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September 10, 2008

Via Hand-Delivery

Chairman Tre Hargett
c/o Ms. Sharla Dillon
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

filed electronically in docket office on 09/10/08

Re: *Petition Of Tennessee American Water Company To Change And Increase Certain Rates And Charges So As To Permit It To Earn A Fair And Adequate Rate Of Return On Its Property Used And Useful In Furnishing Water Service To Its Customers*
Docket No. 08-00039

Dear Chairman Hargett:

Enclosed please find an original and seven (7) copies of filing of Tennessee American Water Company's Notice of Filing.

Please return three copies of this document, which I would appreciate you stamping as "filed," and returning to me by way of our courier.

Should you have any questions concerning the enclosed, please do not hesitate to contact me.

Sincerely,



R. Dale Grimes

Enclosure

Chairman Tre Hargett

September 10, 2008

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cc: Hon. Mary Freeman
Hon. Sara Kyle
Hon. Eddie Roberson
Richard Collier, Esq.
Ms. Shilina Chatterjee Brown
Ms. Kelly Grams
Ms. Emily Knight
Ryan McGehee, Esq.
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David C. Higney, Esq.
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**BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE**

IN RE:

PETITION OF TENNESSEE AMERICAN)	
WATER COMPANY TO CHANGE AND)	
INCREASE CERTAIN RATES AND CHARGES)	
SO AS TO PERMIT IT TO EARN A FAIR AND)	
ADEQUATE RATE OF RETURN ON ITS)	Docket No. 08-00039
PROPERTY USED AND USEFUL IN)	
FURNISHING WATER SERVICE TO ITS)	
CUSTOMERS)	

**TENNESSEE AMERICAN WATER COMPANY'S
NOTICE OF FILING**

Pursuant to the Rule of Completeness set forth in Tennessee Rule of Evidence 106, Tennessee-American Water Company ("TAWC" or the "Company") submits a copy of the relevant portions of the Illinois Commerce Commission's December 20, 2006 Order on Rehearing in *Commonwealth Edison Company, Proposed General Increase in Rates for Delivery Service* (Tariffs filed on August 31, 2005), docket number 05-0597, which supplements and completes the July 26, 2006 Order cited by the Chattanooga Manufacturer's Association ("CMA") in its Post-Hearing Memorandum of Law filed in this docket on September 2, 2008.

The CMA offers the July 26, 2006 Order to support its contention that \$1.7 billion representing goodwill on the books of TAWC's parent, American Water Works Company ("AWK") should be removed from the common equity of AWK for purposes of imposing double leverage on the TAWC capital structure. TAWC vigorously disagrees with removing the goodwill asset and asserts that, in any event, the key issue in the Illinois Commerce Commission decision was the determination of a just and reasonable imputed capital structure, as explained

by the December 20, 2006 Order on Rehearing,¹ and in making that determination the Illinois Commerce Commission (“ICC” or the “Commission”) in fact rejected the capital structure proposed by the Staff and endorsed by Mr. Gorman.² Mr. Gorman’s proposed capital structure in that case was calculated in the same way he suggests in the present case.

At the outset, TAWC opposes the elimination of the goodwill asset based on accounting and rate making principles as set forth in its testimony.³ Furthermore, not only did the ICC reject the capital structure endorsed by Mr. Gorman, but any reliance on the decisions of the ICC in the case of Commonwealth Edison Company (“ComEd”), or the CMA’s interpretation of those orders, is misplaced because there are several important distinctions between ComEd and TAWC. First, the issue arose in Illinois because ComEd was the regulated utility seeking to establish a capital structure for its own ratemaking purpose, and its capital and rate base did not match; in this case, TAWC is the regulated utility, and its capital and rate base are in alignment.⁴ Second, the ICC does not employ double leverage and was not seeking to do so with respect to ComEd; but it is the Tennessee Regulatory Authority’s tradition to employ double leverage and the CMA argues for its application in this case. Third, the ICC did not end its analysis with the elimination of the goodwill asset; it went on to evaluate whether the imputed capital structure preserved the utility’s financial strength, whereas the CMA seeks to improperly eliminate goodwill from the equity only, impairing TAWC’s financial integrity.⁵

¹ Illinois Commerce Commission, Docket No. 05-0597, Order on Rehearing, p. 58 (December 20, 2006).

² Illinois Commerce Commission, Docket No. 05-0597, Order, pp. 128-30 (July 26, 2006).

³ Michael Miller, Pre-Filed Rebuttal Testimony, pp. 27-28 (August 13, 2008).

⁴ The capital structure of AWK does not support the rate base investment of TAWC. TAWC’s capital structure supports its rate base. Under the double leverage methodology, the parent’s capital structure is used because it supports the equity of the subsidiary (TAWC), not its rate base. Unlike ComEd, TAWC does not have a variance between its capital structure and rate base, and unlike the ComEd situation, there is no reason to impute a hypothetical capital structure to match TAWC’s capital and rate base.

