STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

MidAmerican Energy Company	**:**	
	:	
Proposed general increase for	**:**	**Docket No. 14-0066**
Electric service	**:**	

MidAmerican Energy Company's Brief on Exceptions

ORAL ARGUMENT REQUESTED

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MIDAMERICAN ENERGY COMPANY'S BRIEF ON EXCEPTIONS

NOW COMES MidAmerican Energy Company ("MidAmerican") and respectfully submits its Brief on Exceptions pursuant to the Administrative Law Judge's set in the Administrative Law Judge' ("ALJ") Proposed Order of September 4, 2014 ("Proposed Order"), and Section 200.830 of the Rules of Practice of the Illinois Commerce Commission ("Commission"), 83 Ill. Adm. Code § 200.830, in the above-captioned proceeding. Along with its Brief on Exceptions, MidAmerican is also submitting Exceptions to the Proposed Order ("MidAmerican Exceptions") that contain proposed revised language to the Proposed Order in red-lined format and associated Appendix A.

I. INTRODUCTION

MidAmerican appreciates the ALJ's quick issuance of the Proposed Order and generally supports the Proposed Order. The Proposed Order, on most respects properly, applies the applicable law to the evidence. For example, the Proposed Order correctly recommends that the Commission reject Staff's proposal to disallow directly $70,000 in rate case expenses associated with MidAmerican's return on equity witness, because such costs are a reasonable expense incurred during a rate case. The Proposed Order also correctly concludes steam and distribution maintenance are reasonable operating expenses and correctly concludes that the Hourly Costing Model is a reasonable cost of service study to be used to allocate costs among customer classes.

The Proposed Order, however, in some instances recommends rulings that deny proper cost recovery for reasonable test year expenses. In particular, the Proposed Order finds that MidAmerican's incentive compensation payments are tied to customer benefits, but denies full cost recovery for those costs. The Proposed Order also improperly concludes that ratepayer funds were used to pay for the pension asset, despite the fact that MidAmerican has not had a rate case in over twenty-years and is using a historical test year. Finally, the Proposed Order misapplies the Commission rules and allows for a cost incurring 23 months from the test year to be included outside of the twelve month window from the filing of this rate case. MidAmerican addresses these specific issues below.

III. Rate Base

C. Contested Rate Base Adjustments

1. Rate Base Adjustment Related to PIP Incentive Compensation

   Exception No. 1

The Proposed Order disallows recovery of MidAmerican's rate base adjustments associated with incentive compensation. As discussed further discussed *infra* in Section IV, D.1, MidAmerican disagrees with the Proposed Order's finding to disallow incentive compensation. The attached MidAmerican Exceptions include a rate base adjustment to include recovery for portions of the incentive compensation and related payroll taxes and pension costs. MidAmerican's Appendix A also includes the associated rate base adjustments for incentive compensation.

2. Pension Asset

Exception No. 2

The Proposed Order recommends the exclusion of MidAmerican's prepaid pension asset in its rate base. Proposed Order at 11-12. The Proposed Order relies on past Commission orders without recognizing the distinguishing the facts in the present case. Contrary to the assertion in the Proposed Order, MidAmerican did not "redefine" the Commission definition of ratepayer supplied funds. The Commission's analysis in the orders referenced in the Proposed Order never defines "ratepayer supplied funds." This case reflects a record where Staff has defined "ratepayer supplied funds" as "funds provided through normal operating revenues of a utility." MidAmerican Ex. RRT 2.5. The Proposed Order mischaracterizes MidAmerican's position and ignores the evidence MidAmerican presented demonstrating that internally generated funds used for prepaid pension expense came out of retained earnings. Neither Staff nor the cited Commission orders address how money that comes out of retained earnings can be considered ratepayer-supplied funds. *See e.g.* MidAmerican Ex. RRT 2.2 demonstrating that MidAmerican has not had any equity issuances for the last ten years and financed operations with internally generated funds; MidAmerican Ex. RRT 2.0 at 9, ll. 161-169.

