STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Power Company	:	
	:	
Proposed revisions to delivery service tariff sheets and other sheets.	:	**No. 01-0432**
	:	

REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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NOW COMES the Staff of the Illinois Commerce Commission ("Staff"), through its attorneys, and pursuant to 83 Ill. Admin. Code 200.830, files its Reply Brief on Exceptions ("RBOE") to the Briefs of Exception ("BOE") filed in the above-captioned proceeding.

I. REVENUE REQUIREMENT

A. Rate Base

1. Functionalization and Allocation of G&I Plant Accounts

IP's lengthy exception provides no basis for reversing the Proposed Order's conclusion on General and Intangible Plant ("G&I") and Administrative and General ("A&G") expenses. Neither the host of objections raised by IP nor the Company's suggestions that the conclusion fails to pass "legal muster" (IP BOE, p. 1) should deter the Commission from reaffirming the PO on these issues.

As expected, IP devotes much time and energy in its BOE to criticizing Staff's proposed functionalization of General and Intangible ("G&I") plant and Administrative and General ("A&G") accounts. Those criticisms lack merit, as will be explained. At the same time, IP seeks to buttress its own functionalization approach by claiming adherence to the Commission's labor allocator. According to the Company, "in this case, IP followed the direction of the 1999 DSP Order and used the labor expense allocator approach." (IP BOE, p. 2) However, what the Company omits and what IP witness Carter has openly admitted under cross examination, is that before applying the labor allocator, IP conveniently dumped into transmission and distribution the General and Intangible and A&G costs that the Commission had allocated to generation in Docket No. 99-0134. (Tr. 169) In other words, the Company has unilaterally decided to defy the Commission's application of the labor allocator to the generation function, by reallocating costs from generation back to the regulated utility. Then, by allocating this inflated set of costs between transmission and distribution on the basis of a truncated labor allocator, the Company claims adherence to the labor allocation methodology approved in Docket No. 99-0134.

However, as Staff has maintained throughout this case, IP's claim is undermined by the disturbing reality of exorbitant increases proposed for both General and Intangible Plant and A&G expenses. In direct testimony, IP proposed an increase in General and Intangible plant from $109,978,000 in Docket No. 99-0134 to $275,529,000. That represents an increase of $165,551,000 or 151% over the Commission-approved level in Docket No. 99-0134. (Staff Ex. 5.0, p. 6) With respect to A&G expenses, IP's direct testimony proposed a 196% increase from the $15.92 million approved by the Commission in Docket No. 99-0134 to $47.14 million. (Staff Ex. 14.0, p. 15) IP seeks to justify its proposed increase in General and Intangible plant and A&G expenses from an operational standpoint. According to IP:

> The PO, however, ignores the nature and function of common costs such as G&I plant and A&G expenses – costs that support several business functions of a company – by erroneously assuming that when a company eliminates a business function and the related direct investment and expenses, its common costs can be reduced in direct proportion. This is a proposition that is *nowhere* supported by the record, let alone by common sense. (p. 3)

This argument fundamentally mischaracterizes the restructuring process at Illinois Power Company. IP did not eliminate the generation function, but rather sold one plant and spun off its remaining generation to an unregulated affiliate. What the Company did not spin off were the full share of common costs that the Commission had allocated to generation in Docket No. 99-0134. Instead, the

Company reallocated these costs back to the transmission and distribution company and to delivery services customers. This reallocation occurred despite assurances by IP that "Illinois Power's electric customers will see no difference in the level or quality of service they receive, nor will the price they pay increase as a result of the transfer." (Staff Ex. 5.0, p. 10) Furthermore, the Company has failed to explain why these common costs cannot continue to be allocated to generation owned by an affiliate.

It should also be remembered that the decision to restructure the IP utility was a "business decision" in the words of Company witness Carter. (Tr. 155) It would be unfair indeed to make ratepayers pay for a decision made on behalf of IP and its shareholders.

Finally, the Company's proposed reallocation of costs to the transmission and distribution utility raises the issue of least cost ratemaking. If divestiture leads to higher rates, then IP's ratemaking may come in direct conflict with the standard of least cost ratemaking. If the Company had not spun off its generation then customers may have enjoyed lower delivery services rates based on the application of the Commission's labor allocator to the generation function as well. The following cross of IP with respect to A&G expenses reinforces this conclusion:

> Q. Ms. Carter, absent the divestiture, is it possible that A&G expenses would be lower? (Tr. 172)

She responded:

A. Using the same labor allocator in the last case, yes. (Tr. 172)

IP complains that the PO deprives IP of the opportunity to recover its prudently incurred distribution costs. According to IP:

> In effect, the PO penalizes IP for divesting its generating business and converting itself into a T&D company, even though this is exactly what the Restructuring Law allows for, and even though it is the type of structure that is likely to promote competition while maintaining safe and reliable service. (IP BOE, p. 3)

This statement reflects a fundamental misunderstanding of the Proposed Order. It does not seek to penalize IP for divesting generation. Rather, it seeks to prevent IP from penalizing ratepayers for this divestiture decision. IP goes on to criticize the specific methodology approved by the PO for functionalizing common costs to distribution. According to the Company, pegging the percentage increase for General and Intangible plant to the increase in direct plant costs and the increase in A&G expense to other O&M improperly lock these common costs into "fixed relationships" for the foreseeable future." (IP BOE, p. 4) The Company suggests this "fixed" relationship differs from the relationship created by the labor allocator. Staff disagrees. In fact, it is Staff's proposed allocation methodology that is consistent with the Commission's labor allocator. In both cases, General and Intangible Plant and A&G expenses are regarded as indirect costs that are functionalized according to relationships between direct system costs. For the labor allocator, it is the relationship of distribution labor costs to other direct labor costs on the utility system. For Staff's proposed approach, common costs are functionalized to distribution according to the change in associated direct costs over time, from Docket No. 99-0134 to the current proceeding. The general principle that guides Staff's proposed allocation for General and Intangible Plant and A&G expenses is that the changes to these common accounts should be proportional to changes to the direct accounts to which they relate. These are indirect costs that dependent upon on the direct costs to which they relate. Therefore, it would be reasonable to assume that their increase should be commensurate with the increase in related accounts. IP's criticism of Staff's methodology has a hollow ring considering there are gaping flaws in its own proposal. On the one hand, IP touts its approach as following the labor allocator approved by the Commission in Docket No. 99-0134. But this "consistent" approach produces astronomical increases in General and Intangible plant and A&G accounts. That is because IP's proposal fundamentally diverges from the Commission's labor allocator. Instead of adhering to the Commission, the Company seeks to undermine the Commission's decision by reallocating costs from generation to transmission and distribution under the cover of its generation divestiture process. Then, IP employs a meaningless labor allocator between transmission and distribution so it can claim consistency with the Commission approach. However, the ALJ was not impressed by IP's claims and accordingly rejected the Company's proposal. The Commission should do the same.