⁵ The only testimony in this record concerning financial integrity and credit metrics is from Dr. Michael Vilbert, who testified that the CMA’s recommended capital structure would not maintain TAWC’s financial integrity nor

The CMA contends that \$1.7 billion representing goodwill on the books of AWK should be removed from the common equity of AWK for imposing double leverage on the TAWC capital structure because it represents an “intangible asset that has no economic value because it does not support investment in utility infrastructure.”⁶ To support its contention concerning the treatment of goodwill, the CMA submitted a portion of the July 26, 2006 Order filed before the ICC in the ComEd case in docket 05-0597, as well as excerpts from the direct testimony of Robert K. McDonald and the Proposed Order in docket 07-0566.⁷ The CMA, however, disregards the extensive analysis in the December 20, 2006 Order on Rehearing in docket 05-0597, which makes clear that the primary consideration in determining an imputed capital structure for rate-making purposes is the effect on the utility’s financial strength and, in particular, the reasonableness of the capital structure when compared to the capital structures of comparable utilities.⁸ The Commission in fact rejected the capital structure proposed by the Staff and endorsed by Mr. Gorman, which reflected exclusion of the entire amount of capital deemed to support “goodwill”, because this capital structure would not allow the utility to maintain its financial strength and credit rating.⁹

ComEd proposed to use its actual adjusted capital structure reflecting 54.20% equity and 45.80% debt.¹⁰ The Commission Staff proposed that common equity supporting the utility’s “goodwill” be excluded from the equity component of the capital structure, which resulted in a

support an investment-grade credit rating. *See* Michael Vilbert, Pre-Filed Rebuttal Testimony, pp. 4-5 (August 13, 2008).

⁶ Chattanooga Manufacturers Association, Post-Hearing Brief, p. 5 (September 2, 2008).

⁷ In docket 07-0566, the capital structure is an uncontested issue as the CMA points out, however, the common equity proposed by ComEd and accepted by the Commission is 45.04%. *See* Illinois Commerce Commission, Docket No. 07-0566, Proposed Order, p. 73 (July 10, 2008). This equity ratio is significantly more than the 37.11% proposed by the Staff in docket 05-0597 that created the need for an imputed capital structure.

⁸ Illinois Commerce Commission, Docket No. 05-0597, Order on Rehearing, p. 60 (December 20, 2006).

⁹ Illinois Commerce Commission, Docket No. 05-0597, Order, pp. 128-30 (July 26, 2006).

¹⁰ *Id.* at 125.

Staff proposed common equity ratio of 37.11%.¹¹ Two intervenors, including Illinois Industrial Energy Consumers (IIEC) which sponsored Mr. Gorman, supported the Staff's proposal.¹² The Commission agreed that the goodwill asset should not be included in ComEd's equity, but it rejected the Staff recommendation of 37.11% common equity ratio because the Commission believed it may not be sufficient to allow the utility to maintain its financial strength or A- credit rating.¹³ Instead, the Commission imputed a capital structure with 42.86% common equity and 57.14% long-term debt, which is equivalent to what the Commission determined to be sufficient to maintain a reasonable level of financial strength in a prior ComEd rate case (docket 01-0423).¹⁴ On re-hearing, the Commission explained the imputed capital structure as follows:

Record support for a 42.86% common equity ratio includes (a) the sample of electric companies comparable to ComEd identified by Dr. Hadaway in his testimony, which has a 45.70% average common equity ratio, (b) Staff witness Sheena Kight's listing in her testimony of "A" utilities with business profiles of "4", which had an average common equity ratio of 45.46%, (c) Ms. Kight's identification of "A-" utilities with business profiles of "4," which had a 46.14% average equity ratio in 2002 through 2004, and (d) S&P's benchmark range of 38% to 48% common equity ratio for the lowest investment grade ("BBB") utilities with business profiles of "4" (internal citations omitted).¹⁵

The Commission further explained why it rejected the Staff's recommendation. The Commission noted that it "must determine a just and reasonable imputed capital structure."¹⁶ Regarding the Staff's recommendation, the Commission stated:

The Commission finds that the 37.11% common equity capital structure is inadequate to preserve ComEd's financial strength, is inconsistent with the capital structures of the comparable groups identified by the parties, is inconsistent with benchmarks for debt to capital ratios applied by Standard & Poor's, and is inconsistent with the evidence of capital structures of utilities generally. The evidence also indicates that approval of a highly leveraged capital structure with a common equity ratio of 37.11%, as advocated by Staff would significantly impair

¹¹ Illinois Commerce Commission, Docket No. 05-0597, Order, pp. 128-29 (July 26, 2006).

