DIRECT TESTIMONY

of

BONITA A. PEARCE

Accounting Department
Financial Analysis Division
Illinois Commerce Commission

MidAmerican Energy Company

Proposed General Rate Increase for Electric Service

Docket No. 14-0066

April 9, 2014

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WITNESS IDENTIFICATION

Q. Please state your name and business address.

A. My name is Bonita A. Pearce. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

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

A. I am currently employed as an Accountant in the Accounting Department of the Financial Analysis Division of the Illinois Commerce Commission ("ICC" or “Commission”).

Q. Please describe your background and professional affiliations.

A. I am a licensed Certified Public Accountant with a Bachelor of Science in Accountancy from Illinois State University. Prior to joining the Commission in March 2001, I was engaged in the practice of public accounting for sixteen years. I returned to the practice of public accounting for a brief period in 2005, but returned to the Commission in 2006.

Q. Have you previously testified before a regulatory body?

A. Yes, I have testified on a number of occasions before the Commission.

Q. What are your responsibilities in this case?

A. I have been assigned to this case by the Manager of the Accounting Department of the Commission to review the rate filing of MidAmerican Energy Company ("MEC," "MidAmerican" or the "Company"), analyze the underlying data, and propose adjustments when appropriate.

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

A. The purpose of my testimony is to propose necessary adjustments to the Company's rate base to remove accounts payable from materials and supplies; and to reduce the balance of fossil fuel inventory.

Q. Are you sponsoring any schedules or attachments as part of ICC Staff Exhibit 2.0?

A. Yes. I prepared the following schedules and attachments that reflect data as of, or for the test year ending December 31, 2012:

Schedule 2.01 - Adjustment to Remove Accounts Payable from Materials and Supplies

Schedule 2.02 - Adjustment to Fossil Fuel Inventory – Including CONFIDENTIAL Calculations on pp. 2 - 5

Attachment A – Response to DR BAP 11.02

Attachment B – Response to DR BAP 2.01

Attachment C – Response to DR BAP 13.04

<u>ADJUSTMENTS</u>

<u>Adjustment to Materials and Supplies - Accounts Payable</u>

Q. Please describe ICC Staff Exhibit 2.0, Schedule 2.01 - Adjustment to Materials and Supplies - Accounts Payable.

A. Schedule 2.01 presents my adjustment to reduce the Company's test year materials and supplies inventory (exclusive of fossil and nuclear fuel stocks) by the amount of accounts payable associated with the purchase of materials and supplies for the 2012 test year, as calculated on ICC Staff Ex. 2.0, Schedule 2.01, page 2.

Q. Please explain your rationale for reducing rate base by the amount of accounts payable associated with materials and supplies inventory.

A. The Company's proposed 13-month average of materials and supplies inventory has not been reduced by the associated accounts payable. (MEC Schedule B-8.1, page 4 of 13, Note 3.) The Company's shareholders do not incur any cost of financing when materials and supplies are purchased on account with a vendor until the account is paid. An account payable balance represents "vendor financing" of purchased merchandise until it has been paid in full. Since the vendor is effectively financing these purchases until payment is received, the Company's shareholders have no investment in that portion of the materials and supplies inventory. Accordingly, the balance of materials and supplies inventory should be reduced for the associated portion of accounts payable because shareholders are not entitled to earn a return on an investment (materials and supplies inventory) until it has been funded by the shareholders. The Commission has upheld this type of adjustment in prior MEC rate cases, including Docket No. 09-0312. MidAmerican Energy Co., ICC Order Docket No. 09-0312, 5 (March 24, 2010).

Adjustment to Fossil Fuel Inventory

Q. Please describe ICC Staff Exhibit 2.0, Schedule 2.02, Adjustment to Fossil Fuel Inventory.

A. Schedule 2.02 presents my adjustment to reduce the balance of fossil fuel inventory to a five-year average because that amount is more representative of a normal inventory level than is the Company's proposed 13-month average balance for the 2012 test year.

Q. Please explain why a five-year average is more representative than the average balance during the most recent 13 months.

A. The Company dramatically increased the amount of fossil fuel inventory on hand during the past five years, as demonstrated on Staff Ex. 2.0, Schedule 2.02, CONFIDENTIAL calculations on pages 2-5. More specifically, MEC maximized the level of fossil fuel inventory during the test year. Part 285.310(c), Inventory Policies on Coal and Oil, states in relevant part:

> MidAmerican Energy Company does not have a formal policy on inventory levels for coal and oil. Coal inventories

> have been targeted for 55-75 days since the mid-2000s. This would allow for an extended interruption of rail service to any generating facility. **During the test year inventory levels at all facilities were increased to maximum levels** to take advantage of lower priced rail service that was expiring December 31, 2012.

83 Ill. Adm. Code 285.310(c) (emphasis added). Based on this statement by MEC, the 13-month average reflected on MEC Schedule B-1, line 8, column (e) is not representative of a normal test year. Moreover, MEC has committed to retire four coal-burning generation units and to convert a fifth generation unit from coal to natural gas, probably by the end of the first quarter 2015. (Attachment A, Response to DR BAP 11.02.) The rates set in this proceeding will take effect in November 2014 so that by the time the rates become effective, MEC's inventory of fossil fuels will likely be far lower. Accordingly, my calculation, based on a five-year average, is a more representative proxy of normal fossil fuel inventory levels than the 13-month average included by MEC in the 2012 test year rate base. For these reasons, my adjustment should be adopted by the Commission.

<u>Unresolved Matters</u>

Q. At the time of pre-filing this testimony do you have unresolved issues to address?

A. Yes, DR BAP 15 series is outstanding until later this month. DR BAP 15 is a follow-up to DR BAP 11.02 (Attachment A). It requests additional information regarding the impact on Illinois ratepayers of MEC's planned retirement of four generation stations during the first quarter of 2015. Therefore, I recommend that MEC fully address in rebuttal testimony the matters raised by Staff in DR BAP 15, as well as other relevant implications of which the Company may be aware.

<u>Rate Base – Original Cost Determination</u>

Q. Why is an Original Cost Determination finding necessary?

A. Requirements for preservation of records are associated with an original cost determination. Appendix A to 83 Ill. Adm. Code 420, entitled Preservation of Records of Electric Utilities, requires the preservation of specific records. Under this rule, many records must be maintained for a specific number of years relative to the date as of which original cost of plant has been unconditionally determined or approved by the Commission in an original cost determination proceeding or a rate case.

Q. Do you have a recommendation regarding the determination of original cost that is a required finding by the Commission in this proceeding?

A. Yes, I do. I recommend that the Commission approve the actual December 31, 2012 plant balances, as reflected on MEC Schedules B-4 and supporting schedules, for purposes of an original cost determination, subject to any adjustments ordered by the Commission in the course of this proceeding. I further recommend that the Commission include the following provision in the Final Order:

> It is further ordered that the $701,292,619 original cost of plant for MidAmerican at December 31, 2012, as reflected on the Company's Schedule B-4, Page 4 of 4, Line 81, Column (e) is unconditionally approved as the original cost of plant.

<u>Other Recommendations</u>

Q. Do you have any other recommendations to the Commission?

A. Yes, I recommend that the Commission accept my proposed adjustments, as reflected in ICC Staff Exhibit 2.0, Schedules 2.01 and 2.02, attached.

I further recommend that the Commission approve MEC's presentation of Illinois generation assets pursuant to the 1997 legislation for regulatory ratemaking purposes, as more fully described in the responses to DR BAP 2.01 (Attachment B) and DR BAP 13.04 (Attachment C). Accordingly, I propose the following language be reflected in the Findings and Ordering section of the Commission Order for the instant proceeding:

> It is further ordered that MEC's regulatory asset associated with recovery of original cost for certain generation assets, which assets have been written down in accordance with GAAP reporting on the MEC Form 21 ILCC as a result of the 1997 Customer Choice and Rate Relief Law (220 ILCS 5/16-111, is hereby approved.

<u>Conclusion</u>

Q. Does this conclude your prepared direct testimony?

A. Yes, it does.

MidAmerican Energy Company
Adjustment to Materials and Supplies - Accounts Payable
For the Test Year Ended December 31, 2012
(In Thousands)

Line No.	Description	Amount	Source
	(a)	(b)	(c)
1	M&S - Accounts Payable per Staff	$ (40)	Staff Ex. 2.0, Sch. 2.01, Page 2 of 2, Column (e), Line 18
2	M&S - Accounts Payable per Company	-	Company Schedule B-8.1, Page 4 of 13, Note b)
3	Staff Reduction to Materials and Supplies	$ (40)	Line 1 minus Line 2

MidAmerican Energy Company
Adjustment to Materials and Supplies - Accounts Payable
For the Test Year Ended December 31, 2012
(In Thousands)

Line No.	Description	Materials & Supplies	Stores Exp Undistributed	Total Materials & Supplies Cols. (b) + (c)	Accounts Payable Associated with M&S	Source
	(a)	(b)	(c)	(d)	(e)	
		Amounts from MEC Schedule B-8.1			Note 1.	
1	November 2011	$ 71,965	$ 5,008	$ 76,973	$ -	
2	December 2011	73,474	5,148	78,622	1,649	
3	January 2012	73,231	5,180	78,411	(211)	
4	February 2012	73,543	5,326	78,869	458	
5	March 2012	74,561	5,598	80,159	1,290	
6	April 2012	73,595	5,623	79,218	(941)	
7	May 2012	73,951	5,512	79,463	245	
8	June 2012	73,769	5,358	79,127	(336)	
9	July 2012	74,953	5,557	80,510	1,383	
10	August 2012	75,778	5,375	81,153	643	
11	September 2012	76,294	5,222	81,516	363	
12	October 2012	76,231	4,858	81,089	(427)	
13	November 2012	76,764	4,577	81,341	252	
14	December 2012	81,327	4,547	85,874	4,533	
15	Total 13 Months	977,471	67,881	1,045,352	8,901	(Sum of Lines 2 - 14)
16	13 Month Average	60,793	3,408	64,201	685	(Line 15 divided by 13)
17	Jurisdictional Allocation - Illinois (Company Schedule B-8.1, p. 13, line 277, col. (c))				5.77%	
18	Accounts Payable per Staff				$ 40	(Line 16 times Line 17)

Note 1. The Accounts Payable associated with Materials and Supplies Inventory is represented by the month's increase in inventory balance (Column (d)) from the prior month.

MidAmerican Energy Company
Adjustment to Reduce Fossil Fuel Inventory
For the Test Year Ended December 31, 2012
(In Thousands)

Line No.	Description		Amount	Source
	(a)		(b)	(c)
1	Fossil Fuel Inventory Balance per Staff	$	7,450	Note 1, Amount on line 6 divided by 1,000
2	Fossil Fuel Inventory Balance per Company		11,233	MEC Schedule B-1, line 8, column (g)
3	Staff Adjustment for to Reduce Fossil Fuel Inventory	$	(3,783)	Line 1 minus Line 2

Note 1.

4	Fossil Fuel Inventory Balance per Staff	$	68,596,051	Staff Ex. 2.0, Schedule 2.02, page 5 of 5, line 31, column (f)
5	Percentage Allocable to Illinois		10.86%	MEC Sch. B-8.1, p. 8 of 13, line 164, Existing A & E Allocator - Illinois
6	Illinois Portion of Fossil Fuel Inventory per Staff	$	7,449,531	Line 4 multiplied by line 5

MidAmernican Energy Company
PUBLIC Fossil Fuel Inventory Analysis

Line No.	Year	Generation Station	12 Month Average (January through December) Annual Average Dollar Value - Coal	Annual Average Dollar Value - Oil	Annual Average Dollar Value - Total
(a)	(b)	(c)	(d)	(e)	(f)
			(Sch. F-5, pp. 2-41)		(d) + (e)
1	2007				
2	2008				
3	2009				
4	2010				
5	2011				
6	2012				
7					
8		Average balance - 6 years (2007 - 2012)	-	-	-
9		Average balance - 5 years (2008 - 2012)	-	-	-
10					
11					
12	2007				
13	2008				
14	2009				
15	2010				
16	2011				
17	2012				
18					
19		Average balance - 6 years (2007 - 2012)	-	-	-
20		Average balance - 5 years (2008 - 2012)	-	-	-
21					
22					
23	2007				
24	2008				
25	2009				
26	2010				
27	2011				
28	2012				
29					
30		Average balance - 6 years (2007 - 2012)	-	-	-
31		Average balance - 5 years (2008 - 2012)	-	-	-

MidAmernican Energy Company
PUBLIC Fossil Fuel Inventory Analysis

Line No.	Year	Generation Station	12 Month Average (January through December) Annual Average Dollar Value - Coal	Annual Average Dollar Value - Oil	Annual Average Dollar Value - Total
(a)	(b)	(c)	(d)	(e)	(f)
			(Sch. F-5, pp. 2-41)		(d) + (e)
1	2007				
2	2008				
3	2009				
4	2010				
5	2011				
6	2012				
7					
8		Average balance - 6 years (2007 - 2012)	-	-	-
9		Average balance - 5 years (2008 - 2012)	-	-	-
10					
11					
12	2007				
13	2008				
14	2009				
15	2010				
16	2011				
17	2012				
18					
19		Average balance - 6 years (2007 - 2012)	-	-	-
20		Average balance - 5 years (2008 - 2012)	-	-	-
21					
22					
23	2007				
24	2008				
25	2009				
26	2010				
27	2011				
28	2012				
29					
30		Average balance - 6 years (2007 - 2012)	-	-	-
31		Average balance - 5 years (2008 - 2012)	-	-	-

MidAmernican Energy Company
PUBLIC Fossil Fuel Inventory Analysis

			12 Month Average (January through December)		
Line No.	Year	Generation Station	Annual Average Dollar Value - Coal	Annual Average Dollar Value - Oil	Annual Average Dollar Value - Total
(a)	(b)	(c)	(d)	(e)	(f)
			(Sch. F-5, pp. 2-41)		(d) + (e)
1	2007				
2	2008				
3	2009				
4	2010				
5	2011				
6	2012				
7					
8		Average balance - 6 years (2007 - 2012)	-	-	-
9		Average balance - 5 years (2008 - 2012)	-	-	-
10					
11					
12	2007				
13	2008				
14	2009				
15	2010				
16	2011				
17	2012				
18					
19		Average balance - 6 years (2007 - 2012)	-	-	-
20		Average balance - 5 years (2008 - 2012)	-	-	-
21					
22					
23	2007				
24	2008				
25	2009				
26	2010				
27	2011				
28	2012				
29					
30		Average balance - 6 years (2007 - 2012)	-	-	-
31		Average balance - 5 years (2008 - 2012)	-	-	-

Docket No. 14-0066
Staff Exhibit 2.0
PUBLIC Schedule 2.02

MidAmerican Energy Company
PUBLIC Fossil Fuel Inventory Analysis

Line No.	Year	Generation Station	12 Month Average (January through December) Annual Average Dollar Value - Coal	Annual Average Dollar Value - Oil	Annual Average Dollar Value - Total	13-mo. Average Dollar Value - Total	Difference in Averages Dollar Value - Total
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
			(Sch. F-5, pp. 2-41)		(d) + (e)	Sch. B-8.1, pp. 5-8/13	(f) minus (g)
1	2007						
2	2008						
3	2009						
4	2010						
5	2011						
6	2012						
7							
8							
9							
10							
11							
12	2007						
13	2008						
14	2009						
15	2010						
16	2011						
17	2012						
18							
19		Average balance - 6 years (2007 - 2012)	-	-	-		
20		Average balance - 5 years (2008 - 2012)	-	-	-		
21							
22							
23	2007						
24	2008						
25	2009						
26	2010						
27	2011						
28	2012						
29							
30		Average balance - 6 years (2007 - 2012)	$ -	$ -	$ -		
31		Average balance - 5 years (2008 - 2012)	$ -	$ -	$ -		

ILLINOIS COMMERCE COMMISSION

Utility Company: **MidAmerican Energy Company**

Regarding: **Docket No. 14-0066 – MidAmerican Energy Company Proposed general increase in rates for electric delivery service (tariffs filed December 16, 2013)**

Date Submitted: **March 20, 2014**

STAFF DATA REQUEST BAP 11.02

Responder Name: Spencer Moore
Phone: 712-366-7172
Job Title: Project Director, Supply

BAP 11.02 Referring to Section 285.305(o)(3), MEC Form 10-Q, for the quarter ended 9-30-2013, Page 42 of 56, please provide the following information regarding MEC's plan to retire four coal-fueled generating units and to limit a fifth unit to natural gas combustion by March 31, 2015:

a). Explain and estimate the likelihood that the retirement(s) and/or changeover from coal to natural gas for these units will occur before March 31, 2015;

b). Provide an estimate of the month and year in which the retirements and changeover are most likely to occur;

c). Provide updates during the remainder of the instant proceeding if the response to (b) changes;

d). Provide an estimate of the financial impact the retirement of these four units and the changeover from coal to natural gas on the fifth unit would have on the test year revenue requirement if reflected in a pro forma adjustment; and

e). Indicate MEC's rationale for not reflecting these changes in the 2012 test year revenue requirement.

Response:

a) MidAmerican expects to enter into retirements for Neal 1, Neal 2, Walter Scott 1, and Walter Scott 2 in the first quarter of 2015, likely prior to March 31, 2015. Likewise, MidAmerican expects to make the changeover to natural gas from coal at Riverside in the first quarter of 2015, likely prior to March 31, 2015. This timing could change if an extension is permitted by environmental regulators and MISO.

b) MidAmerican expects that the retirements and changeover referenced in a) above will take place in January, February, or March 2015 unless an extension is permitted by environmental regulators and MISO.

c) No response is applicable at this time.

d) The retirement and changeover of the referenced units in 2015 (or 2016 if an extension is permitted by environmental regulators and MISO) would not impact the test year in this proceeding as the changes are outside of the period for which pro forma adjustments may be considered, i.e. within one year of the filing of the case. The impact of the retirements on MidAmerican Energy's revenue requirement would be considered in the next subsequent rate proceeding, when the costs would be measureable.

e) As discussed in d) above, the changes are outside of the period for which pro forma adjustments may be considered, i.e. within one year of the filing of this case. As noted in the testimony of MidAmerican witness Naomi G. Czachura beginning at line 188, MidAmerican's owned assets allocated to Illinois are already inadequate to meet Illinois load requirements. When the referenced units are retired, that generation will need to be obtained elsewhere, either through an increase in the Iowa generation transfer or through purchases. MidAmerican intends to begin purchasing resources to meet a portion of Illinois generation requirements in 2016. As the costs of purchased capacity and energy are included through the fuel adjustment clause, MidAmerican anticipates making reductions to base rates to reflect the reduction in owned resources being used to serve Illinois customers.

ILLINOIS COMMERCE COMMISSION

Utility Company: **MidAmerican Energy Company**

Regarding: **Docket No. 14-0066 – MidAmerican Energy Company Proposed general increase in rates for electric delivery service (tariffs filed December 16, 2013)**

Date Submitted: **February 12, 2014**

STAFF DATA REQUEST BAP 2.01

Responder Name: Mary Jo Anderson
Phone: 515-281-2273
Job Title: Senior Technical Accountant

BAP 2.01 Referring to MEC's Schedule B-1, line 2, column (e), Illinois Jurisdiction Gross Electric Plant of $701,292,619,

a). Please reconcile this amount to the balance of Illinois Direct Electric Utility plant reflected on Form 21 ILCC, page 2a, column (j), line 2, $685,624,686 as of December 31, 2012; and,

b).Please provide all supporting calculations for the derivation of the portion of total electric plant attributed to the Illinois Jurisdiction.

Response:

a) See MidAmerican Attachment BAP 2.01A for a reconciliation of amounts reported on Form 21 ILCC and Schedule B-1 in this case. The following discussion explains the reconciling items, by line.

2. Quad Cities Station ("QCS") – Following industry restructuring legislation in Illinois in the late 1990's, the carrying value of MEC's investment in QCS was written down for GAAP reporting purposes. For rate purposes, however, MEC believed that all original costs for QCS were recoverable from customers, and the writedown was classified as a regulatory asset. The "contra" asset is therefore ignored for purposes of the calculation of rate base.

3. Anderson Erickson lease – This is a contra-asset for utility equipment that was leased to a single customer for their specific use. The Illinois portion of revenue from these assets is included in the rate case so this contra is excluded from rate base.

4. Plant held for future use – Not used and useful and excluded from rate base.

5. A contra-accumulated depreciation balance associated with the cost of removal accrued through depreciation on assets for which a legal obligation exists for such removal, and such amounts are reported as a liability for GAAP reporting purposes. For rate purposes these amounts are treated like any other cost of removal imbedded in accumulated depreciation; therefore, the contra account is ignored in the determination of rate base.

6. Plant acquisition adjustments – The difference between purchase cost and the seller's book value for transmission lines acquired is excluded from rate base.

7. Capital leases – Amounts recorded for capital leases are for GAAP reporting only and are excluded from rate base.

b) Supporting calculations for the derivation of the portion of total electric adjustment amounts to the Illinois Jurisdiction can be found on MidAmerican Attachment BAP 2.01A. MidAmerican Attachment BAP 2.01B contains the report allocating total electric plant to the Illinois jurisdiction. Both an Excel spreadsheet and pdf copy of the attachment is included. The following accounts should be excluded from this report to arrive at the amount listed on Schedule B-1: ARO accounts 1.317.00, 1.347.00, 1.359.10, 1.374.01, 1.374.02 and capital lease accounts 1.311.30, 1.390.30, and 1.396.84.

Line	Description	Plant in Service	Accum. Depreciation	Comments
	(a)	(b)	(c)	(d)
1	Amount per Schedule B-1	701,292,619	(379,759,274)	
2	Quad Cities Station adjustment	(16,820,747)	12,241,773	Write-down of QCS for GAAP that is classified as a regulatory asset for regulatory purposes. Writedown ignored for rate purposes.
3	Andersen Erickson lease contra	(119,101)	64,613	Excluded from rate base for ratemaking purposes
4	Plant held for future use (A/C 105)	23,129	-	Excluded from rate base for ratemaking purposes
5	Accumulated depreciation contra balances for ARO liabilities	-	1,563,900	Treated as accumulated depreciation for regulatory purposes since cost of removal is included in depreciation rates.
6	Plant acquisition adjustment balances for RPGI, Pell transmission lines	42,247	(1,189)	Excluded from rate base for ratemaking purposes
7	Capital lease and asset retirement assets	1,206,679	(1,002,080)	Excluded from rate base for ratemaking purposes - only lease payments included in O&M.
8	Amount per Form 21 p.2a line 2/5	685,624,826	(366,892,257)	

Line	Page 1 Reference	Total Company	Illinois %	Illinois Dollars
	(a)	(b)	(c)	(d)
9	Column (b)			
10	Line 1	(See MidAmerican Attachment BAP 2.01B)		
11	Line 2	(16,820,747)	100.00%	(16,820,747)
12	Line 3	(1,096,694)	10.86%	(119,101)
13	Line 4			
14	Transmission	231,983	9.97%	23,129
15	Distribution	855,569	0.00%	-
16		1,087,552		23,129
17	Line 6	423,741	9.97%	42,247
18	Line 7	(See MidAmerican Attachment BAP 2.01B)		
19				
20	Column (c)			
21	Line 1	(See MidAmerican Attachment BAP 2.02A)		
22	Line 2	12,241,773	100.00%	12,241,773
23	Line 3	594,967	10.86%	64,613
24	Line 5	14,400,553	10.86%	1,563,900
25	Line 6	(11,929)	9.97%	(1,189)
26	Line 7	(See MidAmerican Attachment BAP 2.02A)		

ILLINOIS COMMERCE COMMISSION

Utility Company: **MidAmerican Energy Company**

Regarding: **Docket No. 14-0066 – MidAmerican Energy Company Proposed general increase in rates for electric delivery service (tariffs filed December 16, 2013)**

Date Submitted: **March 25, 2014**

STAFF DATA REQUEST BAP 13.04

Responder Name: Rick Tunning
Phone: 515-242-4075
Job Title: Manager-Corporate Accounting

BAP 13.04 Referring to p. 54 of MEC's 1997 Form 10K, please provide a detailed explanation and rationale behind the conclusion that MEC's "generation operations serving Illinois were no longer subject to the provisions of SFAS 71 due to passage of restructuring legislation in Illinois".

Response:

The discussion that follows consists of analysis performed in late 2004 with respect to the accounting actions taken in 1997 relative to the application of SFAS 71. While the electric industry and MEC continue to evolve, overall the 2004 analysis summarized below has not changed to a degree that would warrant a different conclusion with respect to the applicability of SFAS 71.

<u>Legislative Background</u>

In December 1997 MEC discontinued application of FAS 71 for the Illinois generation portion of its business pursuant to Illinois electric industry restructuring legislation. The legislation, among other things, implemented a rate freeze, allowed for customer choice of energy suppliers, and allowed for significantly expedited reorganization of generation assets to either affiliate or unaffiliated entities along with provisions for recovery of associated stranded costs. The legislation also implemented a "revenue sharing" mechanism that allowed for either customer refunds or accelerated cost recovery for Illinois ROE's in excess of a defined ROE threshold.

Section 16-111(a) of the legislation provided that during the "transition period" through January 1, 2005 (subsequently extended to January 1, 2007), the ICC could not increase or decrease rates. Effective January 1, 2007 that freeze ends and MEC's bundled rates will be subject to cost-based ratemaking.

Pursuant to Section 16-111(g) of the legislation, during the transition period a utility may "…sell, assign, lease or otherwise transfer assets to an affiliated or unaffiliated entity…" without obtaining approval of the ICC. Taking such action would have the effect of removing such assets from the calculation of cost-based, bundled rates.

Accounting Guidance

EITF Issue 97-4 provides guidance on issues related to the application of FAS 71 and 101. Issue 97-4 addresses (1) when to stop applying FAS 71 to the separable portion of the business being deregulated, (2) how to evaluate whether to continue to recognize all or some regulatory assets and liabilities and (3) how to evaluate whether to establish new regulatory assets and liabilities.

Paragraph 5 of FAS 71 provides the criteria required to be met to apply FAS 71 accounting. The three criteria are:

1. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

2. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.

3. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

MEC Application of Accounting Guidance

EITF Issue 97-4 required an assessment of whether the separable portion of its business being deregulated qualified for FAS 71 accounting at the time sufficient guidance became available regarding the "rules" for deregulation – in this case, when legislation passed on December 16, 1997. At that time, the Iowa Legislature was also in the process of considering similar industry restructuring legislation. Accordingly, under the assumption that customer choice was a distinct possibility in Iowa, its primary jurisdiction, MEC had very good reason to believe that its entire generation portfolio would be removed from cost-based ratemaking. With that thought in mind, MEC determined that its Illinois generation would not qualify for regulatory accounting.

The Iowa legislature failed to pass deregulation legislation in the 1998 session and MEC focused instead on strategies within the regulated framework in Iowa, ultimately continuing a form of incentive regulation via extension of a rate freeze and revenue sharing mechanism initially adopted in 1997. As a result of this change in perspective, any consideration of legal separation of the Illinois generation business from MEC was dropped. Unfortunately by that time, the 1997 entries reflecting the discontinuance of FAS 71 for Illinois generation, and related disclosures, had already been made.

In conjunction with the discontinuation of FAS 71 for Illinois generation, MEC wrote off the Illinois generation portion of several regulatory assets and liabilities in December 1997. Although the 1997 entries were not reversed, subsequent to 1997, MEC has accounted for Illinois generation as if it were rate regulated and has applied FAS 71 accounting to this portion of its business consistent with its perspective on the business after the failure of the deregulation movement in Iowa. Had MEC known in 1997 that Iowa restructuring legislation would not be enacted, it is unlikely that FAS 71 would have been discontinued.

With the benefit of hindsight, MEC believes that at the time of the passage of the Illinois legislation and at all times since that date, it has met the three requirements of FAS 71 accounting outlined above for its Illinois generation operations. The basis for that conclusion is outlined below.

- Unless MEC takes positive action, generation assets will be subject to cost-base ratemaking effective January 1, 2007.

- As stated above, MEC presently has no intention of spinning off any of its generation assets before January 1, 2007. This conclusion is based on the current economic state of the industry and the fact that with the extension of the rate settlement in Iowa through 2010, which retains generation assets and off-system revenues and costs in the calculation of jurisdictional returns, a substantial portion of MEC's generation could not be spun off, making a spin-off of the much smaller Illinois portion very remote.

- The Illinois revenue sharing mechanism currently imposes a cost-based ROE cap to Illinois operations. The ROE calculation includes actual revenues, O&M, depreciation, and the cost of debt and preferred assigned to Illinois electric operations, including those assigned to Illinois generation. The "over-earning" experienced since the mechanism has been in place has been driven primarily by generation margins on off-system sales.

- The fuel adjustment clause mechanism continues in Illinois, providing for the automatic recovery of fuel costs associated with Illinois generation.

- Revenue, O&M and depreciation from the Illinois generation operations continue to be characterized as utility activity, not nonregulated, in MEC's GAAP and regulatory financial statements.

- All customers within MEC's Illinois regulated service territory are presently under bundled, cost-based tariffs approved by the ICC. Since 1/1/98, only a minimal number of customers have chosen to utilize an alternative energy supplier and all have since returned to bundled service. While customers have the ability to contract with alternative electric suppliers, that situation is analogous to historical competition from fuel switching or self-generation. Further, the situation is not indifferent from a situation where bundled natural gas customers elect to become transportation-only customers and seek their own supply of gas.

- Losses on reacquired debt written off in the December 1997 entry have been included back into the cost of capital calculations on a pro forma basis for Illinois rate cases, consistent with the rate treatment for such items prior to 1997. The first case in which this was done was Docket 99-0534.

Other Illinois utilities also discontinued application of FAS 71 accounting in 1997 for their Illinois generation operations. Several of those utilities have legally separated their generation business from that of the regulated utility. MEC has not, and does not intend to separate its generation business from that of its transmission and distribution business, and in that respect is not comparable to their situation.

Conclusion

MEC believes that the discontinuation of FAS 71 accounting for Illinois generation in 1997 was an incorrect conclusion and that the application of FAS 71 accounting subsequent to 1997 was proper and supportable and continues to be so today.