The Proposed Order erroneously adopts Staff's definition of ratepayer supplied funds and also equates "general corporate funds" with ratepayer-supplied funds. This assertion ignores the fact that the profits companies earn may either be paid out as a dividend to shareholders or be kept as retained earnings and invested back into the company, *i.e.* to finance operations and capital expenditures, or a combination of both dividend payouts and the retention of earnings. There is no legal basis for treating earnings as ratepayer supplied funds. *See Board of Pub. Util. Comm'rs. v. New York Tel. Co.,* 271 U.S. 23, 31-32 (1926). The record demonstrates that

MidAmerican did finance the prepaid pension asset and has done so with internally generated funds from retained earnings. *See e.g.* MidAmerican Ex. RRT 2.2; MidAmerican Ex. RRT 2.0 at 9, ll. 161-169.

The Proposed Order implies that a utility is not allowed to use any retained earnings to make utility investments. If ratepayer supplied funds are "general corporate funds," then MidAmerican should not be allowed to a substantial amount of investment in rate base because MidAmerican has invested significant amounts in utility plant using retained earnings, or what is labeled as "ratepayer-supplied funds." *See* MidAmerican Ex. RRT 2.5 and MidAmerican Ex. RRT 2.0 at 9, ll. 161-169.

According to the Public Utilities Report ("PUR") Guide, retained earnings are "earnings of a corporation kept by it for use in the business and thus not distributed to stockholders as dividends. Retained earnings are an important source of capital funds and are shown as surplus or reinvested earnings in the net worth section of the balance sheet." *PUR Guide: Principles of Public Utilities Operation and Management*, *Glossary of Terms* (2011). As noted in MidAmerican's testimony, exhibits and briefs, MidAmerican has not issued any common equity over the last ten years. MidAmerican Ex. RRT 2.2; MidAmerican Ex. RRT 2.0 at 9, ll. 161-169; MidAmerican IB at 12, MidAmerican RB at 5. MidAmerican's balance sheet reflects the fact that a significant share of its earnings were not distributed to shareholders, but instead were retained and reinvested in the business, including the pension asset. *Id.* To say that MidAmerican's retained earnings are somehow ratepayer contributions is incorrect and the Proposed Order does not explain how this conclusion can be drawn based on this record. The fact remains that ratepayers do not acquire a legal or equitable interest in utility property and the revenue generated by the service belongs to the utility. *See Board of Pub. Util. Comm'rs. v. New York Tel. Co.*, 271 U.S. 23, 31-32 (1926).

The record is clear. Staff did not explain how retained earnings can be considered ratepayer supplied funds. Staff also did not challenge the reasonableness of the pension expense. MidAmerican supported the nature and reasonableness of the expense. In this case, it is proper to allow recovery for the pension asset financed through retained earnings.

In the event the Commission declines to provide a clear definition of how retained earnings can be considered ratepayer supplied funds, the Commission should consider MidAmerican's alternative position of the Commission removing the pension asset from rate base and making a corresponding adjustment to remove pension income currently proposed to off-set the cost of service. MidAmerican Ex. RRT 2.0 at 10-11, ll. 191-209. This symmetrical ratemaking treatment is reasonable and appropriate, allowing customers to receive benefit from not including the asset in rate base, but not allowing them to then also receive the benefit that is created by the asset through lower pension expense. The Proposed Order asymmetrically provides both benefits to customers while shareholders on the other hand finance the asset while receiving no rate recovery. *Id*. MidAmerican's alternative proposal is just and reasonable to both ratepayers and shareholders.

Accordingly, the Commission (1) should approve the inclusion of MidAmerican's pension asset in rate base, or (2) should adopt MidAmerican's alternative position. The proposed language from Exception No. 2 as outlined in MidAmerican's Exceptions should be used.

D. MidAmerican's Proposed Rate Base

MidAmerican's proposed rate base is reflected in MidAmerican's Exceptions and the Attachment A to MidAmerican's Brief on Exceptions.

IV. Revenue Requirement – Operating Revenues and Expenses

D. Contested adjustments to MidAmerican's proposal

1. PIP Incentive Compensation and Associated Payroll Tax and Pension Costs

Exception No. 3

The Proposed Order excludes 100% of MidAmerican's incentive compensation expense from the revenue requirement. At the same time, the Proposed Order clearly recognizes that MidAmerican has presented sufficient evidence of tangible ratepayer benefits stemming from implementation of its incentive compensation program:

> There is no dispute that many of MidAmerican's goals primarily benefited ratepayers and MidAmerican provided sufficient evidence that ratepayers received tangible benefits. Accordingly, the incentive compensation costs associated with those goals should be recoverable by MidAmerican.

