

City/CUB/IEEC Exhibit 1.0

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

COMMONWEALTH EDISON COMPANY)

**Annual formula rate update and
revenue requirement reconciliation
under Section 16-108.5 of the
Public Utilities Act.**)

Docket No. 14-0312

Direct Testimony and Exhibits of

Michael P. Gorman

On behalf of

**City of Chicago, Citizens Utility Board
and Illinois Industrial Energy Consumers**

July 1, 2014



14

ISSUES

15 **Q AFTER YOUR REVIEW OF COMED'S FILING, HAVE YOU IDENTIFIED ANY**
16 **ISSUES WITH COMED'S CALCULATION OF THE NET REVENUE**
17 **REQUIREMENT?**

18 **A** Yes. As I will discuss further in my testimony, I am proposing adjustments to
19 ComEd's calculation of the interest expense on the reconciliation balance, cash
20 working capital and incentive compensation.

21 **RECONCILIATION BALANCE FOR CALCULATING INTEREST**

22 **Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH THE CALCULATION OF**
23 **INTEREST ON THE RECONCILIATION BALANCE.**

24 **A** Part of the annual formula rate filing includes a reconciliation of the actual revenue
25 requirement that existed during the prior year (in this case, 2013), and the revenue
26 requirements that were determined for that year. Any difference is credited to or
27 collected from customers, with interest, during the following year (in this case, 2015).
28 I believe that the reconciliation balance that ComEd is using to calculate the amount
29 of reconciliation interest is overstated.

30 **Q PLEASE DESCRIBE THE ISSUE YOU HAVE WITH THE RECONCILIATION**
31 **BALANCE COMED USED TO CALCULATE RECONCILIATION INTEREST.**

32 **A** ComEd calculated reconciliation interest on the reconciliation balance. The
33 reconciliation balance is the total difference between the revenue requirement
34 actually incurred in 2013 and the revenue requirements that were determined for
35 2013. This balance will be recovered in 2015. However, this balance does not reflect
36 the net cash investment of ComEd in the reconciliation balance. The carrying

37 charges represented by the reconciliation interest should only be calculated on the
38 net cash investment of ComEd in the reconciliation balance.

39 **Q HOW DO YOU DETERMINE THE NET CASH COMED HAS INVESTED IN THE**
40 **RECONCILIATION BALANCE?**

41 A Since the reconciliation balance is a positive balance, the amount reflects additional
42 costs that were incurred in 2013 and were deductible for income taxes. As a result,
43 the reconciliation balance must be reduced by the temporary income tax savings
44 associated with the tax deductibility of these costs to determine ComEd's net cash
45 investment in the reconciliation balance.

46 **Q PLEASE ILLUSTRATE THIS CALCULATION.**

47 A For example, if ComEd incurs \$500,000 more payroll expense during 2013 than was
48 reflected in the revenue requirements determined for 2013, the Company will have a
49 \$500,000 higher reconciliation balance. However, ComEd will deduct the higher
50 payroll expense for the calculation of its 2013 income taxes. As a result, assuming a
51 41% tax rate, ComEd will realize \$205,000 of reduced income taxes associated with
52 the higher payroll expense (\$500,000 x 41%). Therefore, ComEd will only have
53 carried a cash reconciliation balance amount of \$295,000 for the additional payroll
54 expense (\$500,000 - \$205,000).

55 ComEd's cost of carrying the unrecovered payroll is based on its out-of-pocket
56 net cash investment (cash expenditures less income taxes) of \$295,000 through the
57 period the full accounting balance (\$500,000) is recovered. As such, ComEd should
58 only be allowed to recover carrying cost on its out-of-pocket net cash investment of
59 \$295,000. ComEd is made whole for the delayed recovery of the reconciliation

60 balance by fully recovering the \$500,000, and the carrying charges on the associated
61 out-of-pocket net cash investment in the reconciliation balance (\$295,000) during the
62 recovery period.

