BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	*	
	*	
PETITION OF TENNESSEE-AMERICAN WATER COMPANY TO CHANGE AND INCREASE CERTAIN RATES AND CHARGES...	* * * *	DOCKET NO. 08-00039

electronically filed 9/2/08

CHATTANOOGA MANUFACTURERS ASSOCIATION'S POST-HEARING MEMORANDUM OF LAW

The Chattanooga Manufacturers Association (the "CMA") by and through its counsel, pursuant to the procedural schedule in this matter, hereby files this as its post-hearing memorandum. The Company's Petition should not be accepted or approved. Issues that were raised or addressed in discovery, pre-filed testimony and at the hearing by CMA and its witness, Michael Gorman, and the other intervenors' witnesses clearly demonstrates that the rate increase by proposed Tennessee American Water Company (the "Company" or "TAWC") is not just and reasonable.

CMA supports the positions set forth by the State of Tennessee Attorney General's Consumer Advocate and Protection Division (the "Consumer Advocate" or "CAD") of the relative to additional downward adjustments to be made such as those concerning operational and maintenance expenses, weather normalization, and depreciation. CMA further acknowledges and supports the additional positions proffered by the City of Chattanooga (the "City") and the Consumer Advocate relative to excessive service company and management fees and depreciation-related issues.

I. Argument Regarding CMA's Motion in Limine and to Strike.

Preliminarily, CMA reiterates its August 14, 2008 motion to strike, as reserved at the hearing of this case, and submits that the Company inappropriately seeks to introduce "single-issue" ratemaking into this proceeding. The primary issue relates to the Company's wrongful introduction of significantly increased chemical expenses and fuel expense for which the Company now seeks rate recovery. Those singular adjustments to increase claimed attrition year expenses were introduced <u>after</u> discovery had closed, <u>after</u> the Company had no option but to agree to downward adjustments to its initially claimed revenue deficiency of $7.645 million, and upon the brink of this hearing. (*See* Transcript of Pre-Hearing Conference dated August 15, 2008, at p. 119.)

CMA submits that the alleged adjustments for chemical expense, in an amount exceeding $500,000, blatantly disregards fundamental rate-making principles by trying to get in the back-door what could not be brought in the front. (*See* Transcript of Pre-Hearing Conference dated August 15, 2008 at 101-105; 113-114; 116.) The Staff also recognized this issue and issued a data request about what the Company was attempting to do. Despite TAWC's protestations during the pre-hearing conference that the Company was not trying to recover the increased expenses in this rate case, Ms. Miller's pre-filed rebuttal testimony contradicts that position. (<u>Id.</u>; S. Miller Pre-filed Rebuttal, p. 12 at lines 13 & 21, indicating rate recovery is being sought for the expense.) CMA submits that chemical and other expenses, which were gratuitously included when responding to a very narrow TRA Staff request for updates to four other expense amounts, should be excluded from consideration. Indeed. The Company's own counsel argued in the last case "I don't think it's fair to just change one item and come up with a number when there would be lots of other changes. . . ." relative to the attrition year. (*In re Tennessee American Water*, TRA Docket # 06-00290 Hearing Transcript at p. 808.) In response to Mr. Walker's last question on cross-examination, admitting its not proper rate-making procedure, even Ms. Miller acknowledged she didn't know one could make changes to your numbers so late. (Tr. 716.)

II. Argument Regarding Issues Contested at Hearing

After thorough review of the Company's claimed revenue deficiency, cost allocations, rate design, and pre-filed direct and rebuttal testimony, both the TRA Staff and the intervenors identified certain flaws and deficiencies in the methodology or calculations TAWC proffers or adopts in support of the Company's claimed need for ratepayers to generate millions of dollars more in annual revenue through this requested rate increase. Based on its analysis, CMA submits the record in this matter establishes that the Company's proposed annual increase in revenue of $7.645 Million is significantly overstated, is not just and is not reasonable, and should be reduced at least by $5.192 million. (Revised Gorman Direct at 4-6 (Table 1); Hearing Transcript at 2100, 2136-37.) (Hearing Transcript is designated hereinafter as "Tr. at ___.")

The Company's revenue deficiency simply is not and can be no greater than $2.453 million based upon several items found by CMA's expert to exceed a reasonable cost of service for a water utility. (Tr. at 2136-37.) CMA's findings do not account for the additional adjustments the TRA should make when considering testimony and recommendations by other witnesses that further drive the claimed revenue deficiency toward zero (or less). (Id.)

A. **The Rate of Return Issue Is The Single Greatest Dollar Issue In This Case, And The Company's Attempt To Deviate From TRA's Long-Standing Practice Using Double Leverage To Generate Additional Millions In Annual Revenue From Ratepayers Is Not Supportable.**

The Company's requested rate of return, including but not limited to the cost of equity/cost of capital, is too high. CMA's first proposed adjustment, dealing with rate of return, significantly affects the Company's claimed revenue deficiency as this one item represents about 42% of TAWC's claimed revenue deficiency in the attrition year and test period. (Tr. at 2101.) Three factors predominate analysis of the rate of return issue. First, the Company's proposed capital structure ignores and is not consistent with the TRA's standard practice of using a double leverage capital structure to set TAWC's rates. Second, CMA makes an adjustment to insure appropriate treatment of "goodwill." Finally, the Company's requested overall rate of return should be adjusted downward after proper consideration is given to this Authority's 10.2% cost of equity determination in last year's decision; other jurisdiction's awards since 2007; and, Mr. Gorman's, Mr. Miller's and Mr. Vilbert's analyses.