Proposed Order at 22. The disallowance of all incentive compensation expense is also contrary to Staff's assessment that "a **few** of the goals **may** relate to non-recoverable financial performance costs" and "Staff provided evidence supporting a finding that **at least some** of the PIP incentive compensation costs should not be recovered." *Id.*, emphasis supplied.

Instead of including all or a portion of the incentive compensation expense in the revenue requirement in recognition of the uncontested benefits arising from implementation of MidAmerican's Performance Incentive Program ("PIP"), the Proposed Order adopts the draconian approach of eliminating all incentive compensation expense from the revenue requirement. It takes this approach even though it is uncontested that MidAmerican's compensation structure is only competitive if PIP is included and despite MidAmerican's long and consistent history of paying out on average 96% of the incentive compensation budget each year since 2003. MidAmerican Ex. MAG 3.0 at 6, ll. 128-130. MidAmerican objects to this conclusion.

The record reflects relatively slight disagreement between Staff and MidAmerican regarding the benefits from implementation of the PIP. Of the 39 goals in the PIP, Staff contended that **two** of **thirty-nine** PIP goals may be based on net income or earnings. Staff Ex. 12.0 at 7-8, ll. 163-168. The Proposed Order incorrectly concludes at page 22 that MidAmerican "does not appear to fully disagree" that these goals are financial performance based. The record shows that MidAmerican explained that these goals did not affect payout under the PIP. In 2012, even though the net income goal was not achieved, there was 100% payout of the PIP budget. MidAmerican Ex. MAG 3.0 at 8, ll. 178-184. Most importantly, these goals are not “trigger” goals that allow a payout only if met. Staff also objects to five goals as not being jurisdictional. Staff Ex. 6, ll. 118-120.

The Proposed Order also improperly rejects MidAmerican’s alternative recommendation to allow a pro rata portion of incentive compensation expense based on equal weighting of each of the 39 goals included in the PIP for the test period, excluding a pro rata portion for any goal deemed not consistent with prior precedent. Proposed Order at 23. The Proposed Order rejects this suggestion based largely on the assumption that the exact nature of the goals is subject to change from year to year. *Id.* This conclusion is inconsistent with the whole premise of setting rates based upon a representative test year. Rates are developed based on representative costs and it is not consistent with general ratemaking principles to disallow a cost because it might change slightly from year to year. A representative level of expense must be determined in order to develop just and reasonable rates. The record shows that MidAmerican has regularly paid out 96% of MidAmerican's incentive compensation expense every year since 2003. MidAmerican

Ex. MAG 3.0 at 6, ll. 128-130. There is no evidence in the record to suggest that financial performance trigger goals have ever been part of the PIP. It is pure speculation, inconsistent with the record, for the Proposed Order to hypothesize that the mix of goals, PIP payout levels, or the degree of benefits accruing to customers from MidAmerican's PIP will change dramatically from year to year. It is unreasonable to assume, as the Proposed Order does, that this pattern would suddenly change in the future.

In recognition of the concern expressed in the Proposed Order, MidAmerican proposes an alternative conclusion that eliminates any concern about pro rata weighting of the 39 individual goals. As noted in the Proposed Order, the achievements of MidAmerican under the PIP have produced tangible ratepayer benefits. Not only have they produced tangible ratepayer benefits in the form of reduced costs, they have also achieved high levels of customer satisfaction. To provide for recognition of this expense consistent with the undisputed achievement, MidAmerican alternatively recommends allowing 50% of the expense to be included in rates. This would reflect a conservative amount of incentive compensation expense in rates. Excluding half of the total expense ensures that there will be no recovery of costs potentially associated with financial performance or non-jurisdictional matters.

3. <u>State Income Tax Rate Decrease</u>

<u>Exception No. 4</u>

The Proposed Order adopts Staff's adjustment to reflect, what Staff characterizes as a known and measureable change in the Illinois corporate income tax rate, effective January 1, 2015. Proposed Order at 29; Staff Ex. 10.0 at 5, ll. 87-89. While the Proposed Order correctly points out that this cost may be considered "known and measurable," the Proposed Order failed to address that the Commission's rule requires a two-part test: (1) "are reasonably certain to occur subsequent to the historical test year within 12 months after the filing date of the tariffs" **and (2) "** where the amounts of the changes are determinable." 83 Ill. Admin. Code § 287.40.

