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

05-0597

ILLINOIS COMMERCE COMMISSION

2006 Ill. PUC LEXIS 43

July 26, 2006

CORE TERMS: staff, plant, rate base, customer, pension, savings, rate case, delivery, uncollectible, pro forma, reduction, proposed adjustment, governance, ratepayer, capital structure, severance, pension expense, merger, allocator, shareholder, funding, procurement, revised, intangible, rebuttal testimony, allocated, pension contribution, salary, opines, functionalization

OPINION: [*1]

ORDER

By the Commission:

I. PROCEDURAL HISTORY

On August 31, 2005, Commonwealth Edison Company ("ComEd" or "the Company") filed with the Illinois Commerce Commission (the "Commission"), pursuant to Section 9-201 of the Public Utilities Act (the "Act") (220 ILCS 5/9-201), the following tariff sheets: ILL. C.C. No. 4, 8<th> Revised Sheet No. 1.01; 10<th> Revised Sheet No. 1.02; 4<th> Revised Sheet No. 1.03; 2<nd> Revised Sheet No. 1.04; Original Sheet No. 1.05; 45<th> Revised Sheet No. 9; 25<th> Revised Sheet No. 16; 21<st> Revised Sheet No. 18; 37<th> Revised Sheet No. 24; 41<st> Revised Sheet No. 28; 30<th> Revised Sheet No. 34; 31<st> Revised Sheet No. 38; 34<th> Revised Sheet No. 46; 34<th> Revised Sheet No. 49; 35<th> Revised Sheet No. 51; 38<th> Revised Sheet No. 53; 35<th> Revised Sheet No. 55; 4<th> Revised Sheet No. 55.50; 7<th> Revised Sheet No. 55.70; 2<nd> Revised Sheet No. 55.77; 3<rd> Revised Sheet No. 55.8; 3<rd> Revised Sheet No. 61.01; 1<st> Revised Sheet No. 61.41; 2<nd> Revised Sheet No. 61.61; 11<th> Revised Sheet No. 62; 9<th> Revised Sheet No. 62.10; 24<th> Revised Sheet No. 63; 8<th> Revised Sheet No. **[*2]** 67; 16<th> Revised Sheet No. 68; 31<st> Revised Sheet No. 70; 8<th> Revised Sheet No. 71; 28<th> Revised Sheet No. 73; 13<th> Revised Sheet No. 74; 36<th> Revised Sheet No. 77; 28<th> Revised Sheet No. 79; 16<th> Revised Sheet No. 82; 9<th> Revised Sheet No. 82.10; 17<th> Revised Sheet No. 84; 4<th> Revised Sheet No. 85.01; 35<th> Revised Sheet No. 88; 39<th> Revised Sheet No. 92; 1<st> Revised Sheet No. 93.01; 5<th> Revised Sheet No. 95.05; 2<nd> Revised Sheet No. 95.07; 5<th> Revised Sheet No. 95.09.6; 4<th> Revised Sheet No. 109; 2<nd> Revised Sheet No. 140; 4<th> Revised Sheet No. 152; 2<nd> Revised Sheet No. 163; 1<st> Revised Sheet No. 173; 2<nd> Revised Sheet No. 183; 3<rd> Revised Sheet No. 217; 1<st> Revised Sheet No. 221; 2<nd> Revised Sheet No. 225; 2<nd> Revised Sheet No. 232; 1<st> Revised Sheet Nos. 241 and 242; Original Sheet Nos. 304 through 584; ILL. C.C. No. 9, 1<st> Revised Title Sheet; Amendment to Electric Service Agreement between Commonwealth

Deferred Taxes and ITCs Net	85,750
Total Operating Expenses	1,238,885
Net Operating Income	$ 442,261

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.

V. RATE OF RETURN

1. CAPITAL STRUCTURE

ComEd

ComEd stated that its capital structure contains common equity and long-term debt as its sources of capital. ComEd proposed to use its actual capital structure, after a *pro forma* adjustment to remove a one-time fair value step-up in equity that occurred due **[*281]** to the merger accounting, and a measurement period ending June 30, 2005. Mitchell Dir., ComEd Ex. 7.0, 6:118-23. ComEd contends that this capital structure reflects the actual adjusted 54.20% equity and 45.80% debt and is based on ComEd's actual audited book balances of debt and equity. ComEd Ex. 7.1, Sched. D-1. ComEd opines that such actual capital structure -- together with the percentage costs of debt and equity discussed *infra* -- define the actual cost that ComEd incurs in attracting and maintaining the capital that ComEd uses for its only current business: to purchase, operate, and maintain its delivery facilities and to provide delivery service with them.

ComEd argues that its actual capital structure is reasonable. ComEd witness Mitchell states, among other things, that such structure was chosen for sound business reasons; was comparable to previously approved capital structures and the capital structures of other financially sound utilities; and results in reasonable credit metrics. Mitchell Dir., ComEd Ex. 7.0, 5:91-103, 7:144-8:156; Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 19:383-21:412, 15:313-17:340. In addition, witness Mitchell argues that its management carefully **[*282]** considers its levels of debt and equity and has managed the capital structure to maintain a reasonable A-credit rating. Mitchell Reb., ComEd Ex. 20.0, 2:26-29, 3:49-9:192; Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 8:157-75. ComEd also claims that it has consistently maintained a level of equity consistent with both past equity balances and the need to maintain a level of equity sufficient to maintain financial strength when risks inevitably materialize. Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 17:341-45.ComEd claims that no party disputed the proof of its 54/46 capital structure, the actual equity and debt balances on its books from which it was derived, or the appropriateness of the measurement period ComEd used. ComEd also says that no witness testified that an A-credit rating is *per se* unreasonable, or that ComEd's liability management program, which reduced the amount of outstanding debt, was imprudent. Nor, ComEd says, did any witness testify that, historically, ComEd had too much equity or that it is unreasonable for ComEd to maintain a $ 5.194 billion equity balance. Indeed, ComEd states, capital structures consistent with a strong credit rating have been approved for ComEd **[*283]** in each of its last three rate cases. *Commonwealth Edison Co.*, ICC Docket 94-0065 (Final Order, January 9, 1995); *Commonwealth Edison Co.*, ICC Docket 99-0117 (Final Order, August 26, 1999); *Commonwealth Edison Co.*, ICC

Docket 01-0423, 224 P.U.R. 4th 357, 336-37 (Final Order, March 28, 2003).

ComEd argues, however, that Staff, CCC, IIEC, and the AG nonetheless proposed artificial capital structures with much greater leverage than either ComEd or similar utilities actually have. *See, e.g.*, Kight Dir., Staff Ex. 4.0 Corr., 4:74-6:112; Gorman Dir., IIEC Ex. 3.0 Corr, 14:322-25, 18:416-22; Bodmer Dir., CUB/CCSAO Ex. 1.0 2nd Corr., 20:597-22:649. ComEd opines that such proposals understate ComEd's actual capital costs. ComEd witness Hadaway believes that this 37.19% equity/62.81% debt capital structure introduced by Staff (the "37/63 capital structure") would deny ComEd recovery of more than $ 74 million in costs each and every year. Dr. Hadaway added that even if the 37/63 capital structure were not a wholly unrealistic capital structure for ComEd, a company that could support such a capital structure would have a very different cost of equity, **[*284]** a difference that is completely ignored by Staff, CCC, IIEC, and the AG. Hadaway Sur., ComEd Ex. 38.0, 2:30-39 (when leverage increases, the cost of equity increases). ComEd asserts that this result would be confiscatory and, as discussed further below, not sustainable.

ComEd also argues that the record does not support either the purported reason for rejection of ComEd's actual capital structure or the use of a radical artificial replacement. ComEd asserts that the law on recognizing utility capital structures is clear. ComEd argues its entitlement to manage its own business affairs (*Public Utilities Commission v. Springfield Gas Co.*, 291 Ill. 209, 218-19 (1920); *Iowa-Illinois Gas & Electric Co. v. Illinois Commerce Comm'n.*, 19 Ill. 2d 436, 442 (1960)), including choosing its own reasonable capital structure. ComEd further argues that, to disturb a utility's capital structure, it is necessary that the actual capital structure be proven to be unreasonable - which cannot be accomplished by simply suggesting that another capital structure is reasonable, or that another structure might be "optimal" or "lower cost". *People ex rel. Hartigan v. Illinois Commerce Commission*, 214 Ill. App. 3d at 222; **[*285]** 227-28 (3rd Dist. 1991).

ComEd argues the advocates of the 37/63 capital structure for ratemaking purposes never advocated that ComEd actually issue debt sufficient to become financed by 63% debt. Gorman, Tr. at 2004:2-2005:4. ComEd also argues that the direct testimony of IIEC witness Gorman strongly advocates a hypothetical 50/50 capital structure, which in ComEd's opinion both comports with past Commission Orders and can be reconciled with the leverage ratios of ComEd's peers. Gorman Dir., IIEC Ex. 3.0 Corr., 16:363-72. ComEd further states that, although Mr. Gorman ultimately supports the 37/63 capital structure, he did not repudiate his earlier testimony about the reasonableness of a 50/50 capital structure.

ComEd argues that the 37/63 capital structure is not reasonable. ComEd opines that such leverage ratio is far outside that of typical utilities and is higher than any comparable company included in Staff's own sample of comparable companies. Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 18:362-20:394. ComEd also contends that Staff's claim that a capital structure with 37% equity is consistent with a range of financially sound utilities is undermined by the improper inclusion of **[*286]** the non-profit and functionally unregulated cooperative, Old Dominion Electric. ComEd witness Mitchell testifies that when Old Dominion is excluded, "all of the remaining utilities have common equity ratios of at least 41.6% and two had common equity ratios in excess of 60%. None of the remaining companies had common equity ratios nearly as low as the 37.11%. . . ." Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 6:120-23. Mr. Mitchell further argues that, Mr. Bodmer's similar efforts actually rely on

companies with lower credit ratings and distort the overall conclusion that "despite [the] relatively weak S&P bond ratings [of the companies he cites], all but five of which have ratings below "A-," the average of the common equity ratios for the 25 electric companies was 48%." *Id.*, at 10:208 - 11:210.

In its testimony ComEd maintains that the Unicom/PECO merger and the transfer of the former ComEd nuclear assets were two distinct transactions, separated by months, separately authorized by the Act, and separately reviewed by the Commission. ComEd contends that it fully adjusted for the $ 2.292 billion effect of the merger accounting on its equity balance, fully removing that amount from **[*287]** equity in its 54/46 capital structure. Mitchell Reb., ComEd Ex. 20.0, 13:262-16:334; Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 12:238-15:305; Houtsma Reb., ComEd Ex. 18.0 Corr., 25:543-27:591; Houtsma Sur, ComEd Ex. 35.0, 16:352-23:510; Kight, Tr. at 1827:6-21.

ComEd argues that other parties' claims that ComEd's equity should be reduced further is not about the effect of the merger itself, but about the value at which ComEd's former nuclear assets were transferred more than five years ago. ComEd states that the fact that the merger required the write down of the assets to their fair value is not in question. Rather, ComEd argues, the claim is that when the assets were transferred some time thereafter, instead of being transferred at their then current -- and actual -- book value, they should have been written up to their prior "original cost." According to ComEd this claim is based on faulty assumptions -- it is contrary to the record, is contrary to past Commission determinations of ComEd's capital structure and equity balance, and seeks both an unlawful second review of the long-completed transfer transaction and an illegal result.