In sharp contrast to the Company's proposal, the Staff proposal offers a number of advantages by maintaining consistency with the Commission Order in Docket No. 99-0134 in a straightforward, understandable and reasonable manner.

IP also complains about the methodology used to support Staff's proposed functionalization methodology. The timing of this complaint is curious, considering that Staff's adjustments were made in direct testimony and IP did not address the calculations in rebuttal, surrebuttal, cross-examination, briefs or reply briefs. Even though these criticisms come at quite a late stage, Staff believes the order should be as accurate as possible and, therefore, has incorporated two revisions to its proposed adjustments to ensure the accuracy of the results. These changes are presented and explained in the section pertaining to the functionalization of A&G expenses.

IP devotes considerable energy in its BOE to complain about what it considers to be a results-oriented decision in the PO. According to IP:

> The principal basis for the PO's conclusion appears to be the assertion that "there has been no showing that [IP's] remaining operations require such a large increase in G&I relative to the amount established by the Commission in 1999." (PO, p. 17) This assertion is flawed. (IP BOE, p. 9)

IP goes on to complain:

> There is nothing in the 1999 DST Order to indicate that the Commission was determining a specific amount of G&I plant that would be sufficient to support the distribution business…(IP BOE, p. 10)

IP attempts to divert the Commission's attention from the results for good reason. The Company's proposed functionalization simply does not add up. The Company can say what it wants to about its adherence to the Commission's labor allocator, but when its proposal produces a 248% increase in General and Intangible Plant allocations, something is obviously amiss. These increases clearly demonstrate the extent to which IP has undermined the Commission's Order by reallocating common costs in the course of divesting its generation assets.

IP also presents a lengthy explanation why the significant increases in common costs are necessary from an operational standpoint. According to the Company:

> It is the nature of joint and common costs that they are needed to support a single line of business but can support additional lines of business without a significant increase; correspondingly, the elimination of one of several lines of business does not necessarily mean that the firm's common costs can be reduced significantly. (IP BOE, p. 10)

The Company goes on to criticize the Proposed Order on this issue, stating:

> The effect of the PO's conclusion is to *in fact* assume that because IP has divested its generation assets and exited the generation business, its G&I plant balances can be "reduced correspondingly." There is absolutely no basis for such an assumption. (IP BOE, p. 11)

IP's argument ignores three realities. One concerns the basis for IP's divestiture of generation. As Company witness Carter acknowledged, the divestiture of generation was a business decision by IP. The Company was not required by the Commission or anyone else to undertake this restructuring. The Company has the right to divest, but not to use divestiture as a tool to drive up delivery service rates.

Second, IP's proposal to raise rates under the cover of divestiture is particularly problematic given the assurances by the Company that electric ratepayers would not be harmed in any way by the divestiture process. IP's efforts in this case clearly undermine the veracity of those assurances.

Third, it should be remembered that all of IP's generation units, save the Clinton plant, were spun off to an unregulated subsidiary. If generation is not "eliminated" as IP suggests, but remains under the same corporate tent, the question IP fails to answer is "why generation can no longer be allocated a reasonable share of common costs?"

IP then launches into an argument concerning capital additions, arguing that the PO had no basis for failing to include them in their entirety in the revenue requirement. (IP BOE, pp. 12-13) According to the Company:

> There is no basis to conclude that these new and recent additions are being installed for any purpose other than to support IP's <u>current</u> lines of business…IP presented detailed exhibits describing its recent and planned G&I capital additions, and neither Staff nor any other witnesses opposed inclusion of any specific project or component of those additions in rate base. (IP BOE, p. 12)

IP's argument lacks record support. Contrary to the Company's claims, it did not provide detailed supporting exhibits for capital additions, but instead furnished broad and vague descriptions that failed to demonstrate they pertain solely to the distribution function. (Staff Ex. 14.0, p. 13) Thus, IP has no basis for claiming that these additions should be included in their entirety in the revenue requirement.

Furthermore, IP seeks to stand the regulatory process on its head with respect to these issues. First, the Company dumps as many unsupported costs as possible into the revenue requirement and then argues it is the responsibility of Staff and intervenors to justify their removal. However, the ALJ correctly recognized that the responsibility to justify these capital additions lies with IP. IP has not lived up to this responsibility.

IP seeks to shift the burden of proof to others, not just for capital additions, but for other costs as well. Thus, the Company argues:

> Although Staff and IIEC witnesses complain about the amount of the increase in IP's G&I plant proposed for inclusion in rate base in this case as compared to the amount included in rate base in the 1999 DST Case, these witnesses *did not identify any items of G&I plant that were unnecessary, that were not needed to support IP's remaining business including the distribution business, or that*

should have been transferred to the new owners of the generating plants. (IP BOE, p. 14)

This argument is deficient in two respects. First, as has previously been explained, it is IP's responsibility to justify the costs in its revenue requirement. Other parties should not have the burden to sort through the costs that have dumped into distribution with little or no support, and to identify each and every item that should be removed. Second, this argument about whether individual common costs should or should not be included in the revenue requirement runs counter to the notion of the labor allocator which IP claims to embrace in this case. The labor allocator presumes that these common costs are not amenable to direct assignment and should therefore be allocated. Thus, it is inconsistent for IP to demand that others conduct a direct assignment analysis to determine which common costs that IP has included should now be removed from the revenue requirement.