The adjustment in the Proposed Order fails the two-part test. The Illinois state income tax change occurs outside the twelve month period from date of filing the timeframe to quantify known and measurable changes to test year data specified by the rule. 83 Ill. Admin. Code § 287.40; MidAmerican Ex. RRT 3.0 at 3, ll. 39-41. MidAmerican's tariffs were filed on December 16, 2013. Since the Proposed Order reaches out beyond the twelve month period prescribed by the rule, it is also necessary for the Commission to also reach out beyond such period to quantify additional pro forma adjustments, including contractually scheduled pay rate increases for union employees, contractually scheduled escalations for coal transportation costs that also begin in 2015, and additions to rate base to be placed in service in 2015 to be consistent and match all revenues with expenses. *Id.*, ll. 44-46. The test-year rules are intended to prevent a utility from mismatching revenue and operating expense data. *See Business and Professional People for the Public Interest et al. v. Illinois Commerce Commission et al.*, 146 Ill. 2d 175, at 237-238, 242-243 (Dec. 16 1991). The Proposed Order does not match these expenses and revenue as required by rule and law. The fact that there are legally binding contract pay increases or tax rate decreases that are scheduled to occur *after* the test year window, does not trigger the altering of the test year expense levels.

Additionally, the Proposed Order does not address the procedural issues MidAmerican raised and this issue is important as a matter of due process. Pursuant to the Commission rules, the known and measurable changes must be individually identified and supported in the direct testimony of the utility. 83 Ill. Admin. Code § 287.40. As MidAmerican noted in surrebuttal testimony, Staff did not raise this issue in its direct testimony and the change occurs outside the twelve month period date. MidAmerican Ex. RRT3.0 at 3, ll. 37-39. As a procedural matter, the rules require MidAmerican to submit the known and measurable change in its direct case. MidAmerican did not because the change is to occur outside the test-year window. In addition to the pro forma adjustment occurring outside of the test year window, this issue was untimely raised by Staff, as it should have been addressed in Staff's direct testimony. Staff's violation of the Commission rules violated MidAmerican's due process. Under the Commission rules, MidAmerican is precluded from making pro forma adjustments matching other revenues and expenses to the January 1, 2015, date not only because it will occur outside of the test year window, but also because the rules only allow for pro forma adjustments to be made in the direct case. In Docket Nos. 12-0603 and 12-0604, the Commission noted that "[t]he point of requiring that pro forma adjustments be included with the utility's direct case is to allow Staff and intervenors time to review a utility's proposed rate increase." *Lake Wildwood Utilities Corporation, Apple Cannon Utility Company,* Docket Nos. 12-0603 and 12-0604 at 19, June 27, 2013. In this case, Staff had time to review MidAmerican's case and time to raise the issue in its direct testimony. Instead, Staff raised this issue on rebuttal testimony, in which MidAmerican only had twelve days to respond with surrebuttal testimony. This was not sufficient time for MidAmerican to also include any other adjustments to revenue and expenses to allow for the proper matching as required by the Commission rules. Consequently, the Proposed Order also adopts a position that violates the Commission's procedural rules and prejudices MidAmerican from offering further evidence that would match additional expenses and revenues past the test year window.

Accordingly, the tax adjustment is improper as it violates the matching principle, is contrary to the Commission's rules and is unreasonable. Therefore, the Commission should adopt the proposed language in Exception No. 4 as outlined in the MidAmerican Exceptions.

V. Rate of Return

MidAmerican supports the Proposed Order's findings and conclusions regarding the capital structure and long-term debt; however, MidAmerican takes the following exception to the cost of common equity.

D. Cost of Common Equity

Exception No. 5

The Proposed Order correctly recognizes that one of the issues in determining MidAmerican's cost of common equity is what constitutes a comparable proxy group. Proposed Order at 47. However, determining a comparable proxy group was not the only model input that was litigated regarding this issue. The Proposed Order does not address other evidence raised in this case, such as Staff's undervalued risk free rate used in its CAPM analysis. The Proposed Order also disregards recent Commission decisions recognizing the current market conditions and the extraordinary efforts of the Federal Reserve to set interest rates low to stimulate the economy. *See e.g. North Shore Gas Company and The Peoples Gas Light and Coke Company*, Docket Nos. 07-0241 and 07-0242 Cons., at 92 (February 5, 2008) ("North Shore-Peoples 2007 Rate Case"); *Northern Illinois Gas Company d/b/a Nicor Gas Company,* Docket no. 08-0363, at 67-68. March 25, 2009; *North Shore Gas Company, Proposed general increase in natural gas rates, tariffs filed February 25, 2009, The Peoples Gas Light and Coke Company, Proposed general increase in natural gas rates, tariffs filed on February 25, 2009,* Docket Nos. 09-0166 and 09-0167 (Cons.) at 123, January 28, 2010 ("North Shore-Peoples 2010 Order"); *North Shore*