First, ComEd argues that the transfer of the nuclear **[*288]** assets and the resulting effect on ComEd's equity balance, capital structure, and delivery rates have all been reviewed by the Commission in several prior Commission proceedings. ComEd states that it transferred its nuclear assets under the authority Section 16-111 of the Act. ComEd contends the transfer, its terms and structure, and its effect on ComEd's equity were all addressed in the Commission's Section 16-111 proceeding that reviewed the transfer; and the transfer was accomplished in accordance with the law, and with the Commission's determination in the notice proceeding dealing with the transfer. ComEd went on to state that the law required that the accounting be in accordance with GAAP, and GAAP required that the assets be transferred at book value at the time of the transfer ComEd also claims that the accounting entries -- including the effect on equity -- resulting from the transfer were both described to the Commission in advance and submitted when finalized. Houtsma Sur., ComEd Ex. 35.0, 3:56-58, 17:372-18:391.

ComEd argues that retroactive review of the transfer is unlawful and expressly prohibited by Section 16-111(g) of the Act. ComEd further argues that the Commission **[*289]** found that the nuclear unit transfers are covered by this prohibition of Section 16-111. *Commonwealth Edison Co.*, ICC Docket No. 05-0159 (Order Jan. 24, 2006) (the "Procurement Order") at 51.

In addition, ComEd states that the Commission also considered ComEd's equity balance and established the proper post-merger and post-transfer capital structure for ComEd in ComEd's last delivery services rate case (ICC Docket No. 01-0423). In ComEd's opinion the Commission's decision in that rate case established a capital structure for ratemaking, without any reduction to ComEd's equity based on any

notion that the nuclear assets had to be, or should have been, transferred at original cost rather than at book value. *Commonwealth Edison Co.*, ICC Docket No. 01-0423, (Int. Order, April 1, 2002) ("01-0423 Interim Order"), at 112 & App. A at Sched. 1 ComEd also argues that although Staff proposed other adjustments, not relevant here, throughout the proceeding it steadfastly recommended that ComEd's capital structure and equity balance, for ratemaking purposes, be based on its actual book equity balance. Kight, Tr. at 1840:21-1842:17, *quoting*, in part, J. Freetly (Staff) Dir., *Commonwealth* **[*290]** *Edison Co.*, ICC Docket No. 01-0423 Staff, Ex. 5.0, at 9:143-46.

ComEd also argues that the Commission's determination in Docket 01-0423 was wholly inconsistent with the equity balance that proponents of the 37/63 capital structure ask the Commission to use now. ComEd asserts that, in Docket 01-0423, the Commission found that ComEd's equity balance as of the end of 2001 was $ 5.224 billion, a value very similar to the current equity balance, and that this equity balance should be used in deriving the approved rates. ComEd states, however, that no witness here testified that there was any way to reconcile the $ 5.224 billion Commission-approved equity balance with the $ 2.561 billion equity balance the 37/63 capital structure now requires. Mitchell Reb., ComEd Ex. 20.0, 7:141-50; Kight, Tr. at 1841:9-1842:14. n13 Indeed, ComEd offers, the events of the past five years suggest that ComEd's equity balance would, if anything, be equal or higher than the 2001 balance the Commission approved. Mitchell Reb., ComEd. Ex. 20.0, 5:100-6:122, 7:141-50.

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n13 The derivation of the 37/63 capital structure and the $ 2.561 billion equity balance it requires is illustrated in Kight Dir., Staff Ex. 4.0 Corr. Sch. 4.1.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - - **[*291]**

Second, ComEd states that the transfer of ComEd's nuclear assets at a book value reflecting the fair value write-down was mandated by GAAP and expressly authorized, for Illinois law purposes, by Section 16-111(g) of the Act. ComEd maintains that the record is clear that the nuclear assets were properly written down and lawfully transferred, and that GAAP requires that transfer to occur at book value. Houtsma Sur., ComEd Ex. 35.0, 17:372 - 18:391. In contrast, ComEd claims that the record also is clear, that the equity balance implied by the 37/63 capital structure is inconsistent with GAAP and ComEd's audited financial statements. Houtsma Sur., ComEd. 35.0, 17:374-18:391; Kight, Tr. at 1819:23-1825:17.

Third, ComEd contends that the proponents of the 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 claims 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 **[*292]** 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 argues that the 37/63 capital structure becomes even less plausible when the resulting impact on equity is considered: ComEd claims it 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 asserts that this is important, given that ComEd could have avoided the impact on equity by structuring the nuclear asset transfer differently. Kight, Tr. at 1835:1-22. In addition, ComEd argues that the notion that any increase in the assumed value of the plants should only reduce ComEd's equity is further belied by the original financing of the plants, which involved both debt and equity. Houtsma Surr., ComEd Ex. 35.0, 17:374-18:391; Kight, Tr. at 1836:9-16.

ComEd claims that there are several flaws with IIEC claims that a deduction must be made from equity because rate base does not closely correspond to total capitalization, and that "goodwill" does not "support" **[*293]** the provision of delivery service. For instance, ComEd claims that there is no reason that rate base and capital structure should match, or even be close in value. As an example, ComEd refers to Docket 01-0423, where the net rate base was less than 29.4% of the capital structure. *Commonwealth Edison Co.*, ICC Docket No. 04-0423 (Interim Order, April 1, 2002) at 112; *Commonwealth Edison Co.*, ICC Docket No. 04-0423 (Amendatory Interim Order, April 10, 2002), at 2, Finding (5). ComEd contends that numerous factors cause capital structure - a current, largely market-based construct, that is altered by the cumulative retained earnings, dividends, capital contributions, and refinancings -- and rate base -- a largely historical concept, derived from depreciated original cost -- to diverge, and total capitalization may properly be more than, equal to, or in some cases even less than rate base.

ComEd argues that if equity "supports" goodwill as Mr. Gorman suggests, it does so only in the most trivial sense that if goodwill is impaired, equity is reduced. ComEd claims that "goodwill" requires no payments and uses no cash, and that no portion of ComEd's capitalization is sequestered to **[*294]** support the business of "maintaining goodwill." ComEd argues that its entire capital structure -- including all of its equity and debt -- supports its utility business.

ComEd claims that Staff's and IIEC's arguments about TFI debt are red herrings. ComEd states that it proposed its actual capital structure, with no artificial adjustment for TFIs and no reliance on any such adjustment to support its capital structure. ComEd claims that the notion that the rating agencies will view 37% equity as "really" 45% simply because they will ignore TFIs when calculating debt ratios is incomplete and flawed. ComEd offers that if the agencies choose to back out the TFIs for debt ratio purposes, they will also back out the revenues required to pay TFI interest and retire the TFIs. Mr. Mitchell testified that if the Commission were to view the 37/63 capital structure as one that might be somehow magically less leveraged by simply disregarding the TFI balances and forbidding their "replacement" by other debt, it could not ignore the fact that such a fictional TFI-less ComEd would also have considerably less revenue and would be, in fact, a weaker -- not stronger -- company. Mitchell Sur., ComEd Ex. **[*295]** 37.0 2nd Corr., 22:439-23:453.

Moreover, ComEd argues, defending use of an artificial capital structure for setting rates that will not be charged until 2007 with an argument that the rating agencies will ignore TFI debt quantified in terms of its 2005 balances introduces yet another fiction. As ComEd contends, TFIs are temporary -- they are rapidly shrinking in amount, will be gone by the end of 2008, and will be much diminished well before

the proposed rates even go into effect (Kight, Tr. at 1817:19-1818:15) -- and rating agencies are well aware of these facts.

Staff

Staff and the Company agree that short-term debt should not be included in the capital structure since it is not currently financing rate base investments. In addition, Staff and the Company agree that ComEd's balance of preferred securities is zero. (ICC Staff Ex. 4.0 Corrected, p. 11) However, Staff and the Company disagree as to the balance and cost of long-term debt and common equity. While the Company proposes using an adjusted June 30, 2005, capital structure that contains 45.80% long-term debt and 54.20% common equity, Staff witness Ms. Sheena Kight recommends an adjusted capital structure containing 62.89% **[*296]** long-term debt and 37.11% Common Equity. (ICC Staff Ex. 4.0 Corrected, pp. 4-11, Schedule 4.1; ICC Staff Ex. 15.0 2<nd> Corrected, pp. 3-4)

Staff offers that the primary dispute with regard to capital structure involves differing views on the appropriate adjustment to ComEd's June 30, 2005, equity balance given (1) the increase in common equity resulting from the Company's use of purchase accounting to record the 2000 merger of PECO Energy Company and Unicom Corporation (ComEd's corporate parent at the time of the merger) and (2) ComEd's subsequent transfer of its generating assets to an affiliate in 2001 at the restated value of those assets resulting from the application of purchase accounting. (*See* ICC Staff Exhibit 4.0 Corrected, pp. 4-6) The second area of dispute is whether Staff's adjusted capital structure is an appropriate and reasonable capital structure. Staff asserts that its proposed capital structure incorporates necessary and appropriate adjustments to ComEd's June 30, 2005, equity balance, represents an appropriate and reasonable capital structure for ComEd, and should be adopted by the Commission.

Staff's Additional Adjustments to ComEd's Actual Balance of Common **[*297]** Equity

Staff states that ComEd's proposed capital structure is based on its June 30, 2005 capital structure adjusted to exclude $ 2.292 billion of equity that resulted from the application of purchase accounting for the Unicom/PECO merger. (*See* ComEd Ex. 7.0, pp. 2, 6) Staff states that pursuant to purchase accounting, ComEd's assets and liabilities were restated to their fair values as of the merger date, and the difference between the purchase price and the restated fair value of its assets and liabilities was recorded as goodwill. (*Id.*, p. 6) Staff offers that the net effect of these purchase accounting entries was a $ 2.292 billion increase in ComEd's equity balance. (*Id.; see also* ICC Staff Exhibit 4.0 Corrected, pp. 4-5) ComEd witness Mr. Mitchell provided the following summary of the purchase accounting entries that resulted in the $ 2.292 billion increase in ComEd's equity balance:

	($ millions)
Description	**Increase/(Decrease) in Equity**
Plant Write Downs	($ 4,791)
Deferred Taxes and ITCs	2,157
Pension, OPEB and Severance	144
Other Assets, Liabilities and Long Term Debt	77
Goodwill (net of amortization)	4,705

Net Increase in Equity	$ 2,292

(ComEd **[*298]** Ex. 7.0, p. 7) Staff states that according to Mr. Mitchell all of these entries, including goodwill, were excluded from the common equity balance reflected in ComEd's proposed capital structure. (*Id.; see also* ICC Staff Exhibit 4.0 Corrected, pp. 4-6)

Staff witness Ms. Kight reviewed ComEd's proposed common equity adjustments and, although she agreed in general that adjustments were necessary, she disagreed with certain aspects of ComEd's proposed adjustments. Since rates are based on original cost rate base, Ms. Kight contends that capital structure should also reflect the amount of capital originally invested in a utility's assets (assuming that capital structure is reasonable from a cost standpoint), not reassessments of the fair value of the capital invested. (ICC Staff Exhibit 4.0 Corrected, p. 5) Thus, Ms. Kight states that ComEd's June 30, 2005, capital structure, which reflects estimates of fair value for financial reporting purposes, should be adjusted to reflect depreciated original cost. (*Id.*) Staff argues that ComEd's actual capital structure for financial reporting purposes should be adjusted to the extent that purchase accounting and other entries have caused **[*299]** its actual capital structure to no longer reflect the capital supporting its depreciated original cost rate base.