¹² *Id.* at 128.

¹³ *Id.* at 129-30.

¹⁴ *Id.* at 130.

¹⁵ Illinois Commerce Commission, Docket No. 05-0597, Order on Rehearing, p. 58 (December 20, 2006).

¹⁶ *Id.*

ComEd's financial condition at a time when, by most measures, it is already at the lowest investment grade rating.¹⁷

Similarly, the CMA's recommendation of a capital structure with only 29% equity would not maintain the Company's financial integrity and would fall below an investment-grade credit rating.¹⁸ If this treatment of goodwill is adopted, then the removal of goodwill from the equity requires a similar removal from the debt in order to maintain a reasonable debt-equity ratio.¹⁹

Furthermore, the ICC does not impose double leverage, so ComEd is regulated using its stand-alone capital structure. This vital distinction between ComEd and TAWC, if ignored, would create a misleading comparison.²⁰ Therefore, if any credence is placed on the ICC's treatment of goodwill, the effect on financial integrity as well as the double leverage issue must also be evaluated.

For the foregoing reasons, the Company disagrees with the treatment of goodwill endorsed by the ICC. The ICC's rulings are not applicable here due to the distinctions noted above. As discussed by the ICC in its orders, of which the CMA has only presented a limited portion, it is important to consider the financial integrity and credit rating of the regulated utility when setting the capital structure. Contrary to the CMA's one-sided approach, the treatment of goodwill and its effect on the Company's capital structure are inextricably connected. Therefore, if the TRA determines that any weight should be given to the ICC's treatment of goodwill, then, pursuant to Tennessee Rule of Evidence 106, the Company submits the ICC's December 20, 2006 Order on Rehearing for full consideration of this issue.

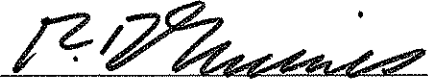
¹⁷ Illinois Commerce Commission, Docket No. 05-0597, Order on Rehearing, p. 57-58 (December 20, 2006).

¹⁸ Michael Vilbert, Pre-Filed Rebuttal Testimony, p. 4 (August 13, 2008).

¹⁹ Michael Miller, Pre-filed Rebuttal Testimony, p. 18 (August 13, 2008).

²⁰ The Company continues to assert that the use of double leverage capital structure diminishes the Company's common equity and understates the actual cost of capital. See Michael Miller, Pre-filed Rebuttal Testimony, p. 17 (August 13, 2008).

Respectfully submitted,

A handwritten signature in black ink, appearing to read "R. Dale Grimes", written over a horizontal line.

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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 10th day of September, 2008, upon the following:

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<input checked="" type="checkbox"/> U.S. Mail	Consumer Advocate and Protection Division
<input type="checkbox"/> Facsimile	Office of Attorney General
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	Nashville, TN 37243-0491
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D. Rate of Return

1. Capital Structure

ComEd

ComEd asserts that the evidence on rehearing supports one of the following three options: (1) adoption of the Company's original proposal during the case-in-chief which was 54.2%; (2) an imputed capital structure with a common equity ratio of 42.86% found in the Final Order; or, (3) the 46% equity imputed capital structure recommended in the Proposed Order in this proceeding. ComEd urges the Commission to reject Staff and Intervenor's proposed 37% common equity capital structure as not supported by the record evidence and wholly inappropriate.

The Company maintains that not only is Staff's 37.11% common equity capital structure not supported by the record but that evidence developed on rehearing demonstrates even more convincingly that the Commission was correct in rejecting that capital structure. ComEd maintains that Staff's proposed capital structure is an outlier when measured against typical utilities and emphasizes the fact that it is lower than the equity ratio of any company included in Staff's own sample of comparable companies. ComEd also points out that Staff witness McNally conceded during testimony on rehearing that a nexus existed in the Commission's Final order between the 42.86% equity ratio capital structure and the capital structure the Commission determined in ICC Dck No. 01-0423 and that the Commission determined that would be sufficient to maintain ComEd's financial strength.

ComEd also points to witness Bodmer's testimony which references a recent Exelon quarterly report on Form 10-Q. According to ComEd, that report shows that ComEd's equity ratio as of June 30, 2006 would be 41.8%. Moreover ComEd argues that if the Commission were to treat the capital structure in this case as it did in Docket No. 01-0423 and approved a pro forma adjustment of ComEd's actual capital structure to take into account transitional funding instruments (TFI) principal repayments through a period of two years after the 2000 test year used in that case, the result here would be a common equity ratio of 43.55%. the Company further contends that incorporation of the same type of updated analysis would also support adoption of a 42.86% common equity capital structure.