On page 16 of its BOE, IP makes two claims with respect to Staff's adjustment of General and Intangible Plant. The first is that there is an error in the calculation. Second, IP claims that the adjustment should be updated to reflect IP's surrebuttal position in the case. (IP BOE, pp. 16-17)

The error claimed by IP concerns the distribution plant depreciation reserve and the G&I plant distribution reserve figures for Docket No. 99-0134 contained in Staff's adjustment of General and Intangible plant. Referring to Staff's rebuttal testimony, IP claims that Staff's adjustment used the incorrect values from the 1999 DST case for both the distribution plant depreciation reserve and the G&I plant distribution reserve and that the adjustment should be updated accordingly. (IP BOE, pp. 18-19)

IP's argument should be dismissed. Staff filed its rebuttal testimony on November 6, 2001. IP filed its surrebuttal testimony on November 14, 2001, and failed to raise this issue at that time. IP waited until its BOE, some 15 weeks later, to introduce a revised adjustment. Inclusion of these adjustments at this late date, could serve to prejudice the parties. For this reason, IP's proposed adjustment should be rejected.

IP's proposal to update the adjustments to reflect its surrebuttal position lacks merit for similar reasons. IP had the opportunity to address these proposed adjustments on two separate occasions prior to close of the record. IP did not provide a schedule with this proposed adjustment in its surrebuttal testimony. Further, IP failed to elicit the position of the parties concerning this adjustment during cross-examination. For this reason, Staff does not support the adjustment.

2. Capitalization of Severance

The PO correctly found that IP improperly capitalized a portion of its severance and early retirement costs. (PO, p. 22) The Company's accounting treatment of capitalizing the severance costs is inappropriate since such costs are a one-time period expense which do not add value to the Company's plant. The costs should have been expensed in the period incurred. (Staff IB, p. 32)

Staff described fully in its Initial Brief the applicable sections of the USOA regarding appropriate capitalization of costs and its interpretation thereof. (Staff IB, pp. 33-34) In summary, the costs are not allowed capitalization because they do not meet the USOA's definition of labor and they have no reasonable applicability to construction costs. (Staff IB, pp. 33-34) Staff demonstrated that the USOA does not allow for the capitalization of severance costs simply because the costs are recorded in A & G expense accounts on the expense side. (Staff IB, p. 33) Further, the Company did not determine the amount to be capitalized based upon any special study, but rather based it upon the same percentage as any other cost recorded in Accounts 920 and 926. (Staff IB, p. 34) The Company presented no independent evidence to support why severance costs should be capitalized, other than the fact that most other costs recorded in Accounts 920 and 926 are capitalized in part. (Staff IB, p. 34)

For reasons set forth in greater detail in Staff's Initial Brief, the Commission should reject the conclusions contained within the Company's BOE and instead adopt the original conclusion contained in the PO.

II. OPERATING REVENUES AND EXPENSES

A. Rulemaking Expense Amortization

The PO correctly found that the Commission's decision in 99-0134 does not allow for the accounting treatment the Company proposes for its 1999 rulemaking costs. (PO, p. 29) The Company's RBOE only repeated its same arguments from the entire case, arguments that the Staff has thoroughly discredited. (Staff IB, pp. 25-28) Staff has shown that the costs in question do not merit a departure from established test year rules for costs, which the Company openly acknowledges are additional, incremental expenses (i.e., incurred in 1999 beyond the amount allowed in its prior DST case.) (Staff IB, p. 25)

The Company's argument is based solely upon its erroneous belief that the Commission's 1999 DST order included approval of all future rulemaking costs. (IP Ex. 1.34, p. 34, lines 728-730) The PO was correct in stating that the Commission did not approve such costs in its prior order. (PO, p. 29) Rather, the

Commission simply allowed the *test year* expenses and *known and measurable* adjustments associated with those rulemakings to be amortized for the test year. The Commission treated these expenses the same as any other operating expense. (Staff Ex. 19.0, p. 6, lines 128-131)

The prior DST case amount was determined based on the historical test year costs plus the known and measurable pro forma amounts at the time, for that case, amortized over five years. Similarly, the revenue requirement in this case should be based on the *current* test year and *its* pro forma adjustments. To do anything otherwise would mismatch prior period operating expenses with current period revenues, as well as overstate the balance of Account 923. (Staff IB, p. 26) The Company's proposal selects isolated expenses related to its prior DST case occurring in 1999 and improperly attempts to make 1999 costs appear to be test year costs. Such action is clearly inappropriate; therefore, the Commission should adopt the conclusion in the PO.

B. Y2K Expense Amortization

Similar to the Rulemaking Amortization issue discussed above, the PO correctly found that the Commission's decision in 99-0134 does not allow for the accounting treatment the Company proposes for its 1999 Y2K costs. (PO, p. 30) In its BOE, the Company stresses the reasonableness of the costs in question, arguing they were incurred to prevent potentially severe problems. (IP BOE, p. 38) However, Staff has shown that the costs in question do not merit a departure from established test year rules. (Staff IB, pp. 28-29) The reasons for this conclusion are very much the same as for Staff's rulemaking amortization adjustment. (Staff IB, pp. 25-30) In summary, the Company's position is that the prior DST case allowed for rate recovery of all future Y2K expense amounts. (IP

BOE, p. 38) In reality, though, the prior DST case amount was based on the historical test year costs plus the known and measurable pro forma amounts at the time, for that case, amortized over six years. Similarly, the revenue requirement in this case should be based on the *current* test year and *its* pro forma adjustments. As the costs in question are clearly 1999 out-of-period costs, the Commission should adopt the conclusion in the PO to uphold proper test year principles.