Ms. Kight opposes the elements of ComEd's adjustments related to utility plant that it no longer owns (primarily reversal of the write downs of utility plant -- subsequently transferred -- made to restate those assets at their estimated fair value pursuant to purchase accounting). According to Ms. Kight the deferred taxes and ITC's written down were largely, if not wholly, associated with that utility plant. (ICC Staff Exhibit 4.0 Corrected, p. 5) In Ms. Kight's opinion such reversals might be appropriate adjustments to ComEd's capital structure if it still owned that utility plant or had received (and retained) as compensation assets equal to the pre-write down value for that plant. (ICC Staff Exhibit 4.0 Corrected, p. 5) However, she states, ComEd neither owns the plant assets that were written down nor received any assets in exchange. (*Id.*) Ms. Kight says that instead, ComEd transferred that plant to an affiliate at its estimated fair value (i.e., at its written down value) as a capital contribution, which did not produce any proceeds for ComEd (receiving treasury **[*300]** stock instead). (*Id.; see also* Staff Cross Ex. 14, pp. 97-98; Staff Cross Ex. 15, Item 5 -- Other Events)

Staff argues that ComEd's transfer of its generation assets distorted the relationship between its actual capital structure and the capital supporting its depreciated original cost rate base. Staff claims the generation assets ComEd transferred had an original cost book value of approximately $ 6.7 billion. (ICC Staff Cross Ex. 15, Item 5 -- Other Events; Tr., p. 2465) Staff submits that because these generating stations and related liabilities were transferred at their restated fair value cost basis (approximately $ 2 billion) and all goodwill remained on ComEd's books, ComEd's actual capital structure necessarily continues to reflect the difference between (1) the original cost value of the assets and liabilities transferred and (2) the fair value cost of those same assets and liabilities (notwithstanding that ComEd no longer owns these assets). Staff argues that because those assets were not transferred at their book value and all goodwill remained on ComEd's books, ComEd's resulting actual capital structure was not reduced commensurate with the original cost book value **[*301]** of the assets and liabilities transferred.

Ms. Kight argues that notwithstanding ComEd's reversal of the purchase accounting adjustments, its proposed capital structure does not reflect the amount of capital originally invested in ComEd's remaining assets. (*Id.*) Ms. Kight offers that ComEd's proposed capital structure overstates the amount of capital in use. (*Id.*) Ms. Kight states that ComEd's proposed $ 2.292 billion adjustment to common equity inappropriately includes the reversal of both write down of plant that ComEd no longer owns and the associated reduction to deferred income taxes and ITC's. (*Id.*, pp. 5-6) Accordingly, Ms. Kight states that ComEd's balance of common equity should be reduced by an additional $ 2.634 billion (the net effect of excluding ComEd's reversal for the $ 4.791 billion plant write down less the $ 2.157 billion reduction to deferred income taxes and ITC's). (*Id.*, p. 6) Ms. Kight claims removal of the adjustments associated with the transferred utility plant from ComEd's proposed capital structure results in a capital structure based on the unrecovered portion of the original investment in ComEd's *remaining* assets.

Reasonableness **[*302]** of Staff's Adjusted June 30, 2005 Capital Structure

Ms. Kight assessed whether it was appropriate to use Staff's adjusted capital structure to determine ComEd's overall rate of return. Ms. Kight states that financial theory suggests capital structure affects the value of a firm and, therefore, its cost of capital, to the extent it affects the expected level of cash flows that accrue to outside parties (i.e., other than debt and stock holders). Ms. Kight went on to state that employing debt as a source of capital reduces a company's income taxes, thereby reducing the cost of capital; however, as reliance on debt as a source of capital increases, so does the probability of default. As default become more probable, expected payments to attorneys, trustees, accountants and other outside parties increase. Further, cash flows decline as the company is forced to forego opportunities otherwise available to it had its financial condition been stronger, including the expected value of the income tax shield provided by debt financing. Ms. Kight argues that beyond a certain point, a growing dependence on debt as a source of funds increases the overall cost of capital. Therefore, Ms. Kight opines, **[*303]** the Commission should not determine the overall rate of return from a utility's actual capital structure if the Commission concludes that capital structure adversely affects the overall cost of capital. (ICC Staff Exhibit 4.0 Corrected, pp. 6-7)

Ms. Kight further testifies that an optimal capital structure would minimize the cost of capital and maintain a utility's financial integrity. However, she states, determining whether a capital structure is optimal remains problematic because (1) the cost of capital is a continuous function of the capital structure, rendering its precise measurement along each segment of the range of possible capital structures problematic; (2) the optimal capital structure is a function of operating risk, which is dynamic; and (3) the relative costs of the different types of capital vary with dynamic market conditions. Consequently, Ms. Kight explains that one should determine whether a proposed capital structure is consistent with the financial strength necessary to access the capital markets under most conditions, and if so, whether the cost of that financial strength is reasonable. (*Id.*) To make these determinations, Ms. Kight compares Staff's proposed **[*304]** adjusted capital structure as of June 30, 2005 to utility benchmarks.

Ms. Kight says that Standard & Poor's ("S&P") categorizes debt securities on the basis of the risk that a company will default on its interest or principal payment obligations. She states the resulting credit rating reflects both the operating and financial risks of a utility. She further offers that although no formula exists for

determining a credit rating, S&P publishes utility benchmark values, by business profile score, for financial ratios it uses to determine credit ratings. According to Ms. Kight S&P currently assigns ComEd a corporate credit rating of BBB+ and a business profile score of 4. Ms. Kight compares the values for those benchmark financial ratios that result from combining Staff's proposed adjusted capital structure with components from Staff's proposed revenue requirement to S&P's benchmarks for utilities with an A or BBB credit rating and a business profile score of 4. Ms. Kight testifies that according to S&P, utilities with a business profile score of 4 should have a funds from operation ("FFO") to interest coverage ("FFOIC") ratio between 3.5X and 4.2X for an A-rating and 2.5X to 3.5X for **[*305]** a BBB-rating. The benchmark ranges for the FFO to total debt ("FFO/Debt") coverage ratio is 20%-28% for A-rated utilities and 12%-20% for BBB-rated utilities. Ms. Kight further testified that Staff's proposed adjusted capital structure results in a FFO to interest coverage ratio of 3.78X, which is indicative of an A credit rating, and a FFO to total debt coverage ratio of 18.04%, which is indicative of a BBB credit rating. n14 Thus, Ms. Kight claims that Staff's proposed adjusted capital structure is indicative of a level of financial strength that is commensurate with at least a BBB credit rating. (ICC Staff Exhibit 4.0 Corrected, pp. 7-8 (emphasis added)) Ms. Kight further testified that a BBB credit rating is indicative of an adequate degree of financial strength. A credit rating of BBB indicates an adequate capacity to meet financial commitments. She also offered that 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. (ICC Staff Exhibit 4.0 Corrected, p. 10)

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - -

n14 The FFO to interest coverage ratio equals interest divided into the sum of the funds available to shareholders, non-cash items (i.e. depreciation, amortization, deferred taxes and investment tax credits), and interest. The FFO to debt coverage ratio equals the sum of the funds available to shareholders and non-cash items divided by total debt. The coverage ratios developed by Ms. Kight determined each component of the ratio based on its contribution to Staff's recommended revenue requirement for ComEd. "Funds available to shareholders" equals Staff's recommended weighted cost of common equity for ComEd (i.e., the product of the cost of common equity and the common equity ratio). Depreciation, amortization, deferred taxes and investment tax credits equal Staff's recommended amounts for those items divided by Staff's recommended rate base. The interest component equals Staff's recommended weighted cost of debt in the capital structure for the Company (i.e., the product of the cost of debt and the debt ratio). Total debt equals Staff's recommended percentage of debt in ComEd's capital structure. (ICC Staff Ex. 4.0 Corrected, pp. 9-10)

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - - **[*306]**

Staff also asserts that under its proposal ComEd's FFO/Debt ratio falls in the top third of the BBB range and its FFOIC ratio is in the middle third of the A range. Staff contends that together the two ratios indicate that its proposed rates are sufficient to support financial strength that is commensurate with a credit rating of "A-" and is therefore consistent with the "A-"credit rating that the Company purports to target. (ICC Staff Exhibit 15.0 2nd Corrected, pp. 2-3) Table 1 presents the coverage ratios

for the financial guidelines for the business profile "4" as well as those resulting from Staff's proposed capital structure and capital costs and ComEd's proposed capital structure and capital costs.

Table 1

	AA	**A**	**BBB**
Financial Guideline Ratios			
FFOIC	4.2-5X	3.5-4.2X	2.5-3.5X
FFO/Debt	28-35%	20-28%	12-20%
Staff Proposal			
FFOIC		3.78X	
FFO/Debt			18.04%
ComEd Proposal			
FFOIC	5.42X		
FFO/Debt	28.62%		

Staff submits that Table 1 also illustrates that ComEd's proposed capital structure results in ratios that are commensurate with an "AA" credit rating, instead of the "A-"credit rating ComEd professes to target. (ICC Staff Ex. 15.0 2nd Corrected, pp. 2-3, ComEd **[*307]** Ex. 20.0, p. 6)

Ms. Kight chose not to use a direct measure of capital structure such as the debt to total capital ratio ("debt ratio") because in Ms. Kight's opinion the debt ratio is less important in determining credit ratings. Staff asserts that unlike the FFO interest coverage and FFO to total debt ratios, the debt ratio neither reflects the cost of a company's debt nor the cash flows available to meet its debt service obligations. Staff also observes that the amount of debt in ComEd's capital structure includes Transitional Funding Notes ("TFNs", also known as Transitional Funding Instruments or "TFIs"). (Tr. p. 1845) Staff claims the rating agencies exclude TFNs when assessing ComEd's financial risk and credit rating financial metric calculations. (IIEC Exhibit 7.0, p. 15; *see also* ComEd Ex. 20.0, p. 29) Staff maintains that the debt ratio under its proposed capital structure would be around 45% excluding the TFNs. That debt ratio is in the top third of the S&P ratio range for a BBB credit rating. (Tr., pp. 1845-1846) Staff further argues that even if the debt ratio was an appropriate consideration, the debt ratio under Staff's proposed capital structure supports at least **[*308]** a BBB+ credit rating when TFNs are excluded, if not higher.

Staff also provides testimony concerning the effect of excluding the TFIs for the FFOIC and FFO/Debt credit metric calculations. n15 Staff testified when the TFIs are excluded from the credit metric calculations, Staff's cost of capital recommendation would result in an FFO/Debt and FFOIC ratios within the low to middle benchmark range for a BBB credit rating. Although the credit metric calculations without TFIs continue to reflect an adequate degree of financial strength, they do not produce ratios consistent with the A-/BBB+ credit ratings supported by the calculations including TFIs.

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - -

n15 The TFI Adjustment comprises three adjustments: (1) removal of $ 1,150 million in Transitional Funding Trust Notes ("TFTNs") from ComEd's balance of debt; (2) removal of $ 65.3 million in TFTN interest from ComEd's total interest charges; and (3) removal of $ 340 million in annual TFTN redemptions from ComEd's operating cash flows. (ICC Staff Exhibit 15.0 2nd Corrected, p. 7)

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - **[*309]**

Staff argues that if the Commission concluded it were appropriate to impute a capital structure that would achieve credit metrics consistent with A-/BBB+ credit ratings (i.e., consistent with the credit metrics achieved including TFIs), ComEd's equity ratio would need to be increased to approximately 45.5%. Table 2 presents the effect of a TFI Adjustment on the FFOIC and FFO/Debt ratios under Staff's cost of capital proposal. Table 2 also presents the common equity ratio, combined with Staff's proposed costs of common equity and debt, that would produce credit metrics similar to those that Staff's cost of capital proposal produces without the TFI Adjustment ("Target A-/BBB+").