Gas Company and The Peoples Gas Light and Coke Company Docket Nos. 12-0511 and 12-0512 (Cons.) at 205, June 18, 2013 ("North Shore-Peoples 2013 Order"). Overlooking these factors, which the Commission has previously recognized, results in underestimating MidAmerican's cost of common equity.

As discussed in further detail below, the record supports a finding adopting Dr. Vander Weide's recommended cost of equity of 10.70%. MidAmerican, however, also offers a compromise approach that bases the authorized return on equity on the Commission's past precedent to consider the current market conditions.

1. <u>Staff's ROE Recommendation Underestimates the Risk-Free Rate used in the CAPM</u>

The Proposed Order adopts Staff's recommended return on equity ("ROE") without recognizing Staff's recommendation does not properly consider the current market conditions. In recent orders, the Commission has also recognized the current market conditions and the extraordinary efforts of the Federal Reserve to set interest rates low to stimulate the economy. As the Commission has observed, "a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment." *In re Aqua Illinois, Inc.*, ICC Docket Nos. 05-0071, 05-0072 (Cons.), at 52-53 (November 8, 2005). *See also In re Central Ill. Pub. Serv. Co.*, ICC Docket Nos. 02-0798, 03-0008, 03-0009 (Cons.), at 83-90 (October 22, 2003). Moreover, the Commission has recognized that, "each of the financial models is theoretical and has its own limitations. The models are also highly dependent on analyst judgment as to the inputs, and therefore are susceptible to manipulation." North Shore-Peoples 2010 Order at 123. These limitations require that the Commission, "also consult general financial market information to ensure that the model results presented us are generally consistent with real world conditions, and to guide our determination of reasonable rates of return on equity based on the models that we deem appropriate to our consideration." *Id.*

The Proposed Order has not addressed why it is unreasonable to discard the evidence presented that the risk free rate employed by Staff does not adequately account for the current market conditions. Since an ROE estimation does not produce a "right" answer when it comes to establishing an authorized ROE, it is not only reasonable but necessary for the Commission to consider evidence beyond the mathematical model results in order to assess their credibility and reasonableness.

In Docket Nos. 07-0241 and 07-0242 (Consol.), the Commission observed "the whole point of conducting such analyses is to develop a proxy for the appropriate ROE. When it can be shown that the proxy itself strays from a zone of reasonableness to the degree where it offers an unreliable estimate of the appropriate ROE, as the Utilities have demonstrated with Staff's DCF analysis in this case, deviation from accepted practice may be warranted." North Shore-Peoples 2007 Rate Case at 92. While MidAmerican understands the facts are slightly different in this case, the theory still holds. The Proposed Order fails to recognize that a forward-looking cost of equity that will be reflected in rates is a better proxy for the risk free rate, particularly under the current market conditions. Therefore, the forecasted rise in interest rates that is widely expected to occur in the future should be incorporated into its analysis. MidAmerican Ex. JHV 3.0, at 20, ll. 217-225. Reliance on a risk free rate based on the interest rates in effect in September of 2013 is hardly a reasonable proxy to estimate an ROE that will be in effect more than 12 month later beginning late 2014.

The Proposed Order adopts Staff's CAPM recommendation which ignores the recent extraordinary efforts of the Federal Reserve to keep interest rates low, and Staff's recommendation does not provide MidAmerican a reasonable opportunity to earn its required return on its investment during the forward-looking period during which rates will be in effect. Instead of using forecasted treasury yield, Staff used average yields on thirty-year U.S. Treasury bonds for the month of September 2013, which failed to take into consideration the forecasted interest rate increases and the fact that the Federal Reserve has taken extraordinary steps to depress the interest rates in order to stimulate the economy. MidAmerican Ex. JHV 3.0, at 20, ll. 217-225.