C. Severance Costs

1. Contested

The PO correctly found that IP should not be allowed rate recovery of its non-recurring, non-operational transactional costs resulting from IP's merger with Dynegy. (PO, p. 33) Staff's Initial Brief summarizes the record evidence that supports this conclusion. (Staff IB, pp. 29-32) Staff demonstrated that the Company's costs, without question, fall into the definition of transaction costs used by the Commission in recent decisions. (Staff IB, p. 30) Recent Commission orders are unambiguous in their determination that transaction costs of mergers are not allowed rate recovery. (Staff IB, p. 30) The Company opines that the PO is based upon an inappropriate application of a small number of prior Commission orders that do not contain the underlying rationale for lumping employee severance costs with other transaction costs. (IP BOE, pp.5, 42) There is nothing unclear, though, about the findings of those orders, which are absolutely contrary to the Company's position. The orders are directly related to the issue at hand and are valid. The Company would rather rely on orders that are only indirectly similar to the facts in the instant proceeding. (IP BOE, pp.42-43) The Company has presented insufficient evidence to show why the

Commission should disregard orders so identical to the current fact set and instead rely on orders that are a stretch, at best.

The Company does not agree with the Commission's position on merger transaction costs, and therefore attempts to cast doubt on the true nature of these costs. Regarding the issue of whether or not the costs in question are merger related costs, the Company criticizes Staff's statement that the severance and early retirement costs were "incurred in order to effectuate a change in Company ownership." (IP BOE, p. 42) Yet, the Company has clearly acknowledged that the costs were incurred as a result of position eliminations or consolidations of activities with Dynegy. (Staff IB, pp. 29-30) The Company's attempt to redefine the nature of the costs should not be accepted by the Commission.

The Company's BOE implies Staff believes the Commission is "precluded" from allowing recovery of the severance costs in this case. (IP BOE, p. 42) Staff never made such a claim. Similarly, Staff is aware that it is at the Commission's discretion whether to allow amortization of a non-recurring expense; it is not a foregone conclusion as the Company suggests. (IP BOE, p. 44; Staff IB, p. 32)

Therefore, for all the reasons stated above, the PO's conclusion is appropriate and should be adopted by the Commission.

2. Technical Correction

Staff agrees with the technical error which the Company identifies beginning on page 60 of its BOE. Staff agrees that its severance cost adjustment should be reflected as an A & G expense, rather than Operation and Maintenance as filed. Such amount was properly classified in direct testimony in the record as A & G expense, but inadvertently changed in rebuttal. (ICC Staff

Ex. 1.0, Schedule 1.2, Page 1 of 3, Column (f), Line 8) Therefore, in reference to IP's Addendum A, Staff accepts IP's reclassification of ($2,956,000) in Column (e) of the schedule labeled "Appendix A, Page 2 of 13." This reclassification affects the net amount of Staff witness Lazare's A & G expense adjustment in Column (l) of the same schedule. This technical change has an impact on cash working capital. Therefore, the cash working capital component of the revenue requirement should be updated to reflect the technical changes described above and for any other changes adopted in the Final Order.

D. Incentive Compensation

The PO correctly found that IP should not be allowed to recover the expenses associated with its current incentive compensation plan ("ICP"). (PO, pp.41-42) Contrary to the Company's statement, this conclusion was not based upon simple application of prior Commission orders denying recovery of incentive compensation costs. (IP BOE, p. 5) Rather, it was based upon the record in the instant proceeding and Staff's analysis of the Company's current plan. (PO, p.41) Staff's Initial Brief outlined the reasons to support such conclusion. (Staff IB, pp. 35-36) First, the plan is heavily dependent on achievement of IP's affiliates' financial goals, solely benefiting the shareholders with no benefit to ratepayers at all. (Staff Ex. 1.0, pp. 27-28 and Staff Cross Ex. 3) The plan is also dependent upon achievement of IP's financial goals, which primarily benefit shareholders, not ratepayers. (Staff Ex. 1.0, p. 28) Next, there is no ratepayer protection in the event the goals are not met, since even if no cost were incurred by the Company, ratepayers still would fully fund the ICP. (Staff Ex. 1.0, p. 28) Additionally, the ICP changes annually and therefore it is impossible to determine a "normal" level of ICP expense for the test year. (Staff Ex. 1.0, p. 30) Finally, the deficiencies cited in prior Commission orders disallowing the Company's ICP expense were not addressed by the Company. (Staff Ex. 1.0, pp. 30-31)

The Company continues to call on the Commission to take a fresh look at the topic of incentive compensation. (IP BOE, p.5) As described above, Staff did conduct analysis on IP's current plan and its benefits to ratepayers; Staff's adjustment and the PO were not simple applications of prior Commission findings. The Company claims the PO is imposing a higher standard of proof for this expense than other components of IP's operating expenses. (IP BOE, p. 46) Such accusation is unfounded and unsupported by the record in this case.

The Company's listing of benefits to ratepayers of its incentive compensation plan is transparent. The Company continues to plead that since incentive compensation is common in American business and used as an employee retention and attraction tool, it should be allowed rate recovery. (IP BOE, p.5) Yet, the Commission has previously ruled, both specifically for Illinois Power as well as for other companies, that these facts alone do not warrant rate recovery. (Staff IB, pp. 39, 42-43)

The Company opines that its incentive compensation plan contributes to its ability to provide safe, reliable and efficient service to its customers. (IP BOE, p. 5) The Company never reconciles the fact, though, that a large amount of the incentive compensation plan funding is based upon corporate earnings goals of Dynegy, Inc. and its unregulated affiliates. Such goals are met by a variety of actions that may not necessarily provide benefits to delivery services ratepayers. (Staff IB, p. 37) Goals based upon financial indicators also create a circularity problem, that is, the more money included in IP's rates for incentive compensation, the easier it will be for Dynegy, Inc. to meet its earnings goals.