Table 2-ComEd Financial Ratios with TFI Adjustment

	Equity	**A**	**BBB**	**BB**
Financial Guideline Ratios				
FFOIC		3.5-4.2X	2.5-3.5X	1.5-2.5X
FFO/Debt		20-28%	12-20%	8-12%
Staff Proposal	37.11%			
FFOIC			3.06X	
FFO/Debt			13.91%	
Target A-/BBB+	45.5%			
FFOIC		3.69X		
FFO/Debt			18.19%	

Staff argues that it does not support imputing a capital structure to achieve credit metrics excluding TFIs consistent with A-/BBB+ credit ratings since in Ms. Kight's opinion **[*310]** this would ultimately lead to a higher rate of return on rate base for ComEd. Staff's recommends a cost of capital of 7.86%. Combining a capital structure with a 45.5% common equity ratio and 54.5% debt ratio (to achieve credit metrics excluding TFIs consistent with A-/BBB+ credit ratings) with Staff's recommended costs of debt and common equity would result in a 8.17% cost of capital. Staff asserts that in Docket No. 98-0319, ComEd claimed that its proposed use of the proceeds from issuing TFNs would lower its cost of capital. n16 Consequently, Staff submits that it would be unfair to ratepayers to authorize ComEd a higher rate of return on rate base on the basis that the TFNs require ComEd to maintain a higher common equity ratio than had the TFNs not been issued.

- - - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n16 Order, Docket No. 98-0319, July 21, 1998, pp. 21-22.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - -

Staff also offers testimony indicating that, under Ms. Kight's proposed capital structure, issuance of the TFNs does not increase the cost of capital in comparison to that which would have existed **[*311]** had no TFNs been issued. It is Staff's opinion that since the TFNs had a AAA credit rating at the time they were issued in December of 1998 and ComEd was rated BBB at that time, the interest rate on the TFNs is lower than that which ComEd would have paid had it issued conventional debt at that time. According to Ms. Kight on December 15, 1998, the 10-year corporate bond yield for electric companies with a credit rating of BBB was 6.32%. In Ms. Kight's opinion replacing the TFNs in the long-term debt schedule with conventional debt at a rate of 6.32% would increase the embedded cost of debt from 6.48% to 6.65%. Staff offers that when it uses the embedded cost of debt of 6.65%, its proposed capital structure, rate base and non-cash operating expenses result in a FFOIC ratio of 3.67X, a FFO/Debt ratio of 17.74%, n17 and an overall cost of capital of 7.96%--ten basis points higher than its recommended cost of capital.

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n17 Staff notes these ratios are consistent with an "A-/BBB+" credit rating.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - -

In summary, Staff asserts **[*312]** that the imputed capital structure of 45.5% equity and 54.5% debt that is necessary to maintain TFI-adjusted financial benchmarks indicative of A-/BBB+ credit ratings increases the overall cost of capital from Staff's proposed 7.86% to 8.17%. Staff argues the Order in Docket No. 98-0319 found that "the record reasonably demonstrates that issuance of the Notes [(i.e., TFNs)] and application of the proceeds as proposed by ComEd will result in a reduction in its overall cost of capital." (Order, Docket 98-0319, July 21, 1998, p. 22) Staff contends that since the standard is and should remain that TFNs do not increase the cost of capital in comparison to that which would have existed had no TFNs been issued, the Commission should not impute a capital structure with a higher proportion of common equity on the basis of ratios calculated with the TFI Adjustment.

CUB-CCSAO-City

CCC argues that ComEd's proposed capital structure is laden with far too much common equity. CCC states that because common equity is significantly more expensive than long-term debt, the excess common equity in ComEd's proposal substantially increases the utility's revenue requirements and, thus, costs for customers. **[*313]** *See e.g.*, IIEC Ex. 3.0 at 17, L. 390-99.

CCC asserts that ComEd is the only party supporting its proposed capital structure. CCC claims the other parties submitting testimony on this issue agree that ComEd's appropriate capital structure should be 62.89% long-term debt and 37.11% common equity as proposed by Staff witness Sheena Kight and adopted by CCC witness Mr. Bodmer and IIEC witness Mr. Gorman. Staff Ex. 4.1; CCC Ex. 4.0 (Corrected) at 2, L. 50-57; IIEC Ex. 7.0 at 6, L. 124-31.

CCC argues that the primary difference between the unified recommendations submitted by Ms. Kight, Mr. Bodmer and Mr. Gorman and ComEd's go-it-alone approach is the treatment of the goodwill asset created at the time of the Unicom-PECO merger that led to the formation of Exelon, ComEd's parent corporation. CCC argues the Unicom-PECO merger created a $ 4.926 billion goodwill asset that is recorded on ComEd's balance sheet. IIEC Ex. 7.0 at 5, L. 105-06. CCC further argues because goodwill does not produce revenues or cash flows, it cannot be treated as debt. *Id.* at 8, L. 185-86. CCC contends that as a result, the goodwill on ComEd's balance sheet increases ComEd's equity balance. CCC Ex. 1.0 (Revised) **[*314]** at 23, L. 676-78.

According to CCC, while ComEd proposed to remove $ 2.292 billion of the goodwill asset from its balance sheet for purposes of determining the appropriate capital structure, the utility asserted that the remaining portion of the goodwill asset -- some $ 2.634 billion -- should remain as part of the utility's common equity balance. March 22, 2006 Tr. at 483-84 (Houtsma); March 30, 2006 Tr. at 2473 (Mitchell). CCC contends that the $ 2.634 billion goodwill asset that ComEd claimed should be included in the utility's common equity balance is associated with its decision to transfer its nuclear plants to an affiliate -- plants that ComEd no longer owns. IIEC Ex. 7.0 at 5, L. 113-18.

CCC states that Mr. Bodmer, Ms. Kight and Mr. Gorman agreed that the entire $ 4.926 billion goodwill asset should be excluded from ComEd's capital structure because the costs approved in this proceeding must be shown to support distribution and transmission assets needed to provide service to customers. CCC states each of these witnesses argued that the $ 2.634 billion goodwill asset that ComEd contended should be included in its common equity balance has nothing to do with providing delivery **[*315]** services to ratepayers.

CCC asserts that perhaps the most compelling evidence that demonstrated that ComEd's proposal to include a portion of its goodwill asset in its capital structure improperly inflated its common equity balance occurred during the cross-examination and re-direct examination of IIEC witness Mr. Gorman. CCC states that during cross-examination, Mr. Gorman testified that ComEd includes more than $ 11 billion in capital on its balance sheet. Yet, the utility has a little more than $ 6 billion in rate base. March 29, 2006 Tr. at 1986.

So, clearly, there's a significant mismatch between the capital on the balance sheet and the amount of rate base. That difference in -- from my perspective, that difference in the capital in rate base is largely attributable to almost a five billion dollar goodwill asset which is not the transmission and distribution utility asset. And that asset -- that goodwill asset is completely supported by common equity.

So the amount of capital -- ComEd's common equity in that 11 billion dollar capital component needs to be reduced by the value of that goodwill asset. That's supported only by common equity or roughly five billion dollars **[*316]** -- or no, 4.96 billion dollars. So when you take ComEd's common equity and reduce it by 4.96 billion dollars of common equity and say that's supporting the goodwill asset and the remaining common equity is supporting transmission and distribution utility plant, then you get a capital structure that roughly matches rate base.

Id. at 1986-87.

CCC asserts that IIEC Redirect Ex. 1 effectively illustrates the explanation Mr. Gorman provided during his cross-examination. According to CCC, IIEC effectively demonstrates the mismatch between amount of capital ComEd shows on its balance sheet and the capital in rate base included in this case.

CCC claims that the record shows that ComEd is alone in its support of its proposed capital structure. In CCC's opinion all other witnesses testifying about this issue agreed that ComEd's proposed capital structure is laden with excess common equity. CCC avers that the primary source of the excess common equity is goodwill asset that has nothing to do with transmission and distribution assets that ComEd includes in its rate base. CCC argues the goodwill asset is wholly unrelated to the objective of this case -- determining the costs needed to **[*317]** provide utility service. CCC further argues the goodwill asset merely inflates the common equity component of the utility's capital structure and, therefore, the rates that customers must pay. As a result, the CCC recommends that the Commission adopt the capital structure proposed by Staff witness Kight and adopted by CCC witness Bodmer and IIEC witness Gorman.

IIEC

IIEC states ComEd has proposed a capital structure made up of 54.2% common equity and 45.8% debt to develop its overall cost of capital. IIEC witness Gorman opposed that capital structure as too heavily weighted with equity, which is more costly for ratepayers. Mr. Gorman argues that ComEd did not fully remove the common equity supporting goodwill from its proposed ratemaking capital structure. After considering the evidence, the testimony of other experts, and the arguments of all parties, in his rebuttal testimony Mr. Gorman found that Staff's proposed capital structure was the best proxy of ComEd's total capital supporting the utility's delivery services. He recommended adoption of Staff's capital structure -- 37.11% equity and 62.89% debt. He stated that the structure is the result of including only equity that **[*318]** actually supports assets used in providing ComEd's delivery services. He opined that Staff's proposed capital structure should, therefore, be used to develop ComEd's overall rate of return for its delivery services.

IIEC states both it and Staff pursued a common objective of developing a capital structure for ComEd that reflected the amount of common equity and debt that now support ComEd's transmission and distribution utility assets. IIEC further states that Staff and IIEC derived the common capital structure through distinct, independent (yet complementary) analyses.

In IIEC's opinion, the Commission should not give excessive weight to technical accounting mechanics to determine the equity component of the proper capital structure. IIEC says the Commission should not lose sight of the core issue: What is a reasonable capital structure that reflects the investment actually supporting ComEd's delivery services assets and operations?

IIEC believes that Mr. Gorman's approach to this question goes directly to the core issues. IIEC argues the Commission must determine a capital structure that is reasonable and that reflects the capital supporting its regulated delivery service assets **[*319]** and operations. IIEC states that in contrast, ComEd includes equity that is not dedicated to the provision of delivery services in its proposed capital structure, unreasonably inflating the utility's revenue requirement as a result.

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 **[*320]** 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, **[*321]** 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 **[*322]** 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 **[*323]** 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 **[*324]** 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 **[*325]** 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 **[*326]** 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* **[*327]** 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 **[*328]** 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, **[*329]** 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 **[*330]** (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 **[*331]** 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 **[*332]** 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 **[*333]** 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 **[*334]** -- 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. n18 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.

- - - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n18 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.

- - - - - - - - - - - - - End Footnotes- - - - - - - - - - - - -

ComEd asserts that CCC's **[*335]** claim that ComEd's long-term debt cost should be cut all the way down to 6.23% is even more untenable. ComEd offers several grounds on which it was inappropriate for CCC to suggest that a hypothetical cost based on Exelon Corporation's cost for debt issued in 2005 be substituted for the actual cost of actual ComEd debt maturing before or soon after ComEd's new rates go into effect in 2007. Bodmer Dir., CCC Ex. 1.0 2nd Corr., 33:982-85. ComEd argues such a hypothetical cost is based on another corporation's debt, not ComEd's. ComEd asserts that it included the actual cost of its own debt -- that is, the debt that it actually is required to pay -- when determining its weighted average cost of capital. ComEd contends, therefore, that the actual cost of debt, not some hypothetical one, is the appropriate test when determining ComEd's cost of capital. Mitchell Reb., ComEd Ex. 20.0, 26:559-27:565.