ComEd also argues that the same list used by witness Bodmer to derive the group of utilities and holding companies in his rehearing testimony includes the following utility companies, which have a common equity ratio in the vicinity of 42.86%: Energy East Corporation (43%); Cinergy Corp (44%); Aquila Corp (42%); SCANA Corp (42%); Vectren Corporation (44%); Xcel Energy (43%); American Electric Power (43%); Progress Energy (42%); AGL resources (42%); Southern Union (42%). Accordingly ComEd argues that this evidence supports the Final Order's imputed capital structure of 42.86%.

Finally, ComEd argues that the new evidence presented by Staff on rehearing demonstrates that the 37.11% equity capital structure is even less appropriate now than at the time the Commission entered its Order. Adopting a 37% capital structure at this juncture would result in an even weaker ComEd than was indicated in staff's prior testimony. According to ComEd, Staff's testimony on rehearing significantly understates the adverse change in facts that make a 37.11% equity capital structure inappropriate. ComEd argues that Staff's analysis fails to fully take into account the Order's disallowances of ComEd's expenses and the negative effect those disallowances have on ComEd's "funds from operations" which is a standard used by many rating agencies. Staff's analysis further fails to take into account the fact that Standard & Poors has downgraded ComEd and assigned it a higher risk business profile of "8."

Staff

Staff, on the other hand, maintains the same position on rehearing and advocates for a capital structure comprised of 37.11% equity and 62.89% long-term debt. Staff asserts that the July 26 Order's rejection of Staff's proposed capital structure is unfounded. Staff further claims that there was insufficient basis or failure by the Commission to articulate its reasons for doing so.

Staff questions the need for the Company to maintain an A- credit rating and points out that since 1991 the Company maintained its financial health with a rating somewhere in the BBB range.

Under Staff's proposed capital structure and rate of return on common equity, and the Order's conclusion regarding rate base and operating expenses, ComEd's Funds From Operations to Debt ("FFO/debt") ratio is 17.73%, which falls in the top third of S&P's benchmark range for a BBB utility with a business profile score of 4, while its Funds From Operations Interest Coverage ("FFOIC") ratio is 3.74x, which falls toward the low end of the middle third of the A range.⁴ (ICC Staff Exhibit 26.0, p. 5) Together, those two ratios indicate that Staff's proposed rates are sufficient to support financial strength that is commensurate with a credit rating of BBB+/A-. Furthermore, such a credit rating is consistent with the issuer credit ratings ComEd held from 1991 through October 2005, which fluctuated from a low of BBB to high of A-. Thus, the actual capital structure supporting ComEd's rate base, 37.11% equity and 62.89% long-term debt, is just and reasonable and should be adopted.

According to Staff, witness Kight testified that: A BBB credit rating indicates an adequate capacity to meet financial commitments. A debt issuer with a BBB credit rating has access to debt capital under most, if not all, financial market conditions while taking greater advantage of the tax-deductibility of debt interest than capital structures that support higher credit ratings

Staff also argues that ComEd has operated successfully with a BBB or BBB+ issuer credit rating nine out of the last fourteen years. With regard to the "support" from an Exelon 10-Q report, Staff takes issue with ComEd witness Mitchell's contention that

adjusting the capital structure measurement date to June 30, 2006 or June 30, 2007 would support a 42.86% equity capital structure. According to Staff, this is irrelevant because the Company chose a June 30, 2005 capital structure measurement period. The actual capital structure supporting ComEd's rate base (with the appropriate adjustments) as of that date consisted of 37.11% equity and 62.89% long-term debt. If the Company wished to use June 30, 2006 or 2007 capital structure measurement date, it should have elected to do so from the start and measured all of its cost of capital components consistently as of that date. The Commission should not allow a party to selectively update a single piece of the revenue requirement to suit that party's agenda, particularly in the last round of responsive testimony when no other party has a chance to respond.

Staff also disagrees with witness Mitchell's third form of "support" for a 42.86% equity ratio capital structure – the list of 10 utility companies with equity ratios in the vicinity of 42.86% that was selectively filtered from a much larger list. Staff points out that witness Bodmer culled from that same master list a subset of 15 utility companies with equity ratios of 38% or lower. Staff believes the mere existence of utilities with equity ratios near a party's desired target equity ratio, does not mean that the target equity ratio is applicable to ComEd. This exemplifies the overriding flaw in the Company's entire capital structure analysis: a sole reliance on dubious equity ratio comparisons as determinative of the capital structure to be approved by the Commission.

Staff also takes issue with ComEd's examples of the previous proceedings in which the Commission used capital structure comparisons to help gauge the appropriateness of a given capital structure proposal. Staff counters that in none of those cases did the Commission dismiss proposals based on financial coverage ratios in favor of proposals based on capital structure comparisons, as the Company proposes the Commission do in this proceeding. While Staff does not dispute that the Commission has, in the past, used capital structure comparisons to help gauge the appropriateness of a given capital structure proposal, Staff nevertheless argues that in this new era of utility purchase accounting adjustments (e.g., goodwill) and asset securitization (e.g., TFTNs) a review of financial coverage ratios provides more insight into a company's financial strength than capital structure comparisons, particularly in this proceeding, given the distortion created by inclusion of TFTNs in ComEd's capital structure. Ironically, despite the Company's apparent disdain for credit metrics in evaluating a capital structure, its entire analysis is based on a credit ratio – the equity ratio (i.e., the leverage metric).

Staff disagrees the Company's use of credit ratios. According to Staff, the Company's equity ratio comparison is misleading, as the equity ratios on both sides of the comparison are distorted. The Company's calculation of the equity ratio for the other utilities to which it compares ComEd assumes that all capital other than long-term debt is equity. That incorrect assumption causes the Company to overstate the equity ratio the Company claims should be determinative of the capital structure to be approved by the Commission. For example, the Company states that the average equity ratio for

Staff's comparable sample is 48%; however, as Staff noted, when short-term debt is properly included, the equity ratio is actually just over 45%.

More significantly, the inclusion of TFTNs in ComEd's debt balance renders ComEd's leverage metric misleading. This is because the leverage metric does not consider the risk and cost associated with the debt in the capital structure and, thus, fails to differentiate between conventional debt and lower risk TFTNs. Since ComEd's TFTNs are less risky than conventional debt, a position argued by ComEd in Docket No. 98-0319, ComEd is less risky than its 62.89% combined debt/TFTN ratio suggests. Although Staff believes that TFTNs are properly included in ComEd's capital structure, one must acknowledge that the lower risk of TFTNs makes comparisons of ComEd's capital structure to other capital structures and capital structure benchmarks misleading.

Staff also argues that the Company's approach completely ignores the Funds from Operations Interest Coverage ("FFOIC") and Funds from Operations to Debt ("FFO/debt") ratios, each of which provides a less distorted measure of ComEd's risk than the equity ratio.

Staff disagrees with the Company that even if one accepts credit metrics as determinative of a capital structure, a 37.11% equity ratio is not acceptable because it produces credit metrics that are weaker than before, which the Company claims were already too weak. According to Staff, although the resulting credit ratios are slightly weaker when Staff's cost of capital recommendations are combined with the Order's rate base than with Staff's proposed rate base, as Staff originally presented, those ratios still indicate a sufficient level of financial strength.

Staff also urges the Commission to not give much weight to the recent downgrades to ComEd's credit rating. Staff instead believes, contrary to ComEd's claim, since the Order *increased* ComEd's rates, it obviously could not worsen ComEd's prospective financial condition. Moreover Staff argues that ComEd's capital structure should not be adjusted to reflect ComEd's current S&P credit rating of BBB- and business profile score of 8, since these downgrades reflect "concern about increased political rhetoric in Illinois regarding a rate-freeze extension and that legislation extending the rate freeze." Staff also points out that, in its discussion of the "difficult political and regulatory environment," Moody's makes no mention of the Order, but does specifically note concerns regarding the recovery of power procurement costs. In addition, the Fitch Ratings report dated July 31, 2006, which Mr. Mitchell also attached to his direct testimony on rehearing, notes that its downgrade reflects "the increased business risk that result from the ongoing regulatory uncertainty in Illinois." In sum Staff believes that all this indicates that ComEd's rating decline was based on increased risk relating to uncertainty with regard to a possible freeze in bundled rates, rather than the capital structure adopted in the Order. Staff, therefore concludes that ComEd's current ratings are not relevant in this proceeding. Staff urges the Commission to not make decisions in the rate case based on speculative actions regarding legislative action.

CUB/CCSAO/City

CUB/CCSAO/CITY all argue that Staff's originally proposed 37.11% equity and 62.89% long-term debt capital structure should be adopted on rehearing; in other words, the commission should reduce the Final Order's common equity from 42.86% to 37.11%. These parties argue that exclusion of all goodwill from the company's cap structure under Illinois law mandates, therefore, that Staff's 37% equity number be the only one that can be adopted because the commission's imputed 42.86% number unlawfully includes a portion of the goodwill asset (cannot be included because it has nothing to do with providing delivery services to ratepayers; it cannot be considered a transmission and distribution utility asset). The Intervenor also point to Staff witness McNally's testimony that the Commission's Final Order did not explain why it is necessary for ComEd to maintain an A- credit rating. The Intervenor also attack ComEd witness Mitchell's testimony on rehearing as misleading. Specifically, CCC takes issue with Mitchell's testimony that both Moody's and Fitch Ratings downgraded CE's credit rating after the Commission's Final Order was released as well as well as Mr. Mitchell's citing of the Negative Credit Watch issued by Standard & Poors. CCC disputes the implication that there is a direct correlation between the actions taken by the credit agencies and the Commissions order. Instead, CCC argue that the actions of the credit agencies are due to the "threats of rate freeze legislation by Illinois governor and General Assembly" and go more to CE's ability to recover its procurement costs.

The Attorney General points out that the Commission specifically disavowed all goodwill from the capital structure; put another way, the commission has stated that the company's capital structure should not include any goodwill. But the capital structure approved by the Commission in its final order incorrectly includes \$695,000,000 of goodwill in common equity. Since there is a mathematical discrepancy here, the AG recommends that this amount be excluded from ComEd's common equity reducing the Company's revenue requirement by \$32,372,000 from the revenue requirement in the Order

2. Cost of Common Equity

ComEd asked for rehearing of the Commission's determination that the average of the only two cost of equity estimates that it concluded was reasonable is an appropriate cost of equity for ComEd. ComEd argues that because the Commission utilized an average of estimates to determine the cost of common equity, ComEd's estimate should have also been included.

While Staff continues to recommend an investor-required rate of return on common equity of 10.19% it acknowledges that if the Commission adopts a capital structure higher than 37% the cost of equity needs to be adjusted downward from 10.19% since the estimate reflects the risk of a sample of companies with an average credit rating of BBB+/A-. Staff points out that should such an adjustment be necessary the Commission should adjust Staff's cost of equity estimate downward as it has in previous cases by using bond spreads to measure the cost differential related to the risk

of the target company relative to the proxy sample from which the cost of equity was derived (Staff Schedule 26.5).

CUB/CCSAO/CITY continue to argue that witness Bodmer's recommended 7.75% cost of common equity be adopted. These parties insist that the Commission consider Mr. Bodmer's discounted cash flow ("DCF") and capital asset pricing model ("CAPM") analyses despite the fact that the Commission already rejected Mr. Bodmer's investment bank analysis as well as his market-to-book analysis in the Final Order. According to CUB/CCSAO/CITY, Mr. Bodmer's cost of common equity analysis and subsequent recommendation is just and reasonable and should be adopted by the Commission.

3. Cost of Debt

Staff states that the Order properly concluded that ComEd's embedded cost of long-term debt is 6.48% but now argues that the appropriate cost of long-term debt depends on the capital structure adopted. Staff urges the Commission that were it to elect to adopt a capital structure with an equity ratio greater than 37.11%, the cost of long-term debt needs to be adjusted downward from 6.48% because many of ComEd's long term debt series carry the higher interest rate associated with the lower credit rating the company had at the time of their issuance.

Commission Analysis and Conclusion

The main issue on rehearing regarding the capital structure is whether the common equity ratio should: (1) stay at 42.86% found in the Final Order; (2) be raised to the 46% originally recommended by ALJs in the ALJPO; or (3) be lowered to the 37% proposed by Staff in its case-in-chief and maintained on rehearing.

The Commission's Order imputed a capital structure of 42.86% common equity ratio. While the Commission modified and reduced the imputed capital structure (46% common equity) recommended in the ALJs' Proposed Order, the Commission explicitly rejected Staff's proposed capital structure with a common equity ratio of 37.11% acknowledging that such a low common equity ratio would not allow the utility to maintain its financial strength and credit ratings. (Final Order at 129-130). The evidence presented on rehearing continues to show that the Commission was correct in rejecting the leveraged capital structure proposed by Staff, AG and CCC. An imputed capital structure must be reasonable. If measured against the capital structures of comparable utilities, Staff's proposed 37.11% equity capital structure is an outlier. The evidence adduced on rehearing has not changed this key fact.

The Commission finds that the 37.11% common equity capital structure is inadequate to preserve ComEd's financial strength, is inconsistent with the capital structures of the comparable groups identified by the parties, is inconsistent with the benchmarks for debt to capital ratios applied by Standard & Poor's, and is inconsistent with the evidence of capital structures of utilities generally. The evidence also indicates

that approval of a highly leveraged capital structure with a common equity ratio of 37.11%, as advocated by Staff would significantly impair ComEd's financial condition at a time when, by most measures, it is already at the lowest investment grade rating.

Staff's argument that the Commission failed to explain itself when it rejected Staff's 37% proposal, instead electing to impute its own capital structure comprised of 42.86% common equity, is inaccurate. The Commission clearly stated its concern that Staff's 37.11% proposal "may not be sufficient to allow the utility to maintain its financial strength of A- credit rating." Staff's argument on rehearing that an A- rating is not necessarily needed since the majority of time since 1991 the Company has maintained its financial health with a rating in the BBB range is not persuasive. The electricity industry and this company have undergone significant changes since 1991 and any comparison dating back to 1991 is unfair at best.

We reject the contention that Staff's 37% proposal is the only capital structure that can possibly be adopted by the Commission. The Commission can clearly adopt an imputed capital structure as it did in its Final Order. Illinois Courts have repeatedly stated that the rates established herein must be just and reasonable for both ratepayers and investors. The Commission must determine a just and reasonable imputed capital structure. If the levels are not set properly, the Company may experience negative market consequences. A severe error may result in rates that are not just inappropriate, but confiscatory.

The record supports approval of an imputed capital structure with a common equity ratio of 42.86%. Record support for a 42.86% common equity ratio includes (a) the sample of electric companies comparable to ComEd identified by Dr. Hadaway in his testimony, which has a 45.70% average common equity ratio, (b) Staff witness Sheena Kight's listing in her testimony of "A" utilities with business profiles of "4", which had an average common equity ratio of 45.46%, (c) Ms. Kight's identification of "A-" utilities with business profiles of "4," which had a 46.14% average equity ratio in 2002 through 2004, and (d) S&P's benchmark range of 38% to 48% common equity ratio for the lowest investment grade ("BBB") utilities with business profiles of "4." Mitchell Reh. Reb., ComEd Ex. 58.0, 27:575-583.

Staff itself conceded that the Commission has, in the past, used capital structure comparisons to guide it in determining the appropriateness of a given capital structure component. Staff further contends that in this new era of utility purchase accounting adjustments and asset securitizations a review of financial coverage ratios should also be considered in determining an appropriate capital structure for ratemaking purposes. We do not disagree. However, the Commission cannot ignore evidentiary record as a whole on this issue and the fact that the company's investment grade rating is already at its lowest by most measures (a single notch above non-investment grade, aka "junk status").

The Commission rejects the AG and CCC suggestion on rehearing that approval of an imputed capital structure with a common equity ratio in excess of 37.11% will

contain goodwill. There is no basis for that contention because an imputed capital structure is not an actual capital structure or an adjusted capital structure. Rather, when the Commission adopts an imputed capital structure, it determines that it is just and reasonable to disregard the actual capitalization of the utility and instead set the debt and equity ratios for ratemaking purposes based on what capital structure a reasonable, comparable utility would have maintained. See, e.g. Sundale Utilities, Inc., Docket No. 04-0637 (Order, Aug. 9, 2005); Consumers Gas Co., Docket No. 92-0283 (Order, April 21, 1993); Illinois Commerce Comm'n v. Eldorado Water Co., ICC Docket No. 93-0219 (Cons.) (Order, July 7, 1994) ; GTE North Inc., Docket No. 93-0301 (Cons.) (Order, Oct. 11, 1994); Central Illinois Public Service Co., et al., Docket No. 00-0802 (Order, Dec. 11, 2001). Accordingly, the Commission concludes that there is no inconsistency between its approval of an imputed capital structure with a common equity ratio of 42.86% and any findings or conclusions contained in the Order concerning the subject of goodwill, purchase accounting, the Unicom/PECO merger or the Exelon reorganization.

The Commission also rejects the AG, CCC, and IIEC argument that the equity ratio must be set to 37.11% because otherwise ComEd will supposedly be earning a return on non-delivery assets. This argument is flawed because ComEd earns a return only on its rate base, not its capitalization. As the Commission found in its July 26th Order, ComEd's rate base contains only delivery assets. The record demonstrates that ComEd has no generation assets to support and no part of ComEd's total capitalization, be it debt or equity, supports generation.

The Commission also disagrees with the parties' assertion that there "must be" some capital supporting a non-delivery activity because ComEd's total capitalization exceeds its rate base. There is no support in logic or the law that rate base and total capital must be even or approximately equal. The record indicates that they can and do significantly diverge for utilities for entirely appropriate reasons having nothing at all to do with plant write-downs, plant transfers, or goodwill. ComEd's rate base is based on net plant values, while total capitalization is based on current market conditions and financial decisions (e.g., when and whether to refinance debt) that have nothing to do with rate base. Moreover, the size of the rate base, not its total capitalization, affects rates. Only the ratio between the components of the capital structure affect rates.

Finally, the Commission rejects Staff's and CCC's distinction between the downgrades being a result of ComEd's ability to recover its supply side power procurement costs versus the utility's ability to recover its delivery costs which is the subject of this rehearing and encompasses the instant issue before the Commission – an appropriate capital structure in a rate case. The issue that has been raised during rehearing is whether there is a nexus between the Commission's Final Order and the credit downgrades that have resulted and whether additional downgrades will result. Staff and intervenors argue that the downgrades were solely and strictly a result of legislative threats to extend the rate freeze. As an initial matter, credit agencies and other financial institutions look at a company as a whole and are influenced by any factor that might negatively impact a company from a financial investment perspective.

Moreover, it is safe to assume, the fact that one of the reports mentions the rate order that the entire market knows and considers that factor in its view and perception of the company.

Turning now to the adjustment advocated by Staff and Intervenor on the cost of common equity and cost of long-term debt in the event an imputed capital structure is adopted or maintained, the Commission finds that no changes are necessary.

The Commission finds that the record does not support Staff's assertions regarding a downward adjustment on the return on equity in the event any capital structure other than Staff's 37% proposal is adopted. Staff believes that its proposal is consistent with and reflects the BBB+/A- average credit rating of companies in its sample group and fears that ComEd would have an even higher credit rating if the cap structure is higher than 37%. We disagree. Given the subsequent credit rating downgrades, the Commission cannot assume that imposing a 37% equity component to the capital structure would correlate to a BBB+/A- credit rating. ComEd's argument on rehearing that its cost of common equity estimate should have been used as well to arrive at the Commission's ultimate determination is also unpersuasive. The Commission's reason for not using the Company estimate was that it deemed it too high. Similarly, the Commission also excluded CCC's 7.75% cost of equity estimate from its consideration as well because it deemed that number to be too low. The body of rehearing testimony presented no new evidence to cause us to veer from our original decision.

Similarly, the Commission finds no record evidence to support a downward adjustment on the cost of long-term debt. Neither Staff nor any other party has demonstrated any error in the calculation of the actual cost of ComEd's debt approved by the Order. The cost of existing embedded debt does not change when the company's credit ratings change. ComEd is still obligated to pay holders of its bonds based on interest rates when the debt was issued. The Commission's Final Order, therefore, properly concluded that ComEd's embedded cost of long-term debt was 6.48% and that determination was based on what interest and other costs ComEd actually agreed to pay at the time the debt was issued.

In sum, the Commission finds that it correctly rejected the 37.11% proposed capital structure in its Final Order. Moreover, the Commission finds that nothing further has been adduced on rehearing that should cause the Commission to alter its view. The Commission remains concerned, especially in light of developments since the Final Order, that Staff's 37% proposal may not be sufficient to ensure the financial health of the company in the eyes of the financial community. The Commission sufficiently articulated its rationale as to why it believed an imputed a capital structure of 42.86% common equity was appropriate. The Commission finds that, in approving an imputed capital structure, the most significant factor is whether the proposed common equity ratio is reasonable when measured against the capital structures of comparable utilities. The Commission finds that a capital structure with a common equity ratio of 42.86% is

reasonable when measured against the capital structures of comparable utilities and will enable ComEd to maintain its financial strength and a reasonable credit rating.

E. Rate Design

1. Rider GCB and GCB7

a. Statutory Construction

ComEd

ComEd states that the July 26 Order errs in its reading of Section 16-125A and its rejection of the proposed Rider GCB7. ComEd notes that in ordering the creation of a permanent bundled rate freeze for the City and other governmental customers, the Commission believed it faced a dilemma that in fact does not exist. ComEd observes that the Commission reads Section 16-125A(b) as allowing ComEd to recover only those "rates and charges . . . in effect on May 1, 1997". And yet, the Commission recognizes that those rates and charges (Rates 6 and 6L) no longer exist. ComEd explains that if the proper rules of statutory construction are applied, however, this dilemma disappears and the appropriate result becomes clear: the Commission should authorize Rider GCB7 and eliminate Rider GCB entirely.

The primary rule of statutory construction, as noted by ComEd, is to give effect to the legislature's intent. *Kraft, Inc. v. Edgar*, 138 Ill. 2d 178, 189, 561 N.E.2d 656, 661 (1990). The best evidence of the legislature's intent is the plain language of the statute. *Id.* ComEd maintains that the plain language of Section 16-125A does not provide for a permanent rate freeze.

Section 16-125A is titled "Consolidated billing provision for established intergovernmental agreement participants." ComEd argues that the clear language of that section requires ComEd to "permit governmental customers acting through an intergovernmental agreement that was in effect 30 days prior to the date specified in subsection (b) and which provides for these governmental customers to work cooperatively in the purchase of electric energy to aggregate their monthly kilowatt hour energy usage and monthly kilowatt billing demand." It is ComEd's position that the language, thus, requires only that ComEd allow these governmental customers to aggregate their energy usage and demands for billing purposes, thereby allowing them to take advantage of a more favorable rate structure. ComEd notes that it did that through Rider GCB and that it proposes to continue to do so through Rider GCB7.

ComEd states that nothing, however, in the language of Section 16-125A requires that ComEd go further and afford to these governmental customers the additional benefit of frozen rate levels that do not reflect the cost to serve those customers -- some \$116 million annually -- and that will require other customers to pay rates well in excess of the costs to serve them. ComEd maintains that to infer the existence of such an extraordinary benefit from the words of Section 16-125A would