721 that explain why an average rate base should be used to calculate ComEd's reconciliation revenue requirement and why a short-term debt interest rate should be applied to the net of deferred income tax balance of any over- or under-recoveries of ComEd's revenue requirement when reconciliation calculations are performed.

Q. What information have you relied upon in formulating your recommendations?

A. I have relied upon ComEd's pre-filed testimony and exhibits in this Docket, including the June 13 compliance filing in response to the Commission's May 29 Order in Docket No. 11-0721. I also have relied upon the Company's responses to data requests submitted by Staff and the AG and a copy of Public Act Numbers 97-0616 and 97-0646, adding 220 ILCS 5/16-108.5 to the Public Utilities Act, that was provided to me by AG counsel. Finally, I also rely upon my prior experience with regulation of public utilities over the past 33 years, including significant experience in Illinois and with alternative forms of regulation for public utilities.

Q. Have you prepared an accounting schedule to summarize the merger expense adjustment being proposed in your testimony?

A. Yes. AG/AARP Exhibit 1.3 sets forth the revenue requirement adjustment being proposed in my testimony.

Q. ComEd has revised its revenue requirement calculations, as compared to its original filing in this docket, in apparent compliance with the Commission's May 29, 2012 Order in Docket No. 11-0721. Have you examined the Company's compliance filing in sufficient detail to identify and develop all ratemaking adjustments that may be needed to determine just and reasonable rates for ComEd?

A. No. With available time and resources, Mr. Effron and I have attempted to verify the accuracy and completeness of the Company's filing and its compliance with the May 29 Order in Docket No. 11-0721. However, our work should be viewed as cumulative with any issues and adjustments raised by Staff and other parties because of the volume of information to be examined and the limited time available to respond to the Company's voluminous filing.

II. MERGER EXPENSES.

Q. Is ComEd seeking to recover merger-related expenses as part of its asserted 2011 revenue requirements?

A. Yes. According to ComEd's corrected response to Data Request No. AG 2.03, a total of $8.1 million of merger-related costs were recorded as expense in 2011, of which $7.2 million is included in jurisdictional expenses and the Company's revenue requirement. I have included a copy of the original and corrected version of this response as AG/AARP Exhibit 1.4.

Q. Do these expenses relate to the recently completed merger of Exelon Corporation with Constellation Energy Group?

A. Yes. From October of 2010 and continuing into early 2011, Exelon and Constellation executives met at different times to discuss a possible business combination and the potential strategic benefits of such a merger. These discussions expanded in January 2011 with the execution of mutual confidentiality and joint defense agreements, the retention of investment banking advisors and counsel and commencement of the sharing of due diligence information. During late January 2011, each of the companies retained additional outside professional advisors, including consultants, accountants and communications firms, to assist management of each company with the evaluation of issues and negotiation of terms. After a series of management and board meetings at both companies continuing into the spring of 2011, a merger agreement was executed on April 28, 2011. The merger was approved by Maryland regulators and the Federal Energy Regulatory Commission ("FERC") and was formally completed on March 12, 2012. I have attached as AG/AARP Exhibit 1.5 a copy of a summary fact sheet regarding the merger.

Q. Why have you proposed to exclude the 2011 merger-related expenses that were recorded by ComEd?

A. The expenses incurred by ComEd in connection with the Exelon/Constellation merger should not be included in determining formula rates for the following reasons:

1. Exelon/Constellation merger expenses are not necessary or reasonable costs incurred to operate the regulated utility, but rather are parent company ownership costs incurred by Exelon to expand and manage its portfolio of businesses.

2. Recovery of parent company merger expenses from utility customers improperly would shift the risks of merger integration from shareholders to ratepayers.

3. The Exelon/Constellation merger is unrelated to ComEd operations and was never brought to the Commission for approval under Section 7-204 of the Public Utilities Act. Accordingly, the Commission has never had the opportunity to evaluate the treatment of merger-related costs and any potential cost savings for ratemaking purposes.

4. ComEd has not demonstrated that these merger expenses are reasonable, necessary or prudently incurred ComEd utility operations expenses.

5. Any claimed future merger synergies or cost savings that may be asserted as justification for immediate merger expense recovery from ratepayers are speculative, highly uncertain and are nearly impossible to accurately quantify.