ComEd says that Mr. Bodmer's hypothetical cost was flawed in several other respects as well. ComEd states that such cost included $ 300 million of short-term debt, even though such debt does not belong in the capital structure for the test period. Mitchell Reb., ComEd Ex. 20.0 Corr., 27:580-84; **[*336]** CCC Ex. 1.01, p. 2. ComEd also claims that Mr. Bodmer's hypothetical cost was based on debt issued in mid-2005, when interest rates were at an historically low level, from which they have since increased. ComEd also argues that Mr. Bodmer's proposed adjustment is inconsistent with the filing requirements in 83 Ill. Admin. Code Sections 285.4000 through 4030, as that proposal would incorrectly calculate ComEd's cost of debt as called for by such requirements. Mitchell Reb., ComEd Ex. 20.0 Corr., 28:591-601.

ComEd states that Mr. Bodmer's proposal was yet another example of CCC's ongoing effort to ignore ComEd's actual costs. In support of this position, ComEd claims that CCC does not question ComEd's use of June 30, 2005 for an historic measurement period date or its computation of its cost of long-term debt. Bodmer Dir., CCC Ex. 1.0 2nd Corr., 33:1004-07. Nor, ComEd claims, did CCC suggest that such cost was imprudent or unreasonable. Instead, ComEd argues, CCC wants the Commission to

ignore these facts, to go well beyond even the *pro forma* period, and to use a hypothetical cost from a holding company that reflects interest rates at **[*337]** their lowest point in recent history and that has nothing to do with the actual costs that ComEd will incur for debt between now and 2007.

Staff

Staff witness Ms. Kight testified that ComEd's embedded cost of long-term debt for June 30, 2005 equals 6.48%. (ICC Staff Exhibit 4.0 Corrected, pp. 3-4; Schedule 4.2, p. 3) To make this determination Ms. Kight stated she prepared a December 31, 2004, debt schedule (Schedule 4.2, pp. 4-6) making certain adjustments to the December 31, 2004 debt schedule presented on ComEd's Schedule D-3 Revised. First, she used the ending balances for unamortized losses presented in ComEd's 2004 Form 21 ILCC on pages 24a-24d for all issues redeemed before 1998. Second, she used straight line amortization of the Net (Gain) or Loss from the date reacquired to December 31, 2004 to determine the December 31, 2004 unamortized balance for the issues reacquired during 2004. Finally, Ms. Kight stated she adjusted the annual amortization of debt discount, premium, and expense to reflect straight-line amortization of each issue's December 31, 2004 unamortized balances over its remaining life. (*Id.*) Ms. Kight then stated she prepared **[*338]** a June 30, 2005 debt schedule (Schedule 4.2, pp. 1-3) by simply updating the 2004 debt schedule to reflect the additional annual amortization of debt discount, premium, and expense and the annual sinking fund redemption, the retirement of two issues, and the issuance of one new issue. (ICC Staff Exhibit 4.0 Corrected, p. 4)

Staff argues that ComEd's initial response to Ms. Kight's determination that ComEd's embedded cost of long-term debt for June 30, 2005 equals 6.48% was to simply contend that she failed to use the balances and amortization amounts provided by the Company in its data request response (attached as ComEd Exhibits 20.5a and 20.5b). (ComEd Ex. 20.0, pp. 28-29) Ms. Kight responded that she did use the balance presented in ComEd Exhibit 20.5a, but did not use the balances and amortization provided in ComEd Exhibit 20.5b because in her opinion some of those numbers did not reflect straight line amortization. (ICC Staff Exhibit 15.0 2<nd> Corrected, p. 5) Rather, the loss on reacquired debt presented in Ms. Kight's long-term debt schedule reflects the use of straight line amortization. (*Id.*) According to Staff, Ms. Kight began with the ending balances for unamortized **[*339]** loss and gain on reacquired debt presented on pages 24a and 24b of ComEd's 2004 Form 21 ILCC, and set the annual amortization of loss to that which would recover that loss in equal amounts each year (i.e., straight-line amortization), consistent with the Commission's rule regarding the amortization of Unamortized Loss on Reacquired Debt. (*Id.*, see General Instruction 17 of the "Uniform System of Accounts for Electric Utilities", 18 CFR 101 (2003), as adopted by 83 Ill. Adm. Code 415.10, subject to the exceptions set forth in 83 Ill. Adm. Code 415.380) Staff states that Ms. Kight calculated the ending balance for June 30, 2005 by subtracting 6-months of amortization from the unamortized balance at December 31, 2004. Staff further explains that in addition, Ms. Kight made an adjustment (also provided in ComEd Ex. 20.5a) to reflect the generation-related unamortized loss on reacquired debt that was written off in December 1997. (ICC Staff Exhibit 15.0 2nd Corrected, p. 5)

Ms. Kight further explained why and how she determined that the amounts contained in ComEd's Exhibit 20.5b failed to reflect **[*340]** straight-line amortization:
To illustrate, the unamortized balances of loss on reacquired debt for the 8.750%, Series 30 as of December 31, 2004, are the same on ICC Staff Exhibit 4.0, Schedule

4.2 and ComEd Ex. 20.5b. However, the June 30, 2005 unamortized balances differ. The annual amortization of Series 30 loss is approximately $ 90,900 using straight line amortization. Therefore, the June 30, 2005 balance should equal the December 31, 2004 balance of $ 772,849 minus half of the $ 90,900 annual amortization, or approximately $ 727,400. However, ComEd Ex. 20.5b lists the June 30, 2005 balance as $ 647,306. The approximately $ 80,000 difference between the two June 30, 2005 balances indicates that ComEd's balance does not reflect straight line amortization.

(*Id.*, p. 6)

Staff states that the surrebuttal testimony of ComEd witness Mr. Mitchell makes the conclusory assertion that he does not agree with Ms. Kight's position "because the balances and amortization amounts shown on ComEd Exhibit 20.5b are accurate and in accordance with applicable accounting and rate making principles." (ComEd Ex. 37.0 2<nd> Corrected, p. 24) Staff argues that ComEd did not offer any analysis **[*341]** or explanation attempting to refute Ms. Kight's specific demonstration that ComEd's balances and amortization amounts do not reflect straight line amortization. Given that General Instruction 17 of the Uniform System of Accounts for Electric Utilities provides for the use of straight line amortization, Staff submits that Ms. Kight's recommended cost of long term debt is the only recommendation supported by the record that is consistent with Part 415.

CUB-CCSAO-City

CCC argues that ComEd's proposed long-term debt cost of 6.50% is overstated and should be reduced to 6.23%. CCC claims that ComEd's calculation of its long-term debt cost includes debt issues that will mature before the rates in this case will become effective (*i.e.*, January 1, 2007). CCC Ex. 1.0 (2<nd> Revised) at 33, L. 1005-08. CCC states that because these debts will mature at or near January 1, 2007, they will not affect the utility's interest expense once the new rates are in place. *Id.* at 34, L. 1012-15.

Rather than include the cost of debt that will mature at or near the time the new rates become effective, CCC claims that it is appropriate to assume that the maturing debt will be refinanced. *Id.* **[*342]** at L. 1019-21. CCC proposes that the cost of debt that Exelon issued to partly fund ComEd's pension obligations -- costs the utility will incur when the new rates are in place -- be used as a proxy for the cost of the maturing debt, . *Id.* at L. 1025-26. CCC states that the cost of the Exelon-issued debt is fixed at 4.813%. CCC opines that the amount of the Exelon debt issue allocated to ComEd -- $ 803 million -- is approximately equal to the amount of debt that is maturing before or near January 1, 2007 - $ 807 million. *Id.* at 1027-31; CCC Ex. 1.01 at 2. CCC states that replacing the cost of the maturing debt with the cost of the Exelon-issued debt reduces ComEd's cost of long-term debt from 6.5% to 6.23%. CC Ex. 1.01 at 3.

CCC argues that debt issues that will mature at or near the time rates go into effect are not relevant for ratemaking purposes. Therefore, CCC recommends that the Commission exclude these debt issues from the calculation of ComEd's cost of long-term debt. In their place, CCC proposes that the Commission adopt Mr. Bodmer's proposal to use the cost of the Exelon-issued debt as a proxy for the debt that will mature on or near January 1, 2007. CCC asserts that **[*343]** this provides a truer

representation of ComEd's debt cost when the rates established in this case are in place.

Commission Analysis and Conclusion

The Commission finds that ComEd's actual ending balances and amortization amounts of unamortized loss on reacquired debt as of June 30, 2005, do not reflect the use of straight line amortization and thus are inconsistent with the Commission rules regarding the amortization of Unamortized Loss on Reacquired Debt. (*See* General Instruction 17 of the "Uniform System of Accounts for Electric Utilities", 18 CFR 101 (2003), as adopted by 83 Ill. Adm. Code 415.10, subject to the exceptions set forth in 83 Ill. Adm. Code 415.380). The Commission further finds that Staff's are consistent with the Commission rules and reflect a cost of long-term debt of 6.48%, and thus rejects ComEd's proposed cost of debt of 6.50%, which is not based on straight-line amortization. The Commission also finds no merit in CCC's suggested hypothetical cost - the record shows, among other things, that such cost is based on a different corporation's debt, improperly includes **[*344]** $ 300 million of short-term debt, and is based on debt issued in mid-2005, when interest rates were at an historically low level. Indeed, CCC does not question ComEd's use of June 30, 2005 for an historic measurement period date or its computation of its cost of long-term debt, nor suggest that such cost was imprudent or unreasonable. Accordingly, the Commission concludes that ComEd's use of its actual long-term debt cost is appropriate

3. COST OF COMMON EQUITY

ComEd

ComEd proposed a cost of common equity ("COE") of 11.00%. ComEd witness Dr. Hadaway states that this proposal was based on the widely accepted discounted cash flow ("DCF") and risk premium methods (including the capital asset pricing model ("CAPM")), which together provide the "most reliable cost of equity estimate." Hadaway Dir., ComEd Ex. 8.0, 1:15-21, 16:338-17:369, 23:495-503, 36:826-38:873.

Dr. Samuel Hadaway, who conducted these analyses for ComEd, testified that he used a comparable company approach, following the United States Supreme Court's traditional *Hope* and *Bluefield* requirements n19, and drawing on companies tracked by *Value Line Investors Service* ("Value Line"), a "widely-followed, **[*345]** reputable source of financial data." Dr. Hadaway states that the comparable companies were comprised of regulated gas local distribution companies and electric utilities with risk profiles similar to ComEd's. ComEd argues that both of these groups are "useful proxies" that the Commission has accepted for establishing COEs on several prior occasions. ComEd also says that Dr. Hadaway used multiple measures to ensure comparability, restricting his sample to companies that, among other things, have bond ratings of at least triple-B plus, have received at least 66% of their revenues from domestic utility sales, are currently paying dividends, with no dividend cuts in the last two years and have no current merger activities. Hadaway Dir., ComEd Ex. 8.0, 2:35-3:47, 5:106-11, 6:114-19.

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n19 *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923).

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - -

According **[*346]** to ComEd Dr. Hadaway used *Moody's* average public utility bond yields and projected single-A utility rates, and reviewed Value Line's projected earned rates of return for the comparable company groups in conducting his risk premium analysis. . ComEd further states that Dr. Hadaway developed a CAPM estimate of the cost of equity for each group. ComEd also noted that under current market conditions, this combination of approaches was the most reliable method for estimating ComEd's COE. Hadaway Dir., ComEd Ex. 8.0, 3:48-58.