It is unreasonable to conclude that current rates already reflect investors' expectations of future interest rates since the current long-term interest rates are determined by both the demand and supply curves for long-term government securities. While the demand curve for long-term government securities may or may not reflect investors' expectations of future interest rates, the supply curve primarily reflects the Federal Reserve Board's policy of keeping interest rates low in order to stimulate the economy. MidAmerican Ex. JHV 3.0 at 20, ll. 217-225. Because current interest rates reflect the influence of both the demand and supply for long-term government bonds, and the supply is largely administered by the Federal Reserve, current interest rates do not reflect or equal long-term interest rate expectations. MidAmerican Ex. JHV 3.0 at 20, ll. 217-225.

Moreover, the Commission has recognized the need to examine the risk free rate in relation to the market conditions. In Docket No. 09-0312, the Commission found:

> MEC is correct that the rates approved by this Order will be applied on a going-forward basis. The period of time during which those rates will apply is, however, unknown[1]. Accordingly, the Commission, which cannot establish a cost of equity that fluctuates with investor expectations over time, must approve a single cost of common equity that will function effectively for an indefinite number of years. If

[1] Fn 90. MEC's rates were last revised in 2002. By comparison, Peoples Gas and North Shore Gas sought revisions in 2007 (Dockets 07-0241 & 07-0242 (consol.)) and again in 2009 (Dockets 09-0166 & 09-0167 (consol.)).

MEC is correct that Staff's selected spot yield is anomalously low, because of transient circumstances that are already trending up toward normalcy, the Company will be disadvantaged in the capital markets in the foreseeable future. Conversely, if Staff is correct that the actual August 18, 2009 yield reasonably reflects the return that knowledgeable investors expect over the next 30 years, customers are likely to overpay for MEC's capital costs if the Company's risk-free rate is utilized.

The Commission concludes that Staff's spot yield is too low to serve as the risk-free rate for CAPM purposes in this instance. Staff itself recognizes that real GDP growth "is a proxy for the real risk-free rate."[2] Ms. Freetly relies on sources predicting average annual real GDP growth of 2.6% (over 10 years) to 2.7% (over 30 years), which "imply a long-term, nominal risk-free rate between 4.3% and 5.2%."[3] She thus accepts the conceptual efficacy of forecasts and demonstrates that her chosen 4.4% rate is at the low end of the particular forecasts she cites[4]. Moreover, those forecasts are consistent with the range of 30-year bond yield forecasts (4.8%-5.2%) that MEC presents.[5] Therefore, the Commission will select a yield of 4.8% for the CAPM risk-free rate here. That is slightly above the mid-point of Staff's acknowledged range of forecasted GDP growth and within the range of MEC's forecasted long-term bond yields. It is also virtually identical to the 4.83% long-run economic growth rate Staff used in its DCF analysis, which was derived from the same actual (August 18, 2009) 30-year Treasury bond yield (averaged with the 10-year Treasury bond yield on that date) used for CAPM purposes here.[6]

In Re: MidAmerican Energy Company, Docket No. 09-0312, at 19-20 (March 24, 2010)

In Docket Nos. 09-0166 and 09-0167 (Consol.), the Commission found that:

The record shows that during the time Staff relied on a spot quote for 30-year Treasury bonds for the risk free rate there was considerable volatility. Indeed, as

[2] Fn 91. Staff Ex. 6.0 at 15; *Id*. at 16 ("…both the real GDP growth rate and the real risk-free rate of return should be similar…").

[3] Fn 92. *Id*. at 15-16.

[4] Fn 93. Curiously, on exceptions, Staff criticizes the very forecasts by which Ms. Freetly validates her selection of the actual 30-year bond-yield of 4.4% (on August 18, 2009) to estimate the long-run risk-free rate. Staff BOE at 3. Yet absent those forecasts, there is no evidentiary basis for Ms. Freetly's choice of treasury bonds over other available proxies for real risk-free rates. As she states, "short and long-term inflation and real risk-free rate expectations, including those that are reflected in the yields on U.S. Treasury Bills, U.S. Treasury Bonds, and the prices of common stocks, should equal over time." Staff Ex. 6.0 at 13. Ms. Freetly selected the bond yield precisely because it "more closely approximates" the forecasted growth rates she relied upon. *Id*. at 16.

[5] Fn 94. MEC Ex. KCM 2.0 at 11-12. On exceptions, Staff erroneously asserts that this Order "adopt[s] the Blue Chip forecast of 30-year U.S. Treasury bond yields as the measure of the risk-free rate." Staff BOE at 6. In fact, we are adopting a risk-free rate derived from Staff's own analysis of GDP growth, which we note to be *consistent with* the forecasts MEC uses.

[6] FN 95 referencing Dockets 09-0166 & 09-0167 (consol.) at 124.

> Mr. Moul noted in his testimony, if Mr. McNally had selected a date just three weeks later his risk free rate would have been higher. According to the record, using a reasonable forecast of 30-year Treasury bonds with Staff's CAPM yields an ROE of 10.52%. NS-PGL Ex. PRM-2.0 (Rev.) at 24-25. Considering the unreliability of solely using spot data in this case, we find using an average of Staff's CAPM cost of equity estimate of 9.95% with Staff's CAPM including *Blue Chip* forecasts of 10.52% is a more equitable result. Thus, we accept a CAPM estimate of 10.24%.
>
> North Shore-People's 2010 Order at 127.

In *Commonwealth Edison Company*, the Commission found that:

> The Commission finds that if Mr. McNally's CAPM were adjusted on an average of the 2 risk –free rates and closer to the average rate throughout the year or half of the 67 basis points. The result of 33.5 points added to his CAPM model would be in the range of 10.50%. This number would be more in the range of Dr. Hadaway's midpoint of 10.6%.

Commonwealth Edison Company, Docket No. 10-0467, May 24, 2011 at 153.

As explained in testimony and in the initial brief, if Staff had employed a forward looking risk free rate based on the forecasted yield on long-term Treasury Bonds of 5.17%, then Staff's CAPM analysis would have produced a cost of equity of 10.10%. The use of a forecasted interest rate does not overstate the ROE, but instead reflects a fair rate of return that allows MidAmerican the opportunity to earn its required rate of return during the forward-looking period in which rates will be in effect.

Accordingly, the Commission should reject the Proposed Order's adoption of Staff's use of a Treasury yield based on information from September 2013 as a risk-free rate in the CAPM and accept the use of a risk-free rate using forward-looking and historical data in this case.

2. <u>Relying on the Results of the Risk Premium Models is Reasonable</u>

The Proposed Order concludes that the Commission does not rely on the Risk Premium models as part of the ROE analysis. Proposed Order at 48. The risk premium method is based on the principle that investors expect to earn a return on an equity investment that reflects a "premium" over the interest rate they expect to earn on an investment in bonds. This equity risk premium compensates equity investors for the additional risk they bear in making equity investments versus bond investments. MidAmerican Ex. JHV 1.0 at 27, ll. 596-603. As such, this analysis should not be dismissed out of hand.

The purpose of a risk premium analysis is to estimate the required return on investment for companies that are comparable in risk to the utility whose cost of equity is being estimated. MidAmerican Ex. JHV 2.0 at 17, ll. 343-356. It is reasonable for the Commission to review historical information on utility investors' required return on equity because the cost of equity can only be estimated with uncertainty, and the required risk premium on utility equity investments varies inversely with interest rates, *i.e.*, the required equity risk premium is higher when interest rates are lower, as they are at present, than when interest rates are higher. MidAmerican Ex. JHV 2.0 at 18, ll. 361-366. The Commission should recognize that the inverse relationship between the required risk premium on utility investments and interest rates can only be determined using historical data. By providing relevant information on the inverse relationship between the required risk premium and interest rates, Dr. Vander Weide's ex ante risk premium approach provides context in estimating MidAmerican's cost of equity that is not included in the DCF and CAPM studies. MidAmerican Ex. JHV 2.0 at 18, ll. 336-370.

Furthermore, it is widely recognized that investors' current expectations of the required risk premium are influenced in part by the historical record of the earned risk premium on stock investments of comparable risk. Thus, the ex post risk premium results also provide the Commission useful information for determining MidAmerican's cost of equity in this proceeding. MidAmerican Ex. JHV 2.0 at 18, ll. 371-375. Because past experience may impact future expectations, the ex post risk premium approach is relevant to an assessment of investor expectations, and accordingly is not outdated.