63 **Q WHY IS IT IMPORTANT TO CORRECTLY MEASURE THE CARRYING VALUE OF**
64 **THE RECONCILIATION BALANCE IN DETERMINING THE INTEREST ON THE**
65 **RECONCILIATION BALANCE?**

66 A While I am not a lawyer, it is my understanding that as a result of the amendments to
67 subsections (c) and (d) of Section 16-108.5 of The Public Utilities Act, the interest on
68 the reconciliation balance must reflect the actual weighted average cost of capital
69 ("WACC"). Previously, the Illinois Commerce Commission ("Commission") had
70 ordered the use of short-term debt rate, which is .40% compared to the actual WACC
71 of 7.04%. As a result, depending on the size of the reconciliation balance, either
72 positive or negative, the associated interest calculated at the actual WACC rate may
73 be a substantial portion of the net revenue requirement. As can be seen in the
74 current case, ComEd seeks to recover a total reconciliation balance of \$260.76
75 million (ComEd Ex. 3.01, Sch FR A-1, Line 24) that includes over \$34 million of
76 interest (ComEd Ex. 3.01, Sch FR A-4, Line 31 minus Line 1e). Based on my
77 recommendation, the calculation of interest on only the net carrying value of the
78 reconciliation balance reduces the amount of interest by over 40%.

79 **Q HOW WOULD YOU PROPOSE TO REFLECT THE REDUCTION TO THE AMOUNT**
80 **OF RECONCILIATION INTEREST TO REFLECT NET CASH INVESTMENT?**

81 A Reconciliation interest should be calculated on a net of tax benefits basis. Currently,
82 reconciliation interest is being calculated on the amount in Mr. Menon's ComEd

83 Exhibit 3.01, Sch FR A-4, Line 1e, entitled "Variance With Collar." This exhibit shows
84 \$226,593,000 as the amount on which interest is calculated. This reflects the
85 difference between the actual 2013 revenue requirement and the revenue
86 requirements determined for 2013. This amount reflects costs that were incurred in
87 2013 and will be collected from customers in 2015. The amount of interest currently
88 calculated on this schedule must be reduced to reflect the tax savings/benefits
89 associated with the reconciliation balance at the tax rate of 41.175%. ComEd's Sch
90 FR A-4 allows an adjustment on line 30a from Workpaper 26. I have calculated the
91 adjustment on Workpaper 26 that is necessary to reflect the reduction of the interest
92 on the reconciliation balance. CCI Exhibit 1.02 shows the calculation on
93 Workpaper 26, reflecting the adjustment to the interest on the reconciliation balance,
94 based on the Company's filed calculation in ComEd Ex. 3.01, Sch FR A-4.

95 **Q WHAT IS THE EFFECT OF YOUR RECOMMENDATION ON THE AMOUNT OF**
96 **RECONCILIATION WITH INTEREST?**

97 A Calculating interest on only the amount of ComEd's net cash investment reduces the
98 reconciliation interest by approximately \$14 million.

99 **Q WAS THE APPROPRIATE RECONCILIATION BALANCE FOR CALCULATING**
100 **INTEREST AN ISSUE IN THE PREVIOUS FORMULA RATE UPDATE CASE,**
101 **DOCKET NO. 13-0318?**

102 A Yes, the issue was raised in Docket No. 13-0318. Subsequently, however, the
103 Commission, on its own motion, initiated Docket No. 13-0553 (companion case to
104 Docket No. 13-0318) under Section 9-201 of the Public Utilities Act ("PUA" or the
105 "Act") to, among other items, address whether ComEd correctly reflected the

106 appropriate tax treatment in calculating interest on the reconciliation balance in the
107 formula rate tariff as authorized by the PUA. In that docket, the Commission stated
108 that it found merit in the intervening parties' proposals to net Accumulated Deferred
109 Income Tax ("ADIT") against the reconciliation balance before calculating interest on
110 that balance, but was concerned that the language in Section 16-108.5(d)(1) of the
111 Act does not require or reference the netting of ADIT. However, the Commission also
112 stated that it would revisit the issue if the parties presented further arguments.