ComEd asserts that other parties' proposed COEs -- 10.19% (Staff), 9.90% (IIEC), and 7.75% (CCC) -- are deficient in multiple respects. Fundamentally, ComEd argues, each of these proposals is significantly below the COEs approved in recent years for electric utilities in the United States. ComEd states, for instance, that in the fourth quarter of 2005, the average COE allowed in eleven cases was 10.75%. Dr. Hadaway testifies that the COEs being proposed by other parties here constitute a "departure for the trend of rising capital costs", and are "well below the mainstream" of COEs in the United States. Hadaway Reb., ComEd Ex. 21.0, 1:21-2:30; Hadaway Sur., ComEd **[*347]** Ex. 38.1. Dr. Hadaway further testifies that this conclusion is particularly apparent with respect to CCC's proposal, which is not only 300 basis points below the national average, but also 244 basis points below Staff's already low proposition, and still 215 basis points below IIEC's even lower suggestion. Hadaway Reb., ComEd Ex. 21.0, 17:381-93.

ComEd claims that in contrast, its own proposal of 11.00% is close to the national average. ComEd argues that this COE makes sense, that ComEd competes in the national equity markets and given the operating and capital risks that ComEd faces -- such as continued dependence on kilowatt-hour volumes to recover costs, competition from self-generation and distributed generation, regulatory lag, potential disagreements over appropriate expenses and operating decisions, and responsibilities as the ultimate provider of last resort. ComEd asserts that these kinds of risks have been noted by rating agencies, and reflected, for instance, by ComEd's having a higher risk profile than most distribution utilities, as well as by the recent downgrading of the long-term rating on ComEd's senior unsecured debt. Hadaway Reb., ComEd Ex. 21.0, 2:41-45, 3:64-4:91. **[*348]**

ComEd argues that the contrast in proposed COEs is even more stark when ComEd's capital structure is considered. ComEd states that its proposed equity ratio of 54.2% is based on its actual historical capital structure as of June 30, 2005, and includes a voluntary adjustment to eliminate the $ 2.3 billion equity impact resulting from the required use of purchase accounting to reflect the Unicom/PECO merger. Mitchell Sur., ComEd Ex. 37.0 2nd Corr., 12:242-56. ComEd also states that this equity ratio lines up well with the equity ratios of the companies in Dr. Hadaway's comparables groups, which averaged 51.8% for the LDC group and 45.7% for the electric utilities. Hadaway Reb., ComEd Ex. 21.0, at 15:347-62. In contrast, ComEd argues, Staff, IIEC, and CCC, however, are pushing for a dramatically lower equity ratio of 37.11%, yet have failed to adjust for the additional financial risk entailed by such a highly leveraged capital structure. Kight Reb., Staff Ex. 15.0 2nd Corr., 8:127; Gorman

Reb., IIEC Ex. 7.0, 11:236-45; Bodmer Reb., CCC Ex. 4.0 Corr., 2:50-51, 18:543-19:551; Hadaway Reb., ComEd Ex. 21.0, 6:131-7:144, Hadaway Sur., ComEd Ex. 38.0, 7:162-8:165. ComEd argues further that, **[*349]** as a result, these other parties' proposed COEs are mismatched with the comparable company groups proposed by Staff and IIEC, each of which involved companies with less leveraged capital structures. Hadaway Sur., ComEd Ex. 38.0, 2:30-33. As an example, ComEd pointed to Mr. McNally's electric group, which has an average COE in 2004 of 48.8% and a projected equity ratio for 2008-2010 of 52%. Hadaway Reb., ComEd Ex. 21.0, 6:131-7:144.

ComEd further alleges that CCC's proposed COE is even more skewed. ComEd asserts that the proposal is not only more than one hundred basis points below any COE recently approved in the United States, but not even based on any of the theoretically correct estimation techniques customarily used by economists to estimate COE. Rather, according to ComEd, the proposal was generated primarily from inapplicable information published by three investment banks in valuing the proposed merger between Exelon and PSEG. Hadaway Reb., ComEd Ex. 21.0, 18:406-19:424.

GDP Growth Rate

ComEd alleges that in preparing his DCF analysis, Dr. Hadaway used GDP growth rates to gauge long-term growth expectations. ComEd noted that the DCF model calls for very long-term growth rates **[*350]** and such expectations are more closely predicted by broader measures of economic growth -- like GDP -- than by near-term analysts' estimates. Hadaway Sur., ComEd Ex. 38.0, 17:397-18:405. ComEd asserts by using GDP data Dr. Hadaway could look beyond the present low-inflation environment that has driven near-term growth estimates far below where they were just five years ago. Hadaway Reb., ComEd Ex. 21.0, 8:170-77.

ComEd alleges that Staff's and IIEC's proposed COEs are flawed because their DCF models fail to consider very long-term growth expectations. ComEd states that Mr. McNally used growth rates projecting earnings for only the next five years, and Mr. Gorman used growth rate estimates of only three to five years. Hadaway Reb., ComEd Ex. 21.0, 7:149-8:177, 11:240-47; Hadaway Sur., ComEd Ex. 38.0, 5:97-103. According to ComEd these shorter-run growth rates reflect today's historically low rates of inflation and analysts' less than optimistic outlook for the electric utility industry, which together skew DCF estimates abnormally low. Hadaway Sur., ComEd Ex. 38.0, 10:216-24.

Investment Bank Analysis

ComEd argues that CCC's use of the investment bank valuation analyses amounted to **[*351]** an improper mixture of "apples and oranges." According to ComEd, the two efforts -- calculating a discount rate for use in a fairness opinion and determining the cost of equity that the market requires that a utility earn for ratemaking purposes -- are very different in purpose and methodology. For instance, ComEd states, a fairness opinion in a context like the proposed Exelon-PSEG merger is intended to provide a relative valuation of the two companies' stock at a certain point in time. ComEd also alleges that, in doing this kind of study, investment banks use various methodologies, which may or may not be similar to those appropriately used in a regulatory proceeding like this rate case. On the other hand, ComEd says, in such a regulatory proceeding, the purpose of estimating a utility's cost of capital is

to allow the utility a reasonable return on its rate base. ComEd argues further that such a return includes a **return on equity** that is set by the market, rather than under Mr. Bodmer's implicit assumption that utility stocks should trade at book (discussed in the next subsection). Hadaway Reb., ComEd Ex. 21.0, 21:426-32; Hadaway Sur., ComEd Ex. 38.0, 14:311-22. For these reasons **[*352]** and others, ComEd argues, neither the Commission, nor any other utility regulatory in the U.S., has accepted Mr. Bodmer's methodology or approach.

For example, ComEd states that Lehman Brothers (one of Exelon's investment banks) used internal forecasts and analyses of Exelon's financial performance and capital expenditures, rather than, for example, a typical regulatory DCF analysis based on data known to the public and revealed in stock prices. ComEd also says that Lehman Brothers conducted its analysis as of a specific point in time in the past, as opposed to determining a required rate of return for the future. Hadaway Sur., ComEd Ex. 38.0, 14:323-30.

In addition, ComEd alleges that while cost of capital in a regulatory proceeding is estimated for application to a utility's rate base -- *i.e.*, its historical, depreciated investment -- an investment bank may derive implied returns based on market-based valuations of those same assets, including the additional cost the utility would need to assemble the same mix of investments from scratch at current market prices. As such, ComEd argues, it would be inappropriate to apply the latter type of rate of return, which is based on a **[*353]** market-priced basket of assets, to a rate base defined by original cost. Hadaway Sur., ComEd Ex. 38.0, 15:331-38.

According to ComEd there are other differences, as well. For example, ComEd says, valuation analysis uses market-based capital structure weights, while regulatory analysis uses book weights. ComEd also says that valuation analysis relies on an estimate of the incremental, after-tax cost of debt, while regulatory analysis calls for the known and measurable embedded, pre-tax cost of debt. Hadaway Reb., ComEd Ex. 21.0, 19:432-36.

Market to Book Ratio

ComEd argues that Mr. Bodmer erred in suggesting that utility stocks should trade at book. ComEd states that when confronted with the fact that utility market-to-book ratios are greater than one for a number of reasons other than over earning, Mr. Bodmer claimed that "regulatory commissions have been granting returns in excess of the cost of capital to utility companies." Bodmer Dir., CCC Ex. 1.0 2nd Corr., 45:1368-70. Thus, ComEd alleges, instead of recognizing that such ratios highlighted the unreasonableness of his own proposed COE, Mr. Bodmer implied that regulatory commissions around the country have been consistently wrong. **[*354]** ComEd concluded that such a stance just underscores how far out of the mainstream Mr. Bodmer is. Hadaway Reb., ComEd Ex. 21.0, 8:398-404.

Staff

According to Staff, Staff witness Mr. McNally estimated ComEd's investor-required rate of return on common equity to be 10.19%. (ICC Staff Exhibit 5.0, p. 18) In order to derive that estimation, Staff states that Mr. McNally measured the investor-required rate of return on common equity with discounted cash flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses. Mr. McNally applied those models to a sample of utility companies ("Comparable Sample") chosen on the basis of the

comparability of their financial and operating ratios to those of ComEd. Staff states that Mr. McNally's sample selection analysis employed six financial and operating ratios, using the average from the period 2002-2004 to normalize the ratios. He conducted a principal components analysis of those financial and operating ratios for the 112 market-traded electric, natural gas, and water companies on *Standard & Poor's Utility Compustat* tape that had sufficient data to calculate the ratios. After calculating the scores for each principal component, he rank-ordered **[*355]** the companies in terms of least relative distance from ComEd's target scores. The Comparable Sample consists of the eight utilities which are the least distance from, and therefore, the most comparable to, ComEd that are assigned an S&P business profile score of three to five; have growth rates from Zacks Investment Research, Inc. ("Zacks"); and have neither pending nor recently completed significant mergers, acquisitions, or divestitures. (ICC Staff Exhibit 5.0, pp. 2-4)

Mr. McNally testified that the DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Mr. McNally further testified that since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in Mr. McNally's Comparable Sample pay dividends quarterly. Therefore, Mr. McNally applied a constant-growth quarterly DCF model. (ICC Staff Exhibit 5.0, p. 5)

Mr. McNally testified that the DCF methodology requires a growth rate that reflects the expectations of investors. Mr. McNally measured the market-consensus expected growth rates with projections **[*356]** published by Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of November 17, 2005. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimate of the cost of common equity was 9.36% for the Comparable Sample. (ICC Staff Exhibit 5.0, p. 8)

Mr. McNally's testimony also pointed out that according to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse and that, in equilibrium, two securities with equal quantities of risk have equal required rates of return. Mr. McNally used a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (ICC Staff Exhibit 5.0, pp. 8-9)

Mr. McNally further testified that the CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Mr. McNally says that **[*357]** he combined betas from Value Line and a regression analysis. The average Value Line beta estimate was 0.81, while the regression beta estimate was 0.62. (ICC Staff Exhibit 5.0, p. 16) Mr. McNally says that for the risk-free rate parameter, he considered the 4.06% yield on four-week U.S. Treasury bills and the 4.81% yield on twenty-year U.S. Treasury bonds -- Both estimates were measured as of November 17, 2005. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 5.4% and 5.9%. Thus, Mr. McNally concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (ICC Staff Exhibit 5.0, pp. 10-13) Finally, for the expected rate of return on the market parameter, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That

analysis estimated that the expected rate of return on the market equals 13.42%. (ICC Staff Exhibit 5.0, p. 14) Inputting those three parameters into the CAPM, Mr. McNally calculated a cost of common equity estimate of 11.01% for the Comparable Sample. (ICC Staff Exhibit 5.0, p. 17)

Based on his DCF and risk premium models, Mr. McNally estimated that **[*358]** the cost of common equity for the Comparable Sample is 10.19%. To determine the suitability of that cost of equity estimate for ComEd, Mr. McNally assessed the risk level of his Comparable Sample relative to that of ComEd. To begin with, the companies composing the Comparable Sample were selected based on the similarity of their financial and operating ratios to those of ComEd. Further, the similarity in risk of the resulting Comparable Sample to ComEd is confirmed by the similarity in the sample average credit rating, business profile score, and factor scores to those of ComEd. Thus, Mr. McNally concluded that the Comparable Sample appropriately reflects the risk level of ComEd and no risk adjustment is necessary. (ICC Staff Exhibit 5.0, pp. 17-18)

GDP Growth Rate

Mr. McNally testified that the difference between Staff's and ComEd's cost of equity estimates is due almost entirely to Dr. Hadaway's inappropriate use of an economy-wide GDP growth rate as a proxy for the growth of the individual companies in his samples, which leads to an overstated cost of equity estimate. (ICC Staff Exhibit. 5.0, pp. 23-24) The Company failed to demonstrate that Dr. Hadaway's GDP growth rate estimate **[*359]** is a reasonable proxy for the growth of his individual sample companies. (ICC Staff Exhibit 16.0, p. 7) To the contrary, the record evidence indicates that Dr. Hadaway's approach is not appropriate.