Based on the foregoing reasons, it is reasonable for the Commission to give weight to the results of the risk premium models presented in Dr. Vander Weide's testimony.

3. Conclusion

The Commission has recognized that "[i]n determining what the cost of equity is for a utility, the Commission must base its decision on sound financial principles that are used by sophisticated investors. *In re Illinois Bell Tel. Co.*, ICC Docket No. 92-0448, 93-0239 (Cons.), at 103 (October 11, 1994) (Emphasis added).

Consistent with prior Commission decisions, the Proposed Order should:

- recognize no single test or model is determinative of the cost of equity, and the more perspectives considered in evaluating the market conditions, the more the results can be checked for reasonableness;
- recognize a risk free rate using analysts' forecasts is an objective means of estimating investor return expectations and should be an integral component of the return on equity determination for an electric utility; and
- recognize that a forward-looking cost of equity that will be reflected in rates that will not become effective until sometime in the future, should incorporate the rise in interest rates that is widely expected to occur in the risk free rate;

When the Commission evaluates the expectations of investors, it will find that Dr. Vander Weide's recommended return on equity of 10.70% is commensurate with that of comparable risk enterprises; will maintain its financial integrity; and will allow it to attract capital on reasonable terms. *See* in *Bluefield Water Works & Improvement Co. v. Public Service*

Comm'n of the State of West Virginia, 262 U.S. 679 (1923) and *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944). An allowed return on equity for MidAmerican's Illinois electric utility operations of 10.70% is reasonable and relies on market data investors would consider. The resulting recommendation including MidAmerican's flotation costs will ensure MidAmerican maintains its financial integrity, will be able to attract capital on reasonable terms and will be afforded the opportunity to earn a return commensurate with the returns available to enterprises of comparable risk.

While MidAmerican submits the record establishes its requested return of equity of 10.70% is just and reasonable, MidAmerican also offers a compromise position that the authorized return on equity should be established at 9.90% based upon the Commission's recent decision in the North Shore-Peoples 2013 Order wherein the Commission averaged the DCF and CAPM recommendations of Staff and the Company witnesses. The alternative is also shown in the attached MidAmerican Exceptions. MidAmerican Exceptions designate the Company's initial position as "MidAmerican's Original Position," and its compromise position is designated "MidAmerican's Alternative Position."

E. Weighted Average Cost of Capital

Based upon the foregoing and as reflected in the MidAmerican Exceptions, the Commission should adopt MidAmerican's recommended return on equity of 10.70%, its recommended cost of debt equal to 4.528%, and its recommended capital structure containing 48.270% long-term debt and 41.730% common equity. As shown below, this produces a return on rate base equal to 7.721%:

MidAmerican's Weighted-Average Cost of Capital

December 31, 2012

Capital Component	Balance	Ratio	Cost	Weighted-Average Cost
Long-Term Debt	$3,525,119,950	48.270%	4.528%	2.186%
Common Equity	$3,777,734,285	51.730%	10.70%	5.535%
Total	$7,302,854,235	100.00%		7.721%

VI. Request for Oral Argument

MidAmerican respectfully requests the Commission consider oral arguments in this docket pursuant to 83 Ill. Admin. Code Part 200.850. MidAmerican respectfully requests the Commission consider argument be held in this proceeding to consider the issues of: (1) the inclusion of the pension asset in rate base; (2) the recovery of incentive compensation; (3) the out of test year state tax adjustment; and (4) other issues which the Commission may deem to assist it in reaching a decision in accordance with the applicable law and based on the evidence in the record. 220 ILCS 5/10-103, 10-201(e).

VII. Conclusion

For the reasons set forth above and reflected in the record, MidAmerican's initial and reply briefs and its proposed draft order, MidAmerican Energy Company respectfully requests that the Commission adopt MidAmerican's Exceptions and enter findings and make conclusions consistent with the positions set forth in these Exceptions.

WHEREFORE, MidAmerican Energy Company respectfully requests that the Illinois Commerce Commission issue an Order approving MidAmerican's rate application, as modified and consistent with MidAmerican Exceptions and Appendix A. MidAmerican also respectfully requests that its Request for Oral Argument be granted.

DATED this 25th day of September, 2014.

Respectfully submitted,

MIDAMERICAN ENERGY COMPANY

By *<u>/s/ Steven R. Weiss</u>*
One of its attorneys

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