1. The Company's proposed capital structure was not based on the TRA's long-standing practice of using a double leverage capital structure.

The Company ignored using the double leverage methodology because it "opposes" the application of double leverage. Instead, TAWC paid $100,000 - which it now seeks to recover from ratepayers - to proffer Mr. Vilbert's testimony wherein he did not even attempt to provide any double leverage calculation to this agency. Mr. Gorman, on the other hand, accepted the TRA's traditional practice of applying double-leverage when preparing pre-filed testimony and work papers. (Gorman Revised Direct at 21-55; and MPG-1.) Only through Mr. Miller did the

Company ultimately address some aspects of double leverage. (Tr. 2161-2166.) But, as Mr. Gorman testified, a complete and correct application of double leverage was never completed by the Company in the testimony or schedules filed. (Tr. at 2226-2228; 2161-2166.) For maintaining the protection of ratepayers through the development of rates that reflect the Company's actual cost of capital, CMA endorses TRA sticking to its guns and continuing to apply the double leverage methodology when analyzing the capital structure of TAWC.

2. <u>CMA's adjustment on capital structure relative to goodwill allows the Authority to properly reflect capital supporting utility plant investment.</u>

As evidenced by the testimony and exhibits, an adjustment to the Company's capital structure is necessary in order to properly reflect those assets truly invested in utility plant. As Mr. Gorman explained, this singular adjustment addresses an accounting entry that resulted in writing up common equity for an intangible asset that has no economic value because it does not support investment in utility infrastructure. (Tr. at 2102, 2104-06, 2110-2114, 2155-56; Revised Gorman Direct at MPG-1.) While the Company's witnesses attend to financial theory and operations related accounting, CMA's witness Mr. Gorman addresses the financial risk that credit analysts would consider in assessing an appropriate capital structure for TAWC. (Tr. at 2104-06, 2110-2114.) In fact, Mr. Gorman provided a recent example recommending the removal of significant goodwill recorded by the Commonwealth Edison Company, and that recommendation to remove goodwill from the company's capital structure was accepted in the prior case by the Illinois Commission. (Tr. at 2111; *see attached* as Exhibit 1, excerpts relative to the ICC finding in its Order for ICC Docket 05-0597, C'wealth Edison's President's Pre-filed Testimony in ICC Docket No. 07-0566, and the referenced Proposed Order in ICC Docket No. 07-0566.) In the more recent case involving Commonwealth Edison, in which a proposed order is now circulating, removing the goodwill from capital structure is not even a contested issue. (Id.)

Upon cross-examination, the Company simply did not want to pursue Mr. Gorman's surrebuttal response to Mr. Miller's rebuttal and exhibit filed on August 15 - the Friday immediately preceding Monday's commencement of this hearing. (Tr. 2165.) Simply put, Mr. Gorman indicates that the Company's analysis once completed with a proper double leverage adjustment results in an overall rate of return that is actually a bit *lower* than what Mr. Gorman proposed. (Tr. 2166; 2198-2200.) Once properly completed under double leverage, the overall return on weighted cost of capital by Mr. Miller would be 7.16% rather than the 7.33% estimated by Mr. Gorman, even assuming for convenience a 10.2% cost of equity (rather than the 9.9% midpoint of Mr. Gorman's analysis). (Tr. 2227-2228.) Either way, once double leverage is applied, the percentage overall rate of return is significantly lower than the Company's original filing proposal. (See MPG-1.)

3. The Company inflates the proposed cost of equity to be applied.

The TRA need not even revisit cost of equity, as the 10.2% finding in last year's case (TRA 06-00290) falls squarely within the range of 9.0 to 10.7% computed under the various accepted models that were analyzed by Mr. Gorman. (Revised Gorman Direct at 3; Tr. at 2109.) The record demonstrates the proper application of various models and illustrates TAWC's current cost of equity to be in the range of 9.0% to 10.7% with a midpoint of approximately 9.9%. (Revised Gorman Pre-filed at 21-55.) TAWC's last authorized return on equity of 10.2% is within the cost range resulting from CMA's expert's analysis. **If** in this case the TRA chooses to revisit the issue of what constitutes a proper return on equity for TAWC, then TAWC's return on equity should be reduced to the 9.9% midpoint of Mr. Gorman's analysis. Otherwise, the

10.2% return on cost of equity orally adopted in May 2007 (set forth in the June 2008 written order) should be the highest possible authorized return on cost of equity to be used by the TRA to set rates in this case.

The Company's witness, Mr. Vilbert, offered a cost of equity methodology never accepted by TRA or adopted in another jurisdiction's Order in the United States of America, and provided a wildly inflated cost of equity of 11.75% that has not been approved by any other public service commission for utility ratemaking authority as discussed more fully below. (Tr. at 337-340.) Moreover, admittedly neutralizing the application of double leverage which the Tennessee Regulatory Authority has insisted upon applying in order to protect TAWC ratepayers, Dr. Vilbert's ATWACC theory is unique finance analysis rather than proper regulatory ratemaking policy for this agency. And, any question whether American Water Works capital structure can support an investment-grade utility company is solved, simply, by review of its credit ratings which are investment-grade. (Tr. 2113-2114.) The Company's proposal to increase its authorized return on equity to 11.75% is unreasonable, unjust and should not be permitted. (Tr. 2108.)

In separate testimony, even the Company's own rate manager (Mr. Miller) reluctantly and tacitly acknowledged this during cross-examination and made recommendations different than those of Mr. Vilbert. Referencing the more recent information in rebuttal MAM-5, as opposed to the 2004 information skewing upward the return, CMA submits it is clear that many rate decisions in 2007 provide a 10% return on cost of equity and authorized returns this year largely fall around 10.15%. (*See* rebuttal exhibit MAM-5.) Indeed, in a manner similar to the last TAWC case and despite CMA's repeated requests from the outset of the case for Company materials relative to cost of equity awards, such listed returns surfaced publicly with <u>rebuttal</u>

exhibit MAM-5 just before hearing.[1] The Company's own schedules illustrate how incongruent Mr. Vilbert's testimony is with fundamental ratemaking practice, failing to reveal any jurisdiction recently adopting such an exorbitant cost of equity figure. Meanwhile, those same authorized returns further support Mr. Gorman's range for TAWC cost of equity based upon his analysis using the DCF, CAPM and other models. (Tr. 2109-2110.)

Thus, the Authority should reject Mr. Vilbert's testimony and apply the traditionally utilized double leverage mechanism. The Authority also should make the appropriate adjustment to intangible "goodwill" as it is not a utility plant asset benefiting the ratepayers of Chattanooga. Finally, the Authority should authorize no more than the return on cost of equity than the percentage determined just months ago. After making those appropriate adjustments, the revenue deficiency of TAWC should be reduced by at least $3.241 million as to rate of return issues.

B. <u>The Company's "Weather Normalization" Adjustment Understates Its Revenue.</u>

Significant time and testimony was provided in this case, like no other, relative to the "weather normalization" and "conservation" usage adjustments first raised by the Company. That is because the Company claims a revenue deficiency in excess of $1 million dollars in this matter relative to such issues. Despite the Company's best efforts to describe his analysis in a different manner (i.e. a 3 yr. average), Mr. Gorman's revenue sales analysis considered the average use of a residential customer and commercial customer for the most recent 3 year period, 5 year period and 10 year period. (Tr. 2127-2131.) Mr. Gorman also analyzed filings made by

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[1] *See e.g.* CMA Data Requests Nos. 11 and 17, dated May 12, 2008. CMA's data requests addressed core issues of regulatory ratemaking. In that regard, CMA implores the Authority to carefully review the data CMA sought, the Company's repeated reticence to provide it, the Company's failure to be readily specific in responses, and the Company's information hoarding until its filing of rebuttal. CMA contends that the Company's tactics and strategies in refusing to transparently provide (until the last moments) basic information such as authorized Rates of Return relied upon or reviewed by its witnesses, fundamentally drives increased rate case expense and should not be condoned.

the Company to the TRA in annual reports. Finally, Mr. Gorman applied logic and professional judgment in identifying the flattening out or leveling of the previous steep trend, which has now essentially disappeared, relative to water conservation/usage.

As the record indicates, the Company witness (Spitznagel) proffers average usage for residential and commercial customers that is simply too low. (Revised Gorman Direct at Revised MPG-7; Tr. 2130-2131.) The ten year average used by Mr. Gorman is long enough to capture the cyclicality of weather and other variables that impact outside customers in addition to conservation efforts, while the more recent data indicates the subsiding of the downward trend referenced by the longer period. (Tr. 2176; 2182; 2185.) CMA's more neutral approach to weather normalization recognizes the potential abnormalities arising from both abnormally wet (resulting in lower sales) and abnormally dry years (resulting in higher sales), whereas the Company seeks to only one side of the equation in its analysis. (Tr. 2177-2178.) CMA submits that the record shows the Company has understated its revenues at current rates by approximately $1.076 million, and that the corresponding amount be removed from the Company's claimed revenue deficiency. (Revised Gorman Direct at Table 1, p. 4.)

C. Adjustments To The Company's Working Capital and Construction Work in Progress Should Be Made.

Numerous deficiencies in the Company's Petition and support materials were identified and proffered by Staff, Mr. Gorman and others. With respect to working capital adjustments, many adjustments suggested were agreed to by the Company resulting in a lower revenue deficiency based upon the initial filing. For example, the 13-month average error was identified by Staff and Intervenors, and should ultimately be adjusted. Other adjustments remain disputed.

(Tr. 2115-2127.) Finally, as discussed above in more detail, the Company gratuitously added certain adjustments that drive up the revenue deficiency toward the initially stated request.

CMA submits one large working capital adjustment to the Company's proposed working capital allowance relative to the lead lag studies. (TR. 2118-2122; Gorman Revised Direct at MPG-3.) For example, despite not writing a monthly check (i.e. cash) for certain expenses, the Company treats a clearly non-cash items like depreciation expense and uncollectible expense as cash items. (Tr. 2122.) CMA recommends that the Authority follow other jurisdictions in refusing to accept inclusion of such non-cash items in lead-lag studies provided by TAWC. (Id.) Other issues relate to the Company's double-counting what it truly needs relative to average cash positions, such as in the lead lag study, and earning rates of return on items for which utilities simply should not or do not receive a return, such as unamortized rate case expenses and unamortized debt expense and prepayments of service company fees such as the call center. (MPG-2 and MPG-3; Tr. 2115-2117.) Such working capital adjustments should result in an aggregate reduction of another $335,000 to the Company's claimed revenue deficiency.

D. Cost Allocations And Lost Water Factors Should Be Used To Adjust The Company's Claimed Revenue Deficiency and Proposed Rate Design.

The Company's mantra about increased capital expenditures driving the need for a rate increase is significant to ratepayers if those ratepayers do not receive the concomitant benefit of improved efficiency of the Company's system. In paying the cost related to increased capital expenditures reducing unaccounted for water, customers should get the benefit associated with those efforts. Water loss issues go to the heart of the reasonableness test which water utilities such as TAWC must prove when demonstrating that proposed costs and allocations are just and reasonable. The operating efficiencies resulting from the modernization of aging infrastructure should included reduced expenses for lost water, and reduced power and chemical expenses, because fewer leaks should be occurring. (Tr. 2205.)

While it would be reasonable for the Authority to use a water loss factor lower than 15%, to the extent TAWC's lost water exceeds the generously conservative 15% level based upon American Water Works Association reports and other jurisdiction's Staff, the claimed revenue deficiency should be reduced. (Tr. 2126-2127.) In balancing the needs of customers and the utility the Authority should impose on the Company a reasonable level of lost water and an allowance of expense only commensurate to that level, such that exceeding a reasonable and prudent management of expense due to lost water would be borne by shareholders rather than ratepayers. (Tr. at 2206-2207, 2230.) In this case, at least $171,000 related to lost water should be removed from the Company's claimed revenue deficiency. (Gorman Revised Direct at 17; Tr. 2234-2235.)

Additionally, the lost water factor is a prime example as to the inequitable cost allocations sponsored by the Company in this matter. Numerous Company representatives bellowed about high pressure lines and pipes, large mains replacements, and capital improvements to better serve areas such as Lookout Mountain while reducing leakage. Despite those statements, the Company inconsistently proposes to design rates that would charge less to those same mountain customers. At a minimum, those customers should receive at least the system average rate increase should this Authority determine any increase in rates is warranted. As CMA testified, since the Company did not provide a detailed, accurate cost of service study relative to the rates being paid by customers affected in this matter, there is no legitimate justification for cost differentials or variations in the rate increases proposed.

E. <u>The Company's Rate Case Expense Should Not Be Accepted As Proposed.</u>

CMA did not drive up rate case expense. CMA stuck to core rate-making issues in its discovery requests sent to the Company, and the Company even acknowleged as much in its pre-filed rebuttal. (M. Miller Rebuttal at 1.) CMA's expert witness, Mr. Gorman, contributed greatly to adjustments amounting to hundreds of thousands of dollars. And, since its members must pay rate case expenses twice – to the Company in the form of rate increases and to its intervention team efforts - CMA members manage rate case expense through fixed fee arrangements such as that implemented with Mr. Gorman. If this is *just a rate case*, then CMA submits the expenditures made by TAWC relative to increasing these utility rates surely cannot be just and reasonable, nor prudent. The rate case expenses should be expressly adjusted in an amount no more than as described by Mr. Gorman relative to amortization and in an amount no more than authorized in rate case concluded just last year.

IV. <u>Conclusion.</u>

While the Company asserts how badly it again needs multi-millions in increased annual revenues, CMA pleads for this Authority to continue to remain mindful of its mission to also consider and balance the needs of consumers. Based upon the testimony, exhibits, arguments and hearing in this rate-making proceeding, CMA submits that the Tennessee American Water Company's allegations that it must recover on an annual basis an additional $7.645 million from is unjust, unreasonable, not supported by the weight of the evidence, and not supported by the record in this matter. The Petition should be **DENIED**.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been served via the method(s) indicated, on this the 2nd day of September, 2008, upon the following:

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GRANT, KONVALINKA & HARRISON, P.C.

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Commonwealth Edison Company	:	
	:	07-0566
Proposed general increase in electric rates.	:	
(Tariffs filed October 17, 2007)	:	

<u>PROPOSED ORDER</u>

July 10, 2008

EXHIBIT

1

Sales	0
Administrative and General	330,887
Depreciation and Amortization	355,623
Taxes Other Than Income	155,780
Regulatory Debits	34,415
Total Operating Expense Before Income Taxes	1,342,942
State Income Tax	20,305
Federal Income Tax	105,287
Deferred Taxes and ITCs Net	55,714
Total Operating Expenses	1,524,248
NET OPERATING INCOME	$ 514,426

The development of the overall electric utility delivery services operating expense statement adopted for purposes of this proceeding is shown in the Appendix to this Order.

VI. Rate of Return

A. Capital Structure (Uncontested)

Staff recommended a December 31, 2006 capital structure consisting of 54.96% long-term debt and 45.04% common equity. Staff Ex. 4.0 Corr. at 3. ComEd and CUB did not object to Staff's proposed capital structure, and IIEC did not address Staff's proposal in its testimony. ComEd Ex. 28.0 at 10; CUB Ex. 4.0 at 14.

ComEd's Capital Structure is not at issue in this proceeding. There being no evidence to the contrary, the Commission accepts the Capital Structure presented by the Company. We therefore find that ComEd's Capital Structure should consist of 54.96% long term debt and 45.04% Common Equity.

B. Cost of Long-Term Debt (Uncontested)

Staff and ComEd agree that the proper estimate for cost of long-term debt is 6.78%. ComEd Ex. at 12; Staff Ex. 17.0 at 2.

The Commission concludes that ComEd's Cost of Long Term Debt for purposes of this Order is 6.78%.

C. Cost of Common Equity

1. ComEd

ComEd witness Hadaway performed an extensive analysis demonstrating that the investor-required cost of equity capital for ComEd is 10.75%. ComEd Ex. 10.0 at 1. Dr. Hadaway's conclusion is supported by a discounted cash flow (DCF) study using growth rates from four recognized securities analysts, as well as by capital asset pricing analyses. Id. at 37. In arriving at his cost of equity estimate, Dr. Hadaway notes

ComEd Ex. 9.0

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	:	
	:	No. 07-
Proposed general increase in electric rates	:	
	:	

Direct Testimony of

ROBERT K. MCDONALD

Senior Vice President

Chief Financial Officer, Treasurer, and

Chief Risk Officer

conducts independent, external audits of ComEd's financial statements. These processes allow ComEd to develop, monitor and control its costs and total expenditures.

III. <u>ComEd's Capital Structure</u>

Q. What are the components of ComEd's capital structure?

A. ComEd's capital structure includes long-term debt and common equity.

Q. What capital structure measurement period has ComEd used for purposes of this proceeding?

A. ComEd has used an historical capital structure measurement period as of December 31, 2006, the end of the latest calendar year for which actual data are available.

Q. As of December 31, 2006, what was ComEd's balance of long-term debt?

A. ComEd's long-term debt, including transitional funding instruments, totaled $4.386 billion.

Q. What was ComEd's common equity balance as of that date?

A. ComEd's common equity balance was $6.298 billion.

Q. Have you calculated the common equity ratio for ComEd's capital structure based on the long-term debt and common equity balances you have described?

A. Yes. ComEd's common equity ratio as of December 31, 2006 was 58.95%.

Q. Does ComEd's proposed revenue requirement use a capital structure with a common equity ratio of 58.95%?

A. No.

Q. Why is ComEd not proposing its actual 58.95% common equity ratio?

A. While that common equity ratio would be reasonable for a utility like ComEd, we recognize that the rationale of the Commission's decision in Docket No. 05-0597 suggests a different result. In Docket No. 05-0597, the Commission determined that, for ratemaking purposes, the goodwill recorded on ComEd's balance sheet should not be included in the common equity balance used for ratemaking, and rejected ComEd's proposed purchase accounting adjustment. Reducing ComEd's common equity balance for goodwill as of December 31, 2006 would result in a common equity ratio lower than 58.95%.

Q. Have you calculated the common equity ratio that would result if ComEd's balance of common equity as of December 31, 2006 were reduced by the goodwill recorded on ComEd's balance sheet as of that date?

A. Yes. As of December 31, 2006, the total amount of goodwill recorded on ComEd's balance sheet was $2.694 billion. Reducing ComEd's $6.298 billion of common equity by the goodwill balance results in common equity of $3.604 billion, and a capital structure with a common equity ratio of 45.11%.

Q. Is ComEd recommending that the Commission approve a capital structure with a common equity ratio of 45.11% in this proceeding?

A. ComEd is asking the Commission to approve a capital structure with no less than 45.11% equity. But the Commission should recognize that a capital structure with 45.11% equity is still quite leveraged for utilities with the type of strong credit ratings that ComEd has historically sought to achieve and that the Commission should conclude are appropriate.

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Commonwealth Edison Company	:	
	:	
Proposed general increase in rates for delivery service. (Tariffs filed on August 31, 2005)	: : :	05-0597

ORDER

July 26, 2006

IIEC argues ComEd's balance sheet has over $11 billion in total capital and its test year rate base is $6 billion. IIEC asserts that b that ComEd does not need $11 billion of capital to finance a $6 billion rate base. IIEC states that the major difference between ComEd's rate base and total capital is a goodwill asset of about $4.9 billion. IIEC asserts that the evidence in the record clearly shows that that $4.9 billion goodwill asset is financed entirely by common equity. Thus, IIEC argues good will is not a transmission distribution asset, it's financed solely with common equity. IIEC contends that it is appropriate to carve that common equity out of the capital structure and attribute it only to the goodwill asset. According to IIEC this leaves approximately 6 to $7 billion in capital to finance a $6 billion rate base. IIEC says this is typical of what one normally sees from ComEd's capital structure in reviewing the utilities' actual capital structure and rates. IIEC says that total capital and rate case don't always match, but they are generally pretty close. So, IIEC states that it is appropriate under these circumstances to remove the common equity supporting the goodwill asset.

IIEC supports Staff's argument that the effects of ComEd's goodwill asset should be removed from the capital structure. IIEC says ComEd's goodwill asset is not a transmission or distribution asset and, it is not used in providing ComEd's delivery services. IIEC states ComEd has excluded it from its proposed rate base in this case. According to IIEC the common equity recorded when that goodwill asset was created is not capital that supports the rate base and services under Commission regulation. IIEC argues ComEd's goodwill must be supported by equity, since "goodwill does not produce revenues and cash flows, and therefore could not be supported by debt capital." According to IIEC, the equity supporting ComEd's goodwill should be excluded from the capital structure used to determine ComEd's delivery services revenue requirement.

IIEC says that since the objective in this proceeding is to measure ComEd's cost of providing regulated utility service, it is appropriate to look at ComEd's total capital and identify what part of that capital represents its cost of funding utility plant investments. IIEC reasons the capital structure proposed by Staff witness Ms. Kight and supported by IIEC is the proper assessment of that capital supporting regulated utility rate base and therefore should be adopted.

Commission Analysis and Conclusion

At issue is the appropriate capital structure *for ratemaking purposes*. The capital structure for ratemaking purposes is based on original cost rate base, and may differ from the capital structure reported for operations.

There are two proposals before the Commission. Both exclude short-term debt from the capital structure, and both set the balance of preferred equity at zero. ComEd asks that the Commission adopt a capital structure of 54.2% common equity ("equity") and 45.8% long-term debt ("debt"). Staff proposes a structure of 37.2% equity and 62.8% debt. CCC and IIEC support Staff's proposal. (The IIEC originally advocated a 50%/50% structure but subsequently withdrew that recommendation and supported

Staff's proposal. The Commission therefore does not view the 50%/50% structure to be at issue.

The dispute centers on whether to include or exclude for ratemaking purposes a net $2.634 billion goodwill asset. ComEd includes this amount in equity within its proposed capital structure; Staff excludes it. "Goodwill" is an intangible that represents the difference in value between the original cost of assets and the value received for their sale or transfer.

The net $2.634 billion amount reflects Staff's elimination of $4.791 billion in goodwill generated by the transfer of the nuclear power plants formerly owned by ComEd and funded by ratepayers through rate base. The plants are now owned by an unregulated affiliate, either directly by ComEd's parent Exelon or through another Exelon subsidiary. The net $2.634 billion amount also reflects Staff's adjustment to set certain costs related to the merger of Unicom and PECO (into Exelon) to reflect original cost. (ComEd had already excluded from its proposal $2.292 billion in goodwill related to the Unicom/PECO merger.)

Staff states that, as a result of the nuclear plant transfer, ComEd neither owns the plant assets nor received other assets in exchange. Accordingly, Staff contends that the transfer distorted the relationship between ComEd's actual capital structure and the capital supporting its depreciated original cost rate base. Staff contends that the generation assets had an original cost book value of approximately $6.7 billion, and were transferred from ComEd at a restated fair value cost basis of approximately $2 billion, with all of the resulting goodwill remaining on ComEd's books. As a result, ComEd's actual capital structure was not reduced commensurate with the original cost book value of the assets and liabilities transferred.

CCC and IIEC both point out that the goodwill asset is not used in providing transmission and distribution service, and therefore is not a cost recoverable in the instant delivery services rate case. ComEd's balance sheet has over $11 billion in total capital. Its test year rate base is approximately $6 billion. The difference is attributable to the goodwill asset of approximately $4.9 billion in gross, financed by common equity. CCC and IIEC contend that, because the goodwill is not used in providing delivery services, it is appropriate to remove the common equity supporting goodwill from ComEd's capital structure. The resulting structure is consistent with that defined by Staff's accounting analysis.

ComEd counters that Staff's resulting capital structure does not reflect its actual capital structure, and that such a ratio will incorrectly signal investors about the financial strength of the Company. ComEd also contends that maintaining goodwill requires no cash, so all of its proposed capital structure supports its utility business.

Furthermore, ComEd argues that the transfer of its assets was lawfully executed, and that GAAP requires the transfer at book value. ComEd charges that Staff seeks a second review of the transactions completed pursuant to prior approval, and that such result is illegal.

Finally, ComEd witness Dr. Hadaway criticizes the Staff proposal because it contains much more debt than the respective capital structures of the companies in the sample group utilized to estimate the cost of common equity. In light of the plant transfers, the Commission does not view a difference in the proportion of debt to signal a problem *per se*

The starting point for the analysis, however, is Section 9-201 of the Act (220 ILCS 5/9-201). It requires that the rates set in this case be "just and reasonable," and further specifies that "the burden of proof to establish the justness and reasonableness of the proposed rates ... shall be upon the utility." (220 ILCS 5/9-201(c).)

In *Citizens Utility Board v. ICC* (the "*CUB*" case), the Appellate Court stated that "the Act requires the Commission to establish rates which are just and reasonable for both the investors and the consumers." (*CUB v. ICC*, 276 Ill. App. 3d 730, 737 (1995); *see also id.* at 736 (*citing Bus. & Prof'l. People for the Pub. Interest v. ICC* (1991), 146 Ill. 2d 175, 208 ("The Commission is charged by the legislature with setting rates which are just and reasonable * * * to the ratepayers [and] to the utility and its stockholders.") *and Ill. Bell Tel. Co. v. ICC* (1953), 414 Ill. 275, 287 ("The rate making process under the act, i.e., the fixing of just and reasonable rates[,] involves a balancing of the investor and the consumer interests.")).) The Court also stated in the *CUB* case that "[c]urrent ratepayers should pay for only that plant which produces current benefits." (276 Ill. App. 3d at 741.)

That case applied the just and reasonable requirement to the capital structure. Citing Section 9-230 of the Act, the Court stated:

> [t]he legislature has directed the Commission to protect against the increased cost of capital sought by a utility with such an inflated level of equity. * * * [T]he Commission should disallow recovery of any cost of capital in excess of that reasonably necessary for the provision of services. If a utility has included excessive equity in its capital structure, it has inflated the rate of return and its capital cost.

(*Id.* at 745-46.)

Section 9-230 provides that:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (i) incremental risk, (ii) increased cost of capital, or (iii) ..., which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.

(220 ILCS 5/9-230.) A year later, the Court discussed the *CUB* and *Business and Professional People* cases, and held:

> Before deciding whether to use a hypothetical capital structure, the Commission was required to determine whether either Bell's risk or cost of capital were increased because of its affiliation with Ameritech. ... We hold that if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR [rate of return] calculation.

(*Ill. Bell Tel. Co. v. ICC*, 283 Ill. App. 3d 188, 206-207 (1996).)

Staff, CCC, and IIEC all argue that ComEd should not earn a rate of return on plant it does not own and does not use for providing distribution services. This view comports with the language of Section 9-230 of the Act, as discussed in the *CUB* and *Illinois Bell* cases. (*See supra.*) Furthermore, ComEd's equity figure contains the net $2.634 billion in goodwill generated from the transfer of its plants. Including this figure in equity necessarily will raise the required rate of return, and therefore the rates set herein.

The Commission finds that ComEd may not make such a recovery through regulated rates. Any recovery of the cost of plant owned by an unregulated generating affiliate will be recovered through the cost of power procured from such affiliate. The Commission therefore further finds that a recovery of such costs in rates by counting the goodwill in equity constitutes a double recovery, is not related to the regulated activities covered by these rates, and accordingly is neither just nor reasonable within the meaning of Section 9-201 of the Act.

ComEd's argument that it might have structured the transfer differently to effectuate the same at original cost is directly related to the issue of earning a return on plant it does not own. ComEd states:

> ComEd pointed out that the proponents of the artificial 37/63 capital structure assume, without evidence that, had ComEd been required to transfer the assets at value (billions of dollars above book), it still would have structured the transfer in exactly the same way. Houtsma Sur., ComEd. Ex. 35.0, 18:386-89. ComEd explained that once the value of the plants is assumed to be different by billions of dollars, there is no basis in logic, fairness, business judgment, or common sense for assuming that the value is the only element of the transaction that would have changed. Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 13:270-15:305. ComEd further noted that the artificial 37/63 capital structure becomes even less plausible when the resulting impact on equity is considered: *ComEd has consistently managed its capitalization to achieve an equity balance above $5 billion, yet the equity balance that would have resulted from a transfer where*

> *nothing but the value is changed would be inconsistent with that practice. ComEd explained that this is important, given that ComEd could have avoided the impact on equity by structuring the nuclear asset transfer differently.*

(ComEd Position Statement/Draft Order (May 4, 2006) at 92 (emphasis added); *see also* ComEd Init. Br. at 167-169 (stating the same at greater length).)

The Commission notes that Section 16-111(g)(4) of the Act provides that "[d]uring the mandatory transition period, an electric utility may * * * record reductions to the original cost of its assets." The Commission therefore views ComEd to admit in its initial brief (at 167-169) and in its position statement (at 92) that ComEd could have chosen to structure the transfer differently, but that it elected not to set the original cost of the transferred assets to their fair value under Section 16-111(g)(4) of the Act. Had it done so, the transaction would not have produced such an enormous difference between the original cost and fair value of the transferred plants, i.e. goodwill. Instead, by disregarding Section 16-111(g)(4), ComEd created a goodwill asset of $4.791 billion.

The Commission finds that this situation falls well within the "increased cost of capital ... which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies" prohibited by Section 9-230 of the Act. It similarly reflects the "inflated level of equity" discussed in *CUB v. ICC*, and the "one dollar more for capital because of its affiliation with an unregulated or nonutility company" holding of *Ill. Bell v. ICC* (*see supra.*) In light of all this, the Commission rejects ComEd's proposed equity figure of 54.2%, which includes a recovery from rate payers based on billions of dollars of goodwill that was avoidable under Section 16-111(g)(4).

The foregoing determination is confined to the unjustness and unreasonableness of ComEd's proposal to recover a return on billions of dollars of plant it does not own through a mechanism that the Company admits it did not have to use. It also reflects the Commission's concurrence with Staff that the "actual" capital structure proposed by ComEd in this case is distorted relative to original cost rate base. It does not constitute a review of, or change to, prior matters. Furthermore, it does not change the methodology of setting rates (for any utility) according to depreciated original cost rate base. Equally important, the equity at issue plainly does not support ComEd's provision of its regulated delivery services.

Although there are only two proposals and ComEd's has been rejected, the analysis is not yet complete. As noted above, Illinois Courts have repeatedly stated that the rates established herein must be just and reasonable for both ratepayers and investors. The Commission must determine whether Staff's proposal of 62.89% debt and 37.11% equity is, in fact, just and reasonable.

In light of the foregoing discussion, the Commission believes that Staff's adjustments have merit, and the Commission is satisfied that Staff's capital structure properly reflects ComEd's level of debt. While Staff contends that the proportions of equity in ComEd's last three rate cases were 38.97%, 39.40%, and 42.86% respectively, the Commission remains concerned that Staff's proposal may not be sufficient to allow the utility to maintain its financial strength or A- credit rating. Accordingly, the Commission declines to adopt a capital structure of 62.89% debt and 37.11% equity.

The Commission observes that Illinois Courts have repeatedly stated that setting rates is a legislative function. (*See, e.g., Bus. & Prof'l People for Pub. Interest v. ICC*, 146 Ill. 2d 175, 196 (1991); *Ill. Cent. R.R. Co. v. ICC*, 387 Ill. 256, 275 (1944); *City of Chicago v. ICC*, 281 Ill. App. 3d 617, 622 (1996); *CUB v. ICC*, 276 Ill. App. 3d 730, 734 (1995).) The Commission therefore concludes that in determining whether a proposed capital structure is just and reasonable, it is the duty of the Commission to protect both ratepayers and investors.

Weighing all of the considerations discussed above, the Commission finds that it is appropriate to impute a capital structure of 42.86% equity and 57.14% debt. This capital structure is equivalent to what the Commission determined to be sufficient to maintain a reasonable level of financial strength in Docket No. 01-0423. The Company has been able to maintain an investment grade credit rating based on the previously determined capital structure. The Commission believes that such structure reflects Staff's adjustments to set rates based on original cost and trims ComEd's balloon of goodwill resulting from the plant transfers to unregulated affiliates.

2. COST OF LONG-TERM DEBT

ComEd

ComEd proposed a cost of long-term debt of 6.50%. ComEd states that this is its actual cost of such debt as of June 30, 2005, the historic capital structure measurement date used for ComEd's capital structure.

With respect to Staff's suggestion that ComEd's long-term debt cost be reduced to 6.48% (Kight Dir., Staff Ex. 4.0 Corr., 3:48-50), ComEd argues that the ending balances and amortization amounts behind that suggestion are not correct. ComEd offers that when the correct balances and amortization amounts are used – as shown in ComEd Exhibits 20.5a and 20.5b – ComEd's cost of long-term debt is 6.50%, just as ComEd is proposing. Mitchell Reb., ComEd Ex. 20.0 Corr., 28:602-29:609; ComEd Ex. 20.5a; ComEd Ex. 20.5b. ComEd also states that although Staff witness Sheena Kight claimed that she did not use ComEd Ex. 20.5b, the balances and amortization amounts reflected in that Exhibit are accurate and in accordance with applicable accounting and amortization principles.[18] Thus, ComEd states its actual balances and amounts -- not Staff's modified ones -- should be used in computing ComEd's cost of long-term debt. Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 24:466-81.

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[18] IIEC initially agreed with ComEd's proposed cost of long-term debt (*i.e.*, 6.50%), but subsequently switched to adopting Staff's position of 6.48%. Gorman Dir., IIEC Ex. 3.0, 19:438-446; Gorman Reb., IIEC Ex. 7.0, 2:35-37. In making this switch, however, IIEC offered nothing to support Staff's position, and thus IIEC's adopted position is invalid for the same reasons that Staff's is.