(Staff IB, p. 37) Further, the Company has presented no evidence to demonstrate any cost savings as a result of the plan. (Staff IB, pp. 38-39) On the contrary, the Company's position puts ratepayers in the position of funding the incentive compensation expense whether or not the Company incurs it in the future at the test year amount. (Staff IB, pp. 39-40)

The Company believes its record of making incentive compensation payments for ten years alleviates the problem of determining a normal level of incentive compensation expense for the Company. (IP BOE, p. 5) However, such record helps little since the Company changes the plan annually and incurs drastic variances in expense levels from year to year. (Staff IB, pp. 40-42) The Company opines that the materiality of its ICP expense, in relation to overall employee compensation, should be considered in allowing rate recovery. (IP BOE, p. 5) The Company has presented no evidence as to the materiality of its ICP expense. Further, Staff's criticisms of the ICP expense were never of the actual dollar amount, but rather specifically related to the plan that caused the expense and the lack of benefits to ratepayers as a result. The materiality of the amount is not a valid factor in deciding this issue. (Staff IB, pp. 35-36)

Therefore, for all the aforementioned reasons, the PO's conclusion is appropriate and should be adopted by the Commission.

E. Functionalization of A&G Expense

IP's discussion of functionalizing A&G expenses raises issues similar to those concerning General and Intangible Plant. First, as with General Plant, the Company tries to explain why the inordinate size of the increase (196%) proposed for these expenses should not be an issue. The Company contends that the A&G level approved in Docket No. 99-0134 should not be considered a standard for measurement because “the Commission did not, in the 1999 DST Case, make a substantive determination of the amount of A&G expenses that would be required to support and operate IP’s distribution business”. (IP BOE, p. 52) IP then demonstrates its sense of vulnerability on this issue by declaring:

> There is no basis for requiring IP (as the PO purports to do) to explain the increase in the A&G expense component of the revenue requirement requested in this case over the amount of A&G expense allocated to the distribution revenue requirement in the 1999 DST Case. (IP BOE, p. 53)

IP’s argument defies common sense. If a category of costs increases by 196% from one case to the next, then, of course, the Commission would want to know why, especially when the Company claims to have used the same costing methodology in the second case as was used in the first. Despite IP’s protests, the level of increase is a critical issue particularly in this case because it demonstrates the extent to which IP has shifted costs to delivery services customers.

IP indicates it prefers to compare proposed A&G expenses for the current transmission and distribution utility with the 1997 utility that included a generation function. (IP BOE, p. 53) Based on this irrelevant comparison, IP can proudly boast that total company A&G expenses have actually declined by 3% from the first to second case. (IP BOE, p. 54) The Company goes on to present a lengthy discussion of why this comparison demonstrates the reasonableness of the Company’s proposal. IP mentions reductions in headcount (IP BOE, p. 54); the reasonably priced services provided by Dynegy and all of the savings from the Dynegy merger. (IP BOE, pp. 55-57) In sum, IP appears to be suggesting that ratepayers should consider a 196% increase in A&G expenses a good deal because if IP hadn't so aggressively cut costs, then the increase would have been even more outlandish.

IP's discussion is clearly irrelevant. The standard for assessing IP's current costs are the comparable costs in the delivery service revenue requirement for Docket No. 99-0134. And the extraordinary increase results because the Company has consciously reallocated costs that the Commission found to be generation-related back in the previous case to distribution. Furthermore, IP's argument fails to explain why the basis for the Commission's allocation of A&G expenses to generation in Docket No. 99-0134 should no longer hold for the generation IP transferred to its unregulated subsidiary.

On page 60 of its BOE, IP proposes revisions to Staff's functionalization adjustment of A&G expenses. The Company maintains that the adjustment should have been based upon the Company's rebuttal A&G expense figure, rather than direct. Furthermore, IP argues that the adjustment should have been further updated to reflect IP's surrebuttal position. (IP BOE, pp. 60-62) Staff objects to these adjustments for the same reasons set forth in the discussion of G & I plant. (See pp. 12-13, supra)

F. Contributions for Community Organizations

The PO concludes correctly that the payments of dues to community organizations should be disallowed, based on the fact that the Company receives membership benefits from these organizations. The Company contested $56,000 of Staff's adjustment to reduce test year operating expense for amounts paid to various chambers of commerce and community organizations. (Staff IB, Appendix A, p. 8 of 13) In its Brief on Exceptions, the Company states that the only reason the PO disallowed these expenses is that IP did not refute Staff's argument that IP receives "membership benefits" for the payments. (IP BOE at 64) The Company asserts that IP's resulting membership does not justify denying recovery of the expenses. IP maintains that it receives a "benefit" from virtually every payment it makes. Accordingly, the Company states, these payments should be allowed as a reasonable and appropriate business expense, as payments that are beneficial to the health of the service area and IP's customers.

The Company admits it receives membership benefits from the payments to these organizations, whose purpose is to promote economic development in the service area. (IP BOE, p. 64) Staff agrees, and notes that the primary benefit received by the Company is promotion and goodwill to residents and businesses within the Company's service territory. Accordingly, these payments constitute a form of advertising expense that is not includible in the determination of electric rates. Furthermore, the receipt of membership benefits by the Company precludes the characterization of these expenses as charitable contributions, which are considered in rate setting. (Staff Ex. 12.0, pp. 3-4)

IP has repeatedly stated that payments to these organizations benefit both the community as a whole and IP's customers, by assisting customers in IP's service territory to maintain jobs or stay in business. IP has asserted that without such assistance the Company would likely have increased uncollectibles and decreased sales. (IP Ex. 1.34, pp 46 – 47) However, the Company has never provided any evidence to support its assertion that payments to these types of organizations directly benefit its customers. Even if a correlation could be shown between the efforts of such organizations and lower uncollectibles and increased sales for IP, it is IP's shareholders who would most directly benefit from such results. (Staff Ex. 12.0, p. 3) Staff witness Pearce did acknowledge during cross-examination that reduced uncollectibles in the test year would be reflected in establishing the revenue requirement, and that higher sales would result in lower per-unit charges to customers to recover the revenue requirement as determined by the Commission. However, as stated above, the Company never provided any evidence to support its assertion that payments to these types of organizations directly benefit its customers in the form of lower uncollectibles or increased sales.

The Commission has accepted similar adjustments in prior orders, including: Commonwealth Edison Company (Docket No. 90-0169) and (Docket 94-0065); and more recently in Central Illinois Light Company (Docket Nos. 99-0119 and 99-0131 (Cons.) The costs in question are not necessary to provide service to IP's delivery services customers and IP has not supported its assertion that these costs benefit its delivery services customers. Furthermore, the Company receives membership benefits from the payments in the form of promotion and goodwill. These payments actually constitute a form of advertising expense that is not includible in rate setting. Therefore, the Commission should continue to accept this kind of proposed adjustment.

III. COST OF SERVICE RATE DESIGN & OTHER TARIFF ISSUES

A. Residential and Small Use General Service Charges

1. Residential

IP’s exceptions to the PO with respect to the Residential Delivery charge are devoid of merit. The Company argues that the higher differential it proposes would be superior from the standpoints of rate continuity and “appropriate” from a cost standpoint. (IP BOE, p. 68)

The Company's argument quickly breaks down. With regard to cost, which should be a primary ratemaking consideration, IP actually admits its proposal is not cost-based:

> It is correct that, viewed in isolation, the 1.4 cents/kWh differential proposed by IP is somewhat higher than the differential that would be based strictly on the recovery of secondary facilities in the first block. (IP BOE, p. 68)

IP then proceeds to provide a convoluted argument about why its proposal is "appropriate" from a cost perspective. (IP BOE, pp. 68-69) The argument is unconvincing to say the least.

As Staff as argued throughout this proceeding, the cost of service not only fails to support IP's 1.4 cent differential, it cannot justify any declining block delivery charge. (Staff Ex. 5.0, pp. 37-39) The Company's tortured argument on this issue in its BOE only illustrates the problem of trying to justify any declining block on a cost basis.

In addition, IP argues that its proposed differential better reflects rate continuity concerns than the GCI proposal, because it reflects a weighted average of the differentials in the Summer and Winter bundled rates, while the GCI proposal reflects the differential in the Summer blocks only. (IP BOE, p. 68) The Company's point has little impact in the larger scheme of things.. The issue of rate continuity is overstated and whatever the benefits to be derived are more than offset by the problems that would be created from the standpoints of cost of service and the conservation of energy.

Thus, Staff finds that IP's BOE only underscores the problems with acceptance of any declining block proposal and the wisdom of replacing the PO's conclusion with acceptance of a flat delivery charge for residential customers.

2. Small Use General Service

It is difficult to grasp the logic of IP's complaints about the PO's acceptance of Staff's proposed facilities charges for Small Use General Service customers. These charges were accepted by the PO for the simple and obvious reason that they more closely reflect the costs calculated in IP's own cost of service study. (IP BOE, p. 68)

IP finds this conclusion to be grossly unfair. According to the Company, Staff did not sufficiently justify its proposal in testimony or discuss it in brief. (IP BOE, p. 69) This leads IP to contend that the record does not support the PO's conclusion that Staff's proposal is more cost-based.

The Company's arguments again miss the mark. The fact remains that Staff's rates are more cost-based as Staff Exhibit 22.0 shows. Furthermore, Staff did justify its proposed rates from a cost of service standpoint in its Initial Brief when it stated:

> Third, the Company's proposed rates do not conform sufficiently to the results of the Company's cost of service study. Staff has addressed this shortcoming by proposing demand charges, facilities charges and unbundled meter charges that more closely cover the corresponding costs in the cost of service study. (Staff IB, p. 57)

This is a clear and forthright statement of Staff's purpose in setting its proposed facilities charges, contrary to IP's claims.

IP then presents its own cost of service argument for its proposed facilities charges. (IP BOE, pp. 70-72) However, the argument is clearly undermined by

Staff Exhibit 22.0, which unequivocally shows that the Staff proposal more closely recovers associated costs.

B. Demand Metered General Service

1. Ratchets

IP takes issue with the PO's rejection of its proposed demand ratchets in four respects.

First, IP notes that the Commission has consistently rejected ratchets in recent cases but argues that its proposal is somehow different because the ratchet would pertain to some, but not all, demand charges. (IP BOE, p. 74) IP is trying to make a distinction that does not exist because the Commission has not conditioned or qualified its opposition to ratchets, as it stated in ComEd's initial Delivery Service proceeding (Docket No. 99-0117):

> The Commission agrees with Staff's arguments on this issue and is of the opinion that the demand ratchet proposals should not be adopted. The Commission has not looked favorably on demand ratchets in prior rate proceedings. Ratchets prevent customers from having control over a substantial portion of their bills for a year. The customer is forced to continue to pay high demand charges even if there is an economic downturn, while the utility is insulated from the same downturn. (Order, p. 65)

Second, IP contends that, contrary to Staff arguments, its proposed ratchet would encourage customers to control monthly demands. (IP BOE, pp. 74-75) However, that would only apply for months when demands approach the peak. In all other months, the incentive to control demands would diminish.

Third, IP argues that the ratchet is cost-based, because associated costs are driven by annual peak demands. (IP BOE, p. 75) This argument does not take into account demand diversity. Not all customers peak at the same time and it is essential that when overall demand peaks, those customers who are below their annual peaks have an incentive to control their demands. This incentive would disappear under IP's proposed ratchet. (Staff Ex. 5.0. pp. 31-32)

Finally, IP advocates the demand ratchet on the basis of rate continuity. (IP BOE, p. 76) Staff believes that rate continuity should not be a concern given when the associated bundled rates are a decade old and feature a flawed ratchet mechanism. (Staff Ex. 5.0, p. 33) Acceptance of this argument would only serve to burden customers with ratchets for the foreseeable future.

2. Facilities Charges

The concerns IP raises with respect to Small Use General Service customers are repeated for demand-metered customers. IP complains again that Staff did not sufficiently justify its proposal in testimony or discuss it in brief. (IP BOE, p. 77-78) This leads IP to contend that the record does not support the PO's conclusion that Staff's proposal is more cost-based.

However, the Company's arguments once again miss the mark. It is worth noting that IP does not take issue with the PO's conclusion that Staff's rates are more cost-based. As Staff Exhibit 22.0 shows, the PO conclusion is accurate. Furthermore, Staff did justify its proposed rates from a cost of service standpoint in its Initial Brief as noted with respect to Small Use General service customers. (IP BOE, p. 57)

IP then tries to justify its proposed facilities charges as more appropriately moving toward cost on a gradual basis. (IP BOE, pp. 78) However, the PO correctly determined that Staff's proposed rates are more consistent with the Commission's longstanding commitment to cost-based rates. Therefore, the Company's exceptions on this issue should be rejected as well.

C. Standby Capacity Requirement

The PO observed that self-generation ("SG") has the potential to provide system wide benefits and accurately noted that IP's standby capacity Requirement ("SCR") proposal provides an anti-self-generation economic signal to any customers considering it as a means of peak shaving. (PO, p. 92) These findings are firmly grounded in the record in this docket as is discussed in detail on pages 63-91 of Staff's Initial Brief and pages 22-28 of Staff's Reply Brief.

Under IP's SCR proposal, the SG customer would be charged a higher effective unit rate on its actual system demand and higher total charges than a similar non-SG customer with variable demand. (Staff Ex. 18, p. 6) IP's argument that it is extremely unlikely that the SCR charges a SG customer would have to pay under IP's proposal "would make a difference in the economics of whether to install SG facilities" is both speculative and irrelevant. The Company has provided no evidence in support of its claim. More importantly, the issue before the Commission in this proceeding is the setting of appropriate and non-discriminatory rates for delivery services.

The record reflects that the Company's proposed SCR would make delivery services for SG more costly than it should be, relative to delivery service for customers using other competitive supply and load management alternatives. (Staff Ex. 8.0, p. 7) The proposed SCR would provide no incentives, based on effective rates, for SG customers to shed load or peak shave. Thus, SCR would discourage the use of more reliable SG units by SG customers and thereby encourage additional system costs that might otherwise be avoided. (Staff Ex. 18, p. 9) Such a result would be inconsistent with the goal of undistorted competition amongst all the options customers will have in the deregulated market. (Staff Ex. 18, p. 13)

IP's proposal to treble the charges if a SG customer's demand is in excess of 110% of the SCR is inappropriately punitive. The Company's justification that "the provision should not pose a meaningful risk…" (IP BOE, p. 83) fails to cure the inherent flaws of the proposal. Given the possibility that its SG unit could fail, or its demand could spike by an unusual amount, the penalty would give a SG customer a strong incentive to overestimate its stand-by requirement in order to limit the exposure to the treble penalties on the excess demand. (Staff Ex. 18, p. 4) The existence of a treble penalty would only exacerbate the situation with regard to the discriminatory treatment provided by SCR.

IP's argument that non-SG customers will fully pay for the distribution investment to provide them with no-notice access to the system, while SG customers will get the same service, but will not fully pay for the distribution investment is similarly flawed. First of all, it is clear from the evidentiary record that IP's proposals to use standby capacity as the basis for determining the total charges to SG customers will overcharge SG customers relative to non-SG customers. (See Staff RB, pp.24-26 and Staff IB, pp. 74-83) Second, it is clear in the evidentiary record provided by IP that non-SG customers also have variable, inconsistent monthly peak demands. In fact, this demand variation has caused IP's concern that non-SG customers with low load factors (varying monthly peak demand) will be subsidized by non-SG customers with high load factors (less variability in monthly peak demand). (IP Ex. 6.6, p. 19) Thus, IP's argument that SG customers will not be paying for the distribution investment to serve them because they have varying demand, would apply equally to some non-SG customers. It is evident from the record that the only real difference between SG and non-SG customers is the decision to use SG as a means of shaving peak.

In sum, by making SG more costly than alternatives, the Company's SCR proposal would reduce the amount of new SG that is installed. Thus, either the modified or un-modified SCR would work to prevent the very real benefits of SG generation from being realized in the long run. In contrast, the elimination of discriminatory treatment of SG from the DST tariff will provide a level playing field among the various load management technologies and competitive service options available to customers in the deregulated market. (Staff Ex.18.0, p. 3)

In its BOE, the Company attempts to bolster its position by referring to FERC Order 888 and stating "[t]he Commission should be aware that the Federal Energy Regulatory Commission ("FERC"), in establishing the pro forma open access transmission tariff ("OATT") in Order 888 and 888-A, came to essentially the opposite conclusion from the PO on this issue." (IP BOE p. 87) As shown below, the Company's attempt to analogize to the FERC orders as support for is position is misleading and erroneous for a number of reasons.

First, and foremost the Company erred in implying that the FERC's proposed methodology for allocating costs to *network* or *point-to-point transmission* customers in any way applies or takes precedent in how the Commission applies its authority to set and design rates for the recovery of distribution level costs from *retail* customers. FERC was explicit in stating that states and state commissions have authority to set retail rates and rate structures to recover costs of distribution system. In Order 888[1], the FERC clearly indicates "states have authority over the service of delivering electric energy to end users." (FERC Order 888, p. 433) FERC further clarifies that "[a]lthough the [FERC] believes its Final Rule will accommodate retail competition, if it is offered voluntarily by a utility or ordered by a state, our policies relate only to the bulk power market and not traditional state regulation of the retail market." (FERC Order 888, p. 433-434) The Final Rule adopted section 35.27 (b) to this effect:

> Nothing in this part (i) shall be construed as preempting or affecting any jurisdiction a state commission or other state authority may have under applicable state and federal law, or (ii) limits the authority of a state commission in accordance with state and federal law to establish (a) competitive procedures for the acquisition of electric energy, including demand side management, purchased at wholesale, or (b) non-discriminatory fees for the distribution of such electric energy to retail consumers for purposes established in accordance with state law. (FERC Order 888, p. 434)

It is clear that the Company's invocation of FERC Order 888 as an attempt to influence the Commission is inappropriate as the order itself in not binding on or relevant to the Commission's decision in the proceeding.

Assuming arguendo, that FERC orders should properly influence the Commission decision in this case, there are several reasons why the Company's portrayal of the Order as support for its position is misguided and incorrect in its substance.

First, the Company erred in assuming that the FERC was making reference to distribution level *customers* with or without "generation behind the meter" when it quoted Order 888, page 297. (IP BOE, p. 88) This section was clearly written to address the concerns regarding pancaked rates for *network*

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[1] All page references correspond to those found at the following web address: http://www.ferc.fed.us/news/rules/pages/order888.htm

customers located in *multiple control areas or with more than one network service provider*. (FERC Order 888 p. 297 and FERC Order 888-A p. 236). It is evident from FERC Orders 888, 888-A, 888-B and 888-C that the FERC is not referring to individual distribution customers, with or without SG, directly arranging and paying for network or point-to-point service by any allocation methodology. All the examples and discussions within the orders clearly indicate that the FERC, when referring to "behind the meter customers" was speaking of *wholesale network or point-to-point customers* such as municipalities (with or without generation behind the utility meter), utilities (with or without their own generation), and RES-like entities, not individual retail customers with or without SG. (FERC 888-A, pp. 246-250) More specifically, the FERC states that the identification of a *retail* customer's "behind-the-meter" generation and load for inclusion in the "calculation of a transmission provider's total network load…is beyond the scope of Order Nos. 888 and 888-A." (FERC Order 888-B, p. 58)

Second, while the Company was correct when it stated that the FERC was concerned about the issues of stranded costs when it proposed that network/point-to-point transmission customers not exclude load served by "behind-the-meter" generation when calculating that customer's network load for billing purposes, the Company erred when it inferred that this argument was applicable to the determination of load of *retail* customers for this or any other purpose. (IP BOE, p. 88) As noted above, FERC states that the identification of a retail customer's "behind-the-meter" generation and load for inclusion in the "calculation of a transmission provider's total network load…is beyond the scope of Order Nos. 888 and 888-A." (FERC Order 888-B, p. 58) More specifically, with regard to the prevention of stranded costs, the FERC states that "costs that are exposed to non-recovery when a retail customer or a newly-created wholesale power sales customer ceases to purchase power from the utility and does not use the utility's transmission system to reach a new generation supplier (e.g., through self-generation or use of another utility's transmission system) do not meet the definition of 'wholesale stranded costs' for which this Rule provides an opportunity for recovery." (FERC Order 888, p. 535, footnote 718) FERC further states that the "…rule is not intended to insulate the utility from the normal risks of competition." (FERC Order 888, p. 625, footnote 902) Only those portions of the retail load that are actually served, on an annual or monthly basis, by the Utility are thereby a legitimate means of allocating recoverable costs. FERC notes repeatedly that the concepts of cost recovery provided in Order 888 do not apply to retail customers that make use of SG as a competitive supply option.

Third, the Company erred when it inferred that the necessarily arbitrary allocation methodology proposed by the FERC for the collection of transmission costs from wholesale transmission customers is superior to the methodology adopted in the PO. FERC states in Order 888 that the actual "load ratio allocation continues to be a *reasonable* for the purposes of *initiating* open access transmission." The methodology was not picked because it was superior to other allocation methodologies in terms of economic price signals or impact, but because "this method is familiar to all utilities, is based on readily available data, and will quickly advance the industry *on the path to non-discrimination*." (FERC Order 888, p. 296 emphasis added) FERC implicates that as the as things develop, other non-discriminatory methods of cost allocation will be found and applied to allocate transmission costs to network and point-to-point customers.

The FERC "emphasized that the Final Rule pro forma tariff is not intended to signal a preference for contract path/embedded cost pricing for the future…the [FERC] indicated that it will in the future entertain non-discriminatory tariff innovations to accommodate new pricing proposals." (FERC Order 888-A, p. 225-226)

Fourth, the Company erred when it stated that its proposed allocation *methodologies* are more in line with the principles outlined by FERC than the allocation *methodology* endorsed by the PO. (IP BOE, p. 89) Throughout the orders, the FERC emphasizes that a central component of any non-discriminatory tariff is a *single* cost allocation method. In describing the characteristics of new pricing proposals for network and point-to-point transmission service that they would entertain, the FERC states "it will allow utilities to propose a *single cost allocation method..."* (FERC Order 888-A, p. 226 emphasis added) It should be noted that the central principle of a *single* cost allocation methodology is the very basis of the Staff proposed single allocation methodology (See PO, pp. 88, 89) and the single allocation methodology adopted by the PO. (PO, p. 93) The Company, on the other hand, has proposed at least two contemporaneous methodologies—one for SG and one for non-SG—within its own proposal. The Company's proposed allocation method clearly violates the central principle of a non-discriminatory allocation methodology, as recognized by both the FERC in Order 888 and the PO.

As indicated above, the Company's reference to FERC order 888, and how FERC has *initially* proposed to allocate costs of transmission among "customers" taking *network* or *point-to-point service transmission service* is irrelevant to the subject of the structure of distribution rates and in error in its substance.

D. Rider ISS

The PO recommends a compromise under which a delivery services customers who is placed on ISS can only return to its former RES once every six months. (PO, p. 103) Staff would prefer no restriction on ISS customers returning to their former RESs, since implementation of such a policy would put the Commission in the uncomfortable position of barring customers from purchasing power from suppliers that are legally qualified to serve them. Nevertheless, the PO's proposed policy could largely prevent the type of gaming behavior that IP is concerned could occur in its territory, even though the record shows that no such behavior has yet occurred. (Staff RB, p. 30) Therefore, Staff has no objection to the PO's compromise solution.[2]

IP on the other hand, continues to assert that any policy that allows an ISS customer to return to its former RES would invite gaming. (IP BOE, p. 97) As noted above, this situation has yet to occur, making IP's concern only a hypothetical one at present. Staff prefers the PO's compromise policy to IP's rather draconian solution to a matter that does not even appear to need a solution.

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[2] Staff notes that the existing provision in Section 3.b of IP's S.C. 110 delivery services tariff prohibiting an ISS customer from returning to its former RES would need to be amended if the PO's compromise policy were put in place.

IV. CONCLUSION

For the foregoing reasons, the Staff of the Illinois Commerce Commission respectfully requests that the Proposed Order be revised to reflect Staff's recommendations.

Respectfully submitted,

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