113 **Q WHY SHOULD THE COMMISSION RECONSIDER ITS RULING IN DOCKET**
114 **NO. 13-0553/13-0318?**

115 A I believe the Commission should reconsider its ruling for the following reasons:

- 116 1. Recognition of deferred income taxes in determining the carrying value of
117 an asset is a fundamental regulatory concept;
- 118 2. Deferred income taxes are being recognized elsewhere, even though
119 specific language does not appear in the Act;
- 120 3. Reducing the reconciliation balance for deferred income taxes reflects the
121 actual cost to the utility;
- 122 4. The adjustment does not disturb the formula rate schedules FR A-1 or
123 FR A-4.

124 **Q PLEASE ELABORATE ON YOUR STATEMENT THAT THE RECOGNITION OF**
125 **DEFERRED INCOME TAXES IN DETERMINING THE CARRYING VALUE OF AN**
126 **ASSET IS A FUNDAMENTAL REGULATORY CONCEPT.**

127 A Offsetting rate base components for associated deferred income taxes prior to the
128 application of a rate of return (carrying cost) is a basic concept historically followed by
129 the Commission. This is true not only in regard to the traditional presentation and
130 calculation of a rate base in general rate cases, but also occurs in non-traditional

131 proceedings such as formula ratemaking and determining rates under the Qualifying
132 Infrastructure Plant Rider.

133 **Q IS THE RECOGNITION OF DEFERRED INCOME TAXES IN FORMULA RATE**
134 **PROCEEDINGS SPECIFICALLY DISCUSSED IN THE ACT?**

135 A The recognition of deferred income taxes only appears once in Section 16-108.5. In
136 Section 16-108.5(c)(4)(D) a carrying cost equal to the weighted cost of long-term debt
137 is applied to the pension asset, net of “deferred tax benefits.” However, all other
138 recognition of ADIT in formula ratemaking was not the result of reliance on specific
139 wording in the Act. For example, the offset for ADIT is a significant component of the
140 rate base used to determine the revenue requirement for formula rates but does not
141 appear to be based on any specific reference to ADIT in Section 16-108.5.

142 **Q DOES THE ACT SPECIFICALLY REQUIRE RECOVERY OF A UTILITY’S ACTUAL**
143 **COSTS?**

144 A Yes. Section 16-108.5(c)(1) states that the formula rates will provide for the recovery
145 of the utility's actual costs of delivery services that are prudently incurred and
146 reasonable in amount consistent with Commission practice and law. As previously
147 discussed, applying the WACC to the reconciliation balance, net of the associated
148 deferred income taxes, reflects the actual carrying cost on ComEd’s out-of-pocket net
149 cash investment. In addition, netting deferred income taxes prior to the application of
150 a carrying charge rate is consistent with Commission practice.

CCI Exhibit 1.02

WP 26
 Page 1 of 1

Commonwealth Edison Company
Other Adjustments
 (In Thousands)

Line No.	(A) Source	(B) Description (A)	(C)	(D)	(E)	(F)	(G)																																																																																																																														
1	(Sch FR A-4 Ln 1e)	Reconciliation Balance		\$ 226,593																																																																																																																																	
2	(Sch FR C-4 Ln 4)	Income Tax Rate		<u>-41.175%</u>																																																																																																																																	
3		Tax Benefits		<u>\$ (93,300)</u>																																																																																																																																	
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25	Aug	Col G Ln 24	(43,960)	0.5867%	(8,947)	(35,271)																																																																																																																															
26	Sep	Col G Ln 25	(35,271)	0.5867%	(8,947)	(26,530)																																																																																																																															
27	Oct	Col G Ln 26	(26,530)	0.5867%	(8,947)	(17,738)																																																																																																																															
28	Nov	Col G Ln 27	(17,738)	0.5867%	(8,947)	(8,895)																																																																																																																															
29	Dec	Col G Ln 28	(8,895)	0.5867%	(8,947)	0																																																																																																																															
30	Tax Benefits with Interest	Sum of (Ln 18) thru (Ln 29)			\$ (107,368)																																																																																																																																
31	Remove Tax Benefits	Col C Ln 3			(93,300)																																																																																																																																
32	Interest Adjustment	(Ln 30) - (Ln 31)			<u>\$ (14,068)</u>	To Sch FR A-4 Ln 30																																																																																																																															

Note:

(1) Will not match CCI 1.01, which reflects other adjustments to ComEd's reconciliation balance