Q. How does the Company explain its proposed inclusion of merger-related expenses within the asserted revenue requirement for ComEd?

A. According to ComEd's response to AG Data Request 2.03:

> The non-incremental (internal) integration costs incurred by ComEd and Exelon Business Services Company ("BSC") are primarily payroll related costs for employees engaged in merger integration activities. These activities focused on the combination of shared services functions including IT, Supply, Finance, Human Resources, Payroll and Accounts Payable processing, Legal, etc. External integration costs included external consultants and other expertise as needed. Such integration efforts are necessary to plan for the future shared services organization, consolidate operations of two separate companies, standardize processes and systems, adopt best practices, and eliminate duplicate positions to obtain future economies of scale and associated synergy savings. The expenses represent the upfront costs of achieving savings from the consolidation of the two organizations, which will more than offset the upfront costs. Because these savings will be included in delivery service rates in future years, the upfront costs represent prudently incurred delivery service costs.

Thus, it would appear that ComEd is seeking cost recovery for the ComEd share of allocated merger integration costs based on the unsubstantiated premise that eventually sufficient merger synergies and cost savings in the future will be "achieved" from the consolidation of Exelon operations with the acquired Constellation businesses in sufficient magnitude to pay for incremental merger costs being incurred now.

Q. Has the Company provided any evidence to support its premise that merger savings will eventually be realized by ComEd in sufficient amounts to pay back the merger integration costs?

A. No. The Company's direct testimony did not address the merger, anticipated merger synergies or rate recovery of merger-related incurred expenses. At the time this testimony was being prepared, AG discovery was outstanding seeking additional information regarding the costs incurred by ComEd or allocated to it from affiliated companies.

Q. Did the Maryland Public Service Commission accept the merger synergies studies produced by Exelon and Constellation and permit unrestricted recovery of merger expenses in future Baltimore Gas & Electric ("BG&E") rate cases?

A. No. Order No. 84698 issued by the Public Service Commission of Maryland on February 17, 2012 indicated an intention to attempt an accounting for "merger-related savings" in future rate cases, but found the applicants' projected merger synergies to be inadequate to qualify as a public interest benefit:

> The Applicants have presented extensive evidence as to various benefits that will inure indirectly to all BGE ratepayers in the form of synergy savings, the sharing of "best practices," and lowering BGE's costs for "shared services." Most significantly, the Applicants estimate that BGE ratepayers will realize, through rate reductions or postponed rate increases, $87.3 million in benefits based upon merger-related synergy savings. The Applicants quantified this amount through a consulting firm's analysis that combined company-wide savings and then allocated those savings among the Applicants' competitive and regulated business segments, including BGE. Staff and MEA even suggested that these savings might be under-stated, highlighting the need for this Commission to ensure that BGE ratepayers actually receive the full extent of any merger-related savings.
>
> We do not discount the Applicants' firm belief that such benefits will ultimately accrue to ratepayers, and we will require BGE to fully account for all merger-related savings in its next rate case. However, projections of benefits through synergies, "shared services" or "best practices" are inherently speculative and, to the extent they materialize, will likely benefit ratepayers only as "forgone requests for rate relief," which we have previously held to be too intangible to qualify as a benefit under PUA § 6-105. Order 9271, p.90

The Maryland Order imposed 40 very detailed conditions upon approval of the transaction that were designed to ensure that the merger would cause no harm to ratepayers and would provide certain, specific and measurable benefits to ratepayers, including the following provisions to address concerns about changes in corporate cost allocations, merger cost recovery and claimed merger savings:

> 23) Shared Services Comparison: As part of its Cost Allocation Manual filings for 2014, 2015, and 2016, BGE shall provide the Commission with a side-by-side comparison, by function, of (i) its post-Merger shared services costs for 2013, 2014, and 2015 and (ii) its equivalent pre-Merger functional costs for 2011.
>
> 24) Tracking Charges for Services Provided to BGE: In the first quarter after the first full calendar year following consummation of the Merger, BGE shall prepare and file with the Commission a side-by-side comparison of the corporate component of Exelon's service company charges to BGE for that full calendar year with the corporate component of CEG's 2011 charges to BGE.
>
> 25) Tracking Merger Savings: BGE shall track Merger savings and account for such savings in its next electric rate proceeding and gas rate proceeding.
>
> 26) No Transaction Cost Recovery: BGE shall not seek recovery in rates of: (i) any acquisition premium or "goodwill" associated with the Merger; or (ii) transaction costs incurred in connection with the Merger by Applicants or their subsidiaries. The categories of "transaction costs" are the following incurred with respect to consummation of the Merger: (i) consultant, investment banker, and legal fees; (ii) change in control or retention payments; and (iii) costs associated with the shareholder meetings and proxy statement/registration statements related to the Merger.
>
> 27) No Relocation of BGE Employees: Exelon shall not, without prior Commission approval, relocate any BGE employees to the Baltimore CEG Headquarters.
>
> 28) Neutral Merger Accounting: Exelon and BGE shall ensure that Merger accounting is rate-neutral for BGE's customers. Exelon and BGE shall ensure that any accounting treatments associated with Merger accounting do not affect rates charged to BGE customers or the calculation of BGE's equity level pursuant to Commission Order No. 82986 in Case No. 9173.

Q. Beyond these conditions with respect to merger costs and planned tracking of potential merger synergy savings, did the Maryland PSC demand more

tangible and immediate benefits for BG&E ratepayers as a condition of merger approval?

A. Yes. In a category of conditions captioned, "***Certain, Specific and Measurable Benefits to Ratepayers,***" the Maryland Order approved a $100 per BG&E residential customer direct rate credit after the merger was completed and required funding of incremental energy efficiency and low income energy assistance for BGE customers:

> 33) Residential Rate Credit: Exelon shall, within 90 days after consummation of the Merger, fund a one-time distribution of $100 per BGE residential customer in direct rate credits, which shall be credited within 90 days after consummation of the Merger, and amount to approximately $112 million, and which shall not be recoverable in rates. The credits will be provided for all residential customers of record with active accounts on a specified date following the Merger. Residential customers served under both a residential electric schedule and a residential gas schedule will receive one credit.
>
> 34) Customer Investment Fund: Exelon shall invest $113.5 million over a three-year period in an interest bearing Customer Investment Fund subsequent to the consummation of the Merger. Funds shall be credited in equal installments, with the first installment credited within 90 days after consummation of the Merger, or as otherwise approved by the Commission, and shall not be recoverable in rates. This investment shall be directed to a fund for the purpose of providing long-term benefits in the form of energy efficiency and low-income energy assistance to BGE customers. These funds shall be directed towards the goals set forth in this Order, which we will specify after further proceedings to determine their most effective use.

The imposition of merger approval conditions that immediately and tangibly benefit customers of BG&E, in addition to restrictions placed upon merger cost recovery in Maryland, is an indication of that Commission's concerns regarding claimed merger savings being sufficient to offset merger costs.

Q. **How do the merger approval conditions in Maryland compare to ComEd's proposed treatment of the Constellation merger expenses in Illinois?**

A. ComEd proposes to include any merger costs it may incur, either directly or through allocations from affiliates, for recovery through formula rates. Then, in the event any synergies or cost savings are realized in the future by ComEd, they would also flow through future annual formula rate calculations.

Q. Did ComEd, Exelon or Constellation ever file a petition for approval of a reorganization/merger under Section 7-204 of the Public Utilities Act in Illinois?

A. No, they did not.

Q. Has the Commission previously allowed recovery of merger-related costs in determining the revenue requirements of Illinois utilities?

A. Yes, but only within the context of a finding under Section 7-204 of the Act that the merger was in the public interest.

Q. Is there any certainty that large utility mergers will actually produce merger savings for ratepayers of the regulated subsidiaries of merged holding companies?

A. The realization of merger savings depends on many factors, among them whether the post-merger utility is successful in its efforts to: 1) realign staffing with retention and severance programs, 2) relocate personnel and consolidate management, 3) integrate complex back-office automated systems, 4) evaluate and standardize disparate methods of operation, and 5) implement all these and other required changes without disrupting service continuity. Generally speaking, there are considerable complexities, costs and risks associated with combining large business organizations, reorganizing management structures and integrating the many complex automated systems that are used to support the businesses. In the Joint

Proxy issued by Exelon and Constellation in connection with merger, these risks were disclosed in the following way:

> • *Transaction Costs*. Substantial costs will be incurred in connection with the merger, including the costs of integrating the businesses of Exelon and Constellation and the transaction expenses arising from the merger.
>
> • *Integration*. There are challenges inherent in the combination of two business enterprises of the size and scope of Exelon and Constellation, including the possibility the anticipated cost savings and synergies and other benefits sought to be obtained from the merger might not be achieved in the time frame contemplated or at all and the possibility that cost savings and synergies may not be able to be obtained across the combined nuclear business given Constellation's partial ownership of its nuclear facilities.
>
> • *Personnel*. The potential for business uncertainty pending completion of the merger, including uncertainty regarding the level and impact of reductions in headcount as a means to achieve transaction-related synergies, could have an adverse impact on the ability to attract, retain and motivate key personnel until the merger is completed.

These merger-related risks and costs, under the ratemaking approach used by ComEd, would be passed through to Illinois ratepayers as a result of annual, formula ratemaking despite the facts that the merger does not directly involve ComEd's distribution operations and the Commission has never made any specific evaluation of whether merger savings can be expected by ComEd and should be explicitly recognized in rates for distribution operations.

Q. Was the Exelon/Constellation merger driven solely or primarily by senior managements' interest in achieving administrative cost synergies?

A. No. According to the Joint Proxy dated October 11, 2011, the Strategic Considerations listed as considered by the Exelon board of directors as the "strategic rationale for the merger" included a number of factors other than regulated utility operating efficiencies and cost savings. I have included at AG/AARP Exhibit

1.6.excerpts from the Joint Proxy to illustrate the focus upon retail energy marketing, increased business scale and scope, business risk reduction due to generation fleet diversification, regulatory diversity and the shared strategic vision of management. There is little opportunity for operational synergies to be realized by ComEd, given that Baltimore Gas & Electric is quite remote from the ComEd service territory.

Q. How would ComEd's proposed ratemaking treatment of merger-related expenses impact ratepayers?

A. The utility's proposed full, immediate and automatic recovery of merger expenses would shift all risks and costs associated with merger integration from Exelon shareholders to Illinois ratepayers. As noted above, ComEd has made no showing that merger synergies will eventually be realized in sufficient magnitude to offset the costs that are incurred to integrate the Constellation and Exelon business units. Further, a perverse incentive to allocate costs to Illinois may result if automatic and immediate recovery of merger costs from Illinois ratepayers is allowed, when the Maryland Commission has rejected recovery of merger costs from consumers and has imposed rate-neutral accounting requirements that do not apply in Illinois. In addition, the basis of the planned attribution of merger costs to ComEd Illinois in relation to the size of claimed or potential savings is of great concern given that a substantial portion of the merged business involves non-regulated generation operations and utility operations in Maryland that have no contiguous boundaries or apparent synergies with ComEd's Illinois distribution operations.

Q. When a utility holding company management elects to change its portfolio of business holdings through mergers or divestitures, should the costs of such

oversee, manage and expand its portfolio of investment holdings. The post-merger Exelon holding company should absorb its comparable "ownership" costs out of earnings, rather than attribute such costs to its regulated utility subsidiaries.

Q. What specific adjustments should be made to the 2011 revenue requirement to remove the merger-related expenses ComEd has recorded?

A. I recommend that the $7,213,346 of jurisdictional expenses set forth in AG 2.03 Corrected Attachment 1 (AG/AARP Exhibit 1.3) be removed from 2011 expenses included in determining the prospective revenue requirement, as well as in the reconciliation and collar computations. AG/AARP Exhibit No. 1.3 sets forth the resulting adjustment that is required. The $17,290 of capitalized merger costs identified in this AG 2.03 Attachment 1 should be treated as an adjustment reducing ComEd's rate base computations.

Q. Will a similar adjustment be required in future ComEd formula rate case filings?

A. Yes. The merger transaction was completed in March of 2012. Merger transaction and integration efforts and the associated costs are therefore likely to be concentrated within calendar year 2012 and should be the subject to Commission attention in future formula rate case proceedings.

III. DOCKET NO. 11-0721 REHEARING ISSUES.

1. <u>Use of an Average Rate Base for Reconciliation Purposes</u>

Q. The Commission has approved rehearing of several issues addressed in Docket No. 11-0721, the first ComEd formula rate case. Are you repeating the

changes be attributed to its regulated utility subsidiaries and become part of the regulated utility's revenue requirements?

A. No. Merger and divestiture activity at the utility parent company level is an investment portfolio management activity that should be viewed as an "ownership" cost, rather than a utility operations expense. Outside of regulation, non-utility parent/holding companies serving competitive businesses would have no opportunity to change the market prices of their products and services in order to directly recover merger transaction and integration expenses. Instead, the costs incurred by the parent company to manage its portfolio of controlled subsidiary businesses must be absorbed out of investment income earned from such investments. Utility subsidiaries of such parent/holding companies that include substantial non-regulated generation operations and out-of-state operations should not be allowed to allocate and recover parent company merger transaction and integration costs simply because of the opportunities created under formula ratemaking in Illinois.

Q. Does a mutual fund, hedge fund or private equity investor have any opportunity to recover the costs of portfolio management from the customers of companies that are within the portfolio through formula driven price increases?

A. Not normally. The transaction and integration costs incurred by an institutional investor are normally absorbed by the parent/owner and funded out of the investment income achieved while holding the investment or through gains experienced when disposing of the investment. For example, a mutual fund must charge a management or other fee to its investors to recover costs it incurs to

testimony you provided in that Docket with regard the need to utilize an average rate base in calculating the reconciliation revenue requirement?

A. Yes. I have included as AG/AARP Exhibit 1.7 excerpts from my Direct Testimony in Docket No. 11-0721 addressing that issue. Pending any modification of its May 29, 2012 Order, the Commission's decision to adopt use of an average rate base in reconciliation proceedings remains applicable here. Unless and until the Commission rules otherwise, the reconciliation rates should reflect use of an average rate base, rather than a year-end rate base, for all of the reasons stated in my testimony in Docket No. 11-0721. I am incorporating by reference that testimony, as attached hereto as AG/AARP Ex. 1.7.

2. Reconciliation Interest Rate

Q. **How did the Commission treat the issue of establishing an interest rate for reconciliation balances and credits under formula rates?**

A. In its Order in Docket 11-0721, the Commission adopted a 3.42% interest rate on the reconciliation balance, which it described a "the weighted costs of short-term and long-term debt [and which] exclude[d] the weighted cost of common equity."[1] However, the Commission later granted rehearing on this issue.

Q. **Is the interest rate for the reconciliation balances and credits under formula rates relevant in this docket?**

A. Yes. However, the interest rate is still under consideration by the Commission due to the pending rehearing. I do not know how or when the Commission will resolve this issue, and address it here in case it is not resolved in Docket 11-0721 prior to the final order in this docket.

[1] Docket 11-0721, Order at 166.

Q. Have you also included excerpts of your previous Direct Testimony from Docket No. 11-0721 regarding the appropriate interest rate to be applied in calculating reconciliation refunds and surcharges?

A. Yes. AG/AARP Exhibit 1.8 contains a copy of the reconciliation interest rate Direct Testimony that I sponsored in Docket No. 11-0721. I hereby incorporate that testimony by reference in this docket.

Q. In its Order dated May 29, 2012 in Docket No. 11-0721, did the Commission address your proposal that a net-of income tax method be used to apply interest to reconciliation balances?

A. At page 167 of its Order, the Commission stated, "The Commission declines to adopt this recommendation. ComEd contends that this recommendation does not provide ComEd with cash. AG/AARP provide little information establishing that this procedure is within generally accepted accounting procedures, or that it would be of benefit to ComEd or to ratepayers."

Q. Does ComEd record a regulatory asset or liability associated with the reconciliation of its annual revenue requirement on its books?

A. Yes. The revenue requirement amount owed to, or recoverable from ratepayers is recorded by ComEd as a regulatory asset or liability. Statement of Financial Accounting Standards 71 ("SFAS 71")[2] recognizes that a unique consideration is introduced by rate regulation that may impact the relationship of costs and revenues. Regulators sometimes include incurred costs in the revenue requirement in a period other than the period in which the costs would be charged to expense by an

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[2] Accounting Standards have recently been codified with legacy SFAS 71 now included within Accounting Standards Codification ("ASC") 840 and 980.

unregulated enterprise and that procedure can create new regulatory assets (future cash inflows from the rate-making process), can reduce assets (reductions of future cash inflows from the rate-making process), or may create new regulatory liabilities (future cash outflows that will result from the rate-making process). Thus, under SFAS 71, a regulated utility is required to capitalize a cost as a regulatory asset or recognize an obligation as a regulatory liability, if it is probable that through the ratemaking process there will be a corresponding increase or decrease in future revenues.

Q. Has ComEd recorded regulatory asset/liability balances pursuant to SFAS 71 because of the formula rate case reconciliation procedures?

A. Yes. In its response to Data Request No. AG 3.01, ComEd indicated that it had recorded a Regulatory Asset balance of $29,005,000 as shown in its FERC Form 1, page 232.1, Line 9, "which represents the estimated under-recovery of ComEd's revenue requirement in 2011 (reconciliation) as of December 31, 2011, determined using the formula rate methodology allowed under the Energy Infrastructure Modernization Act ("EIMA")." This estimated amount was later changed after ComEd evaluated changes required in the Commission May 29 Order in Docket No. 11-0721, but a regulatory asset/liability balance is required to be recognized on the Company's books in accordance with Generally Accepted Accounting Principles ("GAAP") to properly account for the effects of regulation on the Company's accrual-basis revenues and earnings. I have included a copy of this data request response as AG/AARP Exhibit 1.9.

Q. Does ComEd record Accumulated Deferred Income Taxes ("ADIT") associated with its formula rate regulatory asset/liability balance?

A. Yes. As indicated in the response to AG 3.01, the per books ADIT balance associated with the $29 million that ComEd estimated it would collect through reconciliation was a credit of $11.944 million.[3] In this response, ComEd stated, "The deferred income tax balance is treated as non-jurisdictional because the regulatory asset is not included in rate base."

Q. What do the deferred taxes associated with the reconciliation regulatory asset or liability represent?

A. The recorded ADIT amount associated with the EIMA reconciliation regulatory asset or liability represents the estimated income tax cash flow savings arising from the book/tax timing difference between when deductible expenses are incurred and when the related taxable revenues will be collected as a result of the reconciliation process. Using ComEd's accounting estimates mentioned in the AG 3.01 response, the Company will defer the income tax recognition of about $29 million of reconciliation revenues to be recovered in 2013 as a result of the fact that Section 16-108.5 allows it to retroactively reconcile its revenue requirement. All of the related tax deductible *expenses* and other costs incurred in 2011 would be recognized on the 2011 Exelon income tax return, creating a timing difference and an associated ADIT credit balance of $11.944 million, which represents non-investor funds available to the utility from income tax deferrals.

Q. Is the Company correct in excluding from rate base the recorded ADIT balances associated with the reconciliation regulatory asset simply because, "the regulatory asset is not included in rate base," as noted in AG 3.01?

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[3] See ComEd Ex. 10.3 WP 4, page 4 of 4 at line 95.

A. No. There is more to this story. The income tax deferral results in ComEd having non-investor, ADIT funds available to it prior to final recovery of the full reconciliation amount, and these non-investor funds must be recognized somewhere, either in calculating rate base or in calculating the interest applicable to the reconciliation balance. The rate base exclusion of ADIT proposed by ComEd is only reasonable if the interest accrued on the reconciliation balance is applied to a net-of income tax balance, as I recommended in Docket No. 11-0721.

Q. In Docket No. 11-0721, ComEd argues that the recorded ADIT liability does not provide a source of cash to ComEd. Do the recorded ADIT amounts associated with reconciliation regulatory asset/liability balances provide ComEd with cash?

A. Yes. When the collection of taxable revenues lags behind the deduction of expenses on ComEd/Exelon income tax returns, there is a cash flow benefit to the Company because the Company retains revenues that would otherwise be used to pay income taxes. Alternatively, if ComEd's collection of taxable revenues occurs more rapidly than deductible expenses are incurred, the Company's income taxes become payable sooner and cash flow is again impacted. While the cash flows of actually collecting or refunding the reconciliation balances are delayed pending reconciliation, interest is accrued throughout the collection or recovery period to compensate for the timing of such cash flows. It is important to recognize the timing of both the reconciliation revenues and the related income taxes to fully account for all of the cash flows associated with formula ratemaking.

Q. The Commission's Order in Docket No. 11-0721 indicates a concern that recognition of formula ratemaking-related ADIT may not comply with

Generally Accepted Accounting Principles. Does ComEd maintain its books in compliance with Generally Accepted Accounting Principles?

A. Yes. The Company's auditors have certified that ComEd and Exelon financial accounting is in compliance with GAAP.[4] There is no dispute that ComEd maintains its books in accordance with GAAP or that ADIT must be recorded in connection with the reconciliation regulatory asset/liability balance because the reconciliation process creates a book/tax timing difference. The only real dispute is how to treat the ADIT arising from the reconciliation process for ratemaking purposes. GAAP does not provide any direction to regulators about which ADIT balances are jurisdictional or how ADIT balances should be treated in formula ratemaking proceedings. ComEd would prefer to retain these ADIT benefits for shareholders by excluding them from rate base and also ignoring them when applying interest to the reconciliation balance to be charged or credited to customers. ComEd's approach, would allow the Company to collect more than the actual costs associated with the reconciliation balance by ignoring the tax timing differences recognized by GAAP and quantified as \$11.944 million.[5] The more equitable approach is to <u>not</u> ignore income tax effects, but to instead apply interest on a net of income tax basis when calculating charges or credits to customers on ComEd Ex. 10.2, Schedule FR A-4. This was the approach I recommended in Docket No. 11-0721.

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4 In its Annual Report for 2011 at page 41, Exelon states, "Our independent registered public accounting firm, PricewaterhouseCoopers LLP (PwC), issued a report dated Feb. 9, 2012, on its integrated audit of our consolidated financial statements and our internal control over financial reporting. In its report PwC expressed an unqualified opinion that those consolidated financial statements present fairly, in all material respects, the financial position of Exelon Corporation and its subsidiaries at Dec. 31, 2011, and 2010, and the results of their operations and their cash flows for each of the three years in the period ended Dec. 31, 2011, in conformity with accounting principles generally accepted in the United States of America."

5 See ComEd Ex. 10.3 WP 4, page 4 of 4 at line 95.

Q. After the issuance of the Commission May 29 Order in Docket No. 11-0721, has the $29 million regulatory asset now become a large regulatory liability to be returned to customers in the Company's compliance filing?

A. Yes. Under circumstances involving a refund to ratepayers, the application of the reconciliation interest rate to a net of tax basis would serve to decrease the Company's refund obligation (and increase the reconciliation revenue requirement), by reducing total interest amounts accrued. However, regardless of the immediate ratepayer/shareholder impact, a complete accounting for reconciliation interest requires that the related income tax deferral effects not be ignored.

Q. What do you recommend regarding reconciliation interest calculations?

A. I continue to recommend that the interest calculations appearing at Schedule FR A-4 of the formula rate template be modified to account for ADIT associated with the reconciliation balance. Although it would also be correct to remove non-investor supplied funds represented by ADITs from the reconciliation balance subject to interest, given the structure of Schedule FR A-4, where the nominal amount of the "variance" is amortized over the twelve months of "Yr X," the most practical way to account for ADIT effects is to proportionately reduce the allowed interest rate to a net of income tax equivalent rate. This can be accomplished by multiplying the Commission-approved interest rate at line 4 by the inverse of the composite income tax rate on a new line 5, to determine an equivalent net of income tax rate on a new line 6. Mathematically, using the values in ComEd Ex. 10.2 at Schedule FR A-4, this would appear as follows:

Ln	Description	Source	Amounts
4	Annual Interest Rate	ICC Order Dkt 11-0721	3.42%
5	Net of Tax Factor	1 – 41.175% (Sch FR C-4, line 4)	.58825
6	Net of Tax Rate	Line 4 * Line 5	2.01%

Factoring the allowed Annual Interest Rate to reflect the tax impact of the delayed revenue recovery and the ADIT arising from the reconciliation process recognizes the effect of the extra cash retained by the Company due to the income tax deferrals reflected in the ADIT balance and is a more precise accounting for such income tax effects. Another benefit of my recommended approach is that it accurately and effectively matches the ADIT balance to the ultimately approved reconciliation balance, correcting for any imprecise estimates that may have been recorded as ADIT balances on the Company's books. This approach captures the actual cost of the reconciliation to the Company and is superior to simply ignoring the effect of the tax timing difference by excluding the recorded ADIT balances from rate base as ComEd has proposed.

Q. If the reconciliation interest rate is modified by future Commission order, should the "Net of Tax Factor" shown in your table be applied to any revised interest rate used in the future?

A. Yes.

Q. Does this conclude your testimony at this time?

A. Yes.