First, Mr. McNally testified that the considerable divergence of Dr. Hadaway's 6.60% economy-wide GDP growth rate estimate from the three distinct company-specific growth rate estimates Dr. Hadaway employed suggests that his historical GDP growth rate is not a reasonable estimate of the sustainable growth of the individual companies in his samples. The sample averages for each of the three company-specific growth rate estimates for the companies in both of Dr. Hadaway's samples were quite consistent, all falling within a range of approximately one percentage point, from 3.41% to 4.43%. In contrast, the 6.60% GDP growth rate is more than two percentage points higher than the *highest* of any of the other three estimate averages for either sample. (ICC Staff Exhibit 5.0, p. 20)

Second, Mr. McNally testified that the Value Line earnings retention rate forecasts for the companies in Dr. Hadaway's samples, upon which Dr. Hadaway relied to develop his B*R growth rates, also indicate that 6.60% **[*360]** is not a reasonable estimate of the sustainable growth of the individual companies in his samples. As the B*R growth rate model indicates, a company's expected sustainable future growth is a product of the expected rate of return on new investment, R, and the percentage of earnings expected to be reinvested in the company (i.e., the retention rate), B. The greater the rate of return on new investment and the earnings retention rate, the greater the growth rate. Conversely, the lower the rate of return on new investment and the earnings retention rate, the lower the growth rate. Given the Value Line retention rate forecasts, the return on retained earnings for the companies in his samples would have to average over 20%, which is almost twice the 11.0% cost of equity Dr. Hadaway estimated for those companies, in order to sustain 6.60% growth. n20 Conversely, given Dr. Hadaway's 11.0% final cost of equity estimate,

the retention rate for those companies would have to average 60%, which is almost twice the average of the Value Line retention rate forecasts, which Dr. Hadaway relied upon for his analysis, in order to sustain 6.60% growth. Thus, a 6.60% growth expectation is both inconsistent **[*361]** with the rest of Dr. Hadaway's analysis and unlikely to be embraced by investors. (ICC Staff Exhibit 5.0, pp. 20-21) Mr. McNally further pointed out in his testimony that alternatively, if one assumes, for internal consistency, that both Dr. Hadaway's 11.0% final cost of equity recommendation and the Value Line retention rate forecasts Dr. Hadaway relied on are fairly reasonable estimates, then the sustainable growth rate for the companies in his LDC Sample and Electric Sample would average approximately 3.5% and 3.74%, respectively. Those estimates fall squarely within the 3.41% to 4.43% range of the sample averages for the three company-specific growth rates Dr. Hadaway employed and, thus, are clearly much more comparable to the company-specific growth rates Dr. Hadaway employed than to Dr. Hadaway's GDP growth rate estimate of 6.60%. (ICC Staff Exhibit 5.0, p. 23)

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n20 In fact, the Value Line forecasts for 2008-2010 reflect slightly higher retention rates than the actual and forecasted retention rates published in Value Line for 2000-2006 for the companies in Dr. Hadaway's samples. Thus, based on 2000-2006 retention rates, the companies would have to earn even higher returns in order to grow at the 6.60% rate Dr. Hadaway employed in his DCF analyses. (ICC Staff Exhibit 16.0, p. 11)

- - - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - - **[*362]**

In his testimony Mr. McNally testified that the Company's argument for the use of an economy-wide GDP growth rate as a proxy for the growth of the individual utility companies in Dr. Hadaway's samples rests on the implicit assumption that investors expect the long-term growth rates for those utilities to be similar to Dr. Hadaway's estimate of the average long-term growth rate for the overall economy. However, Mr. McNally asserts that ComEd has provided no information to demonstrate that the companies in Dr. Hadaway's samples are average growth companies. To the contrary, the data underlying Dr. Hadaway's own analysis suggests that the utility companies composing his samples are below average growth companies. Specifically, the retention rate for utility companies is typically well below average, as evidenced by the historical, current, and Value Line forecasts of the retention rates of the companies in Dr. Hadaway's samples relative to the average retention rate for the companies composing the S&P 500. Mr. McNally testified that one would expect utilities overall to earn below average returns due to the below average risk reflected in their below average betas (i.e., betas less than **[*363]** one), such as the 0.81 and 0.74 average betas Dr. Hadaway adopted for his LDC Sample and Electric Sample, respectively. Since growth is a function of those below average earnings retention rates and the below average return on those retained earnings, one would clearly expect *below average* growth for utilities. (ICC Staff Exhibit 5.0, pp. 21-22) In its initial brief, Staff explains that the Company's entire argument rests on the hope that the Commission will completely disregard the consistent, established patterns from the available data and simply accept the unfounded suggestion that investors expect the long-term future for utilities, relative to the overall market, to be significantly different from both the past and present as well as from current

projections of the future three to five years hence.

Staff also argues in its initial brief that even if one accepts the use of a GDP estimate as a proxy for the growth of the individual companies in Dr. Hadaway's samples despite the above arguments, the accuracy of Dr. Hadaway's long-term GDP growth rate estimate as a gauge of long-term GDP growth expectations is highly questionable. Staff asserts the Company failed to demonstrate **[*364]** that investors set their long-term expectations of future GDP growth based on growth achieved over that past 57 years, much less that they derive their expectations in the peculiar manner Dr. Hadaway did. Furthermore, Staff argues the actual, published GDP forecasts Staff and IIEC cited indicate that expectations for future GDP growth are significantly lower than the GDP growth rate Dr. Hadaway employed. (ICC Staff Exhibit 16.0, p. 8; IIEC Exhibit 3.0, pp. 3, and 25-26) Thus, Staff opines it is highly dubious to assume that investors expect 6.60% long-term growth for the overall economy, as measured by GDP, much less for utilities specifically.

Finally, Staff in its initial brief argues that even if one ignores all of the foregoing arguments, the companies in Dr. Hadaway's samples cannot sustain a 6.60% growth rate given their current and forecasted dividend policies, even if one accepts the Company's supposition that investors might expect a return as high as 12.55%. Staff further argued that even in the unlikely event that investors do expect very long-run growth rates to be approximately 6.60%, they must also expect a significant change to those companies' dividend payout policies, **[*365]** all else equal. Staff states that change must be reflected in the DCF model, if one wishes to obtain an unbiased cost of equity estimate; unfortunately, the Company's analysis does not incorporate the necessary shift in dividend payment policies. Thus, Staff asserts, not only does the Company rely on the unfounded assumption that investors expect a dramatic rise in retention rates, but its analysis also implies that that rise in retention rates has already occurred, since it does not model any transition from the current retention rates to the higher retention rates that would be needed over the long run. In Staff's opinion the Company effectively overstates ComEd's cost of equity by combining the higher dividend yield resulting from the lower actual current retention rate with the higher growth rate associated with a higher assumed future retention rate. (ICC Staff Exhibit 16.0, pp. 10-11) For all of the foregoing reasons, Staff argues that Dr. Hadaway's application of his GDP growth rate estimate as a proxy for the growth of the individual companies in his samples is inappropriate and should be rejected.

Investment Bank Analysis

Mr. McNally testified that uncertainties regarding **[*366]** the CCC analysis rendered the resulting cost of equity estimate inappropriate for rate setting purposes. Mr. McNally states that CCC estimated ComEd's cost of equity by inference from the weighted average cost of capital ("WACC") calculated by Morgan Stanley for the merger of Exelon and PS&G. However, according to Mr. McNally, in order to back out the cost of equity from the investment bankers' WACC estimates, CCC first had to make numerous assumptions. Mr. McNally further testified that unfortunately, we do not know if Mr. Bodmer's assumptions were the same as those the investment bankers used. Thus, we do not know if the CCC cost of equity estimate is the same as that calculated by the investment bankers. For example, we do not know if the investment bankers used the same approach to determining the cost of debt, what mix of debt maturities they used, or if they included short-term debt. Further, Mr. McNally stated that it is unclear whether the Morgan Stanley analysis was for ComEd and PECO separately or for the proposed combined entity. Mr. McNally went on to

state that we also do not know if the investment bankers used the same capital structure or made the same assumptions regarding **[*367]** the treatment of transitional funding instruments. Because of all of these unknowns, the Commission cannot be certain that the investment bankers used the same 7.75% cost of equity Mr. Bodmer inferred or, even if they did, that that estimate represents the required rate of **return on equity** appropriate for rate setting purposes. (ICC Staff Exhibit 16.0, pp. 15-16)

Market to Book Ratio

Staff witness Mr. McNally testified that the CCC market to book value analysis is not useful for establishing ComEd's cost of common equity for several reasons. First, according to Mr. McNally, market to book value ratios combine the discounted value of future cash flows with historical book earnings. The numerator and denominator of the ratio are inconsistent with respect to time and construction. Second, Dr. Bodmer's market to book value analysis is based on the premise that one should expect a utility company to *precisely* earn its cost of capital on a continuing basis. That premise is oversimplified. Mr. McNally says there are many utility ratemaking practices (e.g., deferred taxes and depreciation) that could result in a utility's market value exceeding its book value. That is, the authorized **[*368]** return for each company in Mr. Bodmer's sample is not the only factor influencing its earnings. Thus, a market to book ratio in excess of one does not necessarily mean the authorized rate of return is too high. Third, Mr. McNally says, the Value Line betas for the 71 companies used in Mr. Bodmer's analysis range from 0.50 to 1.75, indicating substantial variation in the riskiness of those companies. Yet, Mr. Bodmer's analysis suggests that there is a single correct cost of equity (i.e., 5.65%), that which would equate market value to book value, for all 71 companies in his analysis. In addition, according to Mr. McNally, even if Mr. Bodmer were correct that the market to book value ratio for a utility that earned its required rate of return on common equity would equal one, companies with different risks must have different required rates of return. Thus, Mr. Bodmer's cross-sectional analysis is useless for establishing ComEd's cost of common equity given that he failed to establish that ComEd's risk is equal to the average risk of the 71 companies used in his analysis. (ICC Staff Exhibit 16.0, pp. 21-22)

CUB-CCSAO-City

CCC argues that because the cost of common equity is not **[*369]** a directly observable number, regulatory commissions have had to rely on subjective models, such as the capital asset pricing model ("CAPM") and the discounted cash flow model ("DCF"), to estimate a utility's cost of common equity. According to CCC witness Bodmer, cost of capital discussions are often opaque and include such esoteric topics as "adjustments to beta for mean reversion, quarterly versus annual discounting in the DCF model, complex statistical research on the equity risk premiums, questions about inflation risk in long-term bonds and so on." CCC Ex. 4.0 at 5, L. 128-31. CCC avers that this often difficult and confusing process has led to returns that are higher than the utilities' actual cost of capital. See CCC Ex. 1.0 (2<nd> Revised) at 40-45, L. 1205-1370.

CCC asserts that this case represents a unique opportunity for the Commission in that there is direct, observable data from less biased sources that the Commission can use to determine the appropriate cost of common equity for ComEd. In particular, CCC witness Bodmer developed his recommended cost of common equity

based on his review of valuations conducted by three leading investment banks -- Morgan Stanley, JP **[*370]** Morgan and Lehman Brothers -- for the merger between Exelon and PSE&G. CCC argues that the valuations done by the three investment banks are a far more reliable indicator of investor needs than the subjective models that are used to bridge evidentiary gaps "that arise because the level of return required to induce real investors to provide capital for the firm is not directly observable." CCC Ex. 1.0 (2nd Revised) at 5, L. 145-46. Mr. Bodmer explains that the coincidence of the Exelon-PSE&G merger provides evidence of the rate of return required by investors from three major investment banks on whom such real world transactions depend. Mr. Bodmer testifies that in the published documents relating to the merger we have more direct expressions of investor expectations than is usually the case. He states that the **return on equity** component used by investment banks in valuing free cash flows is the incremental return required by equity investors, exactly the same thing that [ComEd witness] Dr. Hadaway is estimating in his analysis. Mr. Bodmer further testifies that given the availability of such practical information, the Commission should not prefer the indirect and theoretical over the **[*371]** more direct, actual data available for its consideration. *Id.* at 6, L. 151-59.

CCC asserts that this information is especially valuable because while investment banks and regulatory commissions use different methods to measure the cost of debt and to determine capital structures, "the cost of equity capital in the weighted average cost of capital is the same under the regulatory definition as it is for valuation analyses." *Id.* at 10, L. 305-08. CCC argues in determining ComEd's cost of common equity, the investment banks and the Commission share a common goal -- to establish "the opportunity cost that measures required returns for investments of similar risk." *Id.* at 17, L. 503-05. CCC states that while ComEd witness Dr. Hadaway criticized Mr. Bodmer's use of investment bank valuations for determining his recommended cost of common equity, on cross-examination, Dr. Hadaway agreed that the cost of equity for valuation purposes has the same theoretical purpose as the cost of equity for regulatory purposes. March 30, 2006 Tr. at 2415.

CCC contends that because investment bank valuations are a direct proxy for investment requirements and are, therefore, inherently more objective **[*372]** than subjective applications of theoretical cost of equity models, Mr. Bodmer used the publicly available information regarding estimates of the weighted cost of capital developed by Morgan Stanley, Lehman Brothers and JP Morgan as part of the ongoing Exelon-PSE&G merger to establish his recommended cost of equity. Because Morgan Stanley developed a weighted cost of capital for ComEd, Mr. Bodmer based his cost of common equity analysis on Morgan Stanley's results.

According to Mr. Bodmer Morgan Stanley estimated a cost of capital for ComEd of between 5.25 and 5.75%. CCC Ex. 1.0 (2<nd> Revised) at 36, L. 1071-72. CCC explains that Mr. Bodmer inferred the cost of capital used by Morgan Stanley by making certain assumptions about ranges of ComEd's debt to capital ratio and incremental debt costs. *Id.* at 38, L. 1153-58. Mr. Bodmer's analysis showed that the range of the cost of common equity for ComEd is between 6.20% and 8.11%. *Id.* at 38-39, L. 1160-74. Based on his best estimate of ComEd's debt to capital ratio and incremental debt costs, Mr. Bodmer concluded that the utility's cost of common equity for this case should be set at 7.75%.

CCC argues that in his rebuttal testimony, **[*373]** ComEd witness Hadaway criticized Mr. Bodmer's use of the investment banks' valuations, claiming that "Mr.

Bodmer's approach is fraught with personal judgment and considerable subjectivity." ComEd Ex. 21.0 at 19, L. 437-38. To back up his assertion, Dr. Hadaway modified two assumptions used by Mr. Bodmer to derive a **return on equity** of 11.45%. *Id.* at 20, L. 444-45. Dr. Hadaway concluded that his exercise demonstrates the sensitivity of Mr. Bodmer's approach. *Id.* at 20, L. 454-46.

CCC argues that perhaps unwittingly, ComEd undercut its own expert. Attached to Dr. Hadaway's surrebuttal testimony was a letter that Lehman Brothers provided at ComEd's request. Although the letter was stricken from Dr. Hadaway's testimony (*see* ALJ Notice of Ruling, March 21, 2006), ComEd used the letter as a cross exhibit during its cross-examination of Mr. Bodmer. See March 24, 2006 Tr. at 1277-78; ComEd Cross Ex. 6. CCC points out that Mr. Bodmer testified that the most interesting part of the Lehman Brothers letter was the author's assertion that **returns on equity** "are typically 300 or more basis points more than the discount rates used in investment bank fairness opinions." ComEd Cross Ex. **[*374]** 6 at 3. CCC states that if one subtracts 300 basis points from Dr. Hadaway's recommended 11.0% cost of common equity, the result is 8.00% -- a mere 26 basis points more than Mr. Bodmer's proposed 7.74% **return on equity.** March 24, 2006 Tr. at 1284. Thus, according to CCC, ComEd's cross exhibit confirms the reasonableness of Mr. Bodmer's assumptions in deriving his recommended return on common equity from Morgan Stanley's weighted cost of capital. CCC also states that Mr. Bodmer supported his conclusion regarding the cost of equity used by Morgan Stanley by applying more traditional cost of equity models. According to CCC, Mr. Bodmer conducted a CAPM analysis, a DCF analysis and a price to earnings ratio analysis. Mr. Bodmer's CAPM analysis yielded a range for cost of common equity of 6.69 to 7.31%. CCC Ex. 1.0 at 47, L. 1411-12. Mr. Bodmer's DCF analysis yielded a cost of common equity of 7.88%. *Id.* at 68, L. 2058. His price-to-earnings analysis yielded a cost of common equity of 7.84%. *Id.* at 68, L. 2060. CCC claims that each of these results confirm that Mr. Bodmer's investment bank analysis produces a reasonable cost of equity.

CCC asserts that numerous changes that have **[*375]** occurred since ComEd's last DST case that support adoption of Mr. Bodmer's proposed 7.75% return on common equity. CCC claimed that, at a minimum, these factors show that if the Commission does not adopt Mr. Bodmer's proposal, it should adopt a return on common equity at the low range of the estimates provided by the other cost of capital witnesses. Among these factors are:
Changes in Personal Tax Rates -- Since ComEd's last DST case, personal income tax rates on dividends and capital gains have been reduced. The effect of these tax changes mean that after-tax returns have increased by a substantial amount for a given level of pre-tax return. CCC Ex. 1.0 (2nd Revised) at 11, L. 323-25; at 13-14, L. 373-97.

Declines in Overall Level of Interest Rates -- Overall interest rates have dropped since ComEd's DST rate case. At the time the order was entered in ComEd's last rate case, the yield on 10-year Treasury Bonds was 5.42%. When ComEd filed its current DST case, the long-term treasury rate was 4.02%. CCC pointed out that "the difference in interest rates of 1.40% is almost twice the difference in the allowed equity return from the last case versus [the utility's] request **[*376]** in this case (11.75% versus 11.0%.)." *Id.* at 11, L. 326; at 14, L. 410-05.

Lower Business Risk for ComEd -- In January of this year, the Commission approved ComEd's proposal to procure power post-2006 through an auction. The auction will

allow the utility to pass generation costs directly to customers. *Id.* at 15, L. 425-26. IIEC witness Robert R. Stephens testified that this process allows ComEd to transfer "all fuel cost, power procurement costs, and other operating risk associated with generation supply from itself to customers and to wholesale generation suppliers in the market." IIEC Ex. 1.0 at 4-5, L. 90-102.

Lower Revenue Volatility for ComEd -- As part of its rate design, ComEd proposed to increase customer charges for residential customers. If accepted, the customer charge for single family customers would increase from $ 7.13 per month to $ 9.65 per month and for multi-family customers from $ 2.94 per month to $ 9.65 per month. CCC Ex. 1.0 at 15, L. 437-40. The effect of this proposal is to increase customers' fixed charge, which has the necessary consequence of reducing the volume risk that ComEd would face. In other words, "a greater proportion of ComEd's **[*377]** revenues will not be subject to any variation at all in energy usage" which reduces risk for the utility. *Id.* at 15, L. 440-41.

Completion of large investments in distribution plant -- Following a number of well-publicized and widespread outages that occurred in 1999, ComEd undertook major capital investments in its infrastructure. CCC noted that according to ComEd witness John T. Costello, ComEd's requested rate base in this case is $ 2,572.5 million more than the level the Commission approved in ComEd's last rate case in 2001. ComEd Ex. 3.0 at 7, L. 138-40. CCC calculated that the proposed $ 2,572.5 million increase in rate base represents more than almost 42% of ComEd's proposed $ 6,189.2 million rate base in this case. CCC stated that this flurry of capital investments should "mean that rate base growth relative to sales growth should moderate, and potentially allow the [utility] to earn more than its allowed return." CCC Ex. (2nd Revised) 1.0 at 11, L. 331-33. CCC noted that Mr. Bodmer's comment is supported by ComEd witness J. Barry Mitchell's statement that "we expect to finance the majority of ComEd's capital expenditures with internally generated cash. . . ." ComEd **[*378]** Ex. 7.0 at 5, L. 97-98. According to CCC, taken together, these statements show that it is unlikely that ComEd will need to access the capital market in the near future.

CCC concludes that Mr. Bodmer's analysis showed that a leading investment bank recently concluded that a fair cost of equity for ComEd is 7.75%. CCC asserts that while ComEd claimed that Mr. Bodmer's analysis was speculative and subjective, its Cross Exhibit 6 (the Lehman Brothers letter), confirmed that Mr. Bodmer's recommended cost of equity is comparable to that determined by Morgan Stanley.

CCC added that the changes that have happened since ComEd's last DST rate case, including (1) lower personal tax rates, (2) lower overall interest rates, (3) lower ComEd business risks, (4) greater ComEd revenue stability if its residential rate design proposals are adopted and (5) fewer ComEd large distribution system capital investments in the near future -- and Mr. Bodmer's market-to-book ratio analysis -- all argue for adoption of Mr. Bodmer's direct and objective method for determining the appropriate cost of equity for ComEd.

Alternatively, if the Commission rejects Mr. Bodmer's recommendation, CCC recommends that these **[*379]** factors show that the Commission should adopt a cost of equity at the low end of the ranges submitted by the other cost of equity witnesses.

GDP Growth Rate

CCC argues that all witnesses other than Dr. Hadaway who testified regarding cost of common equity concluded that the ComEd witness' use of long-term gross domestic product ("GDP") to estimate long-term growth expectations as part of his DCF analysis improperly inflated his DCF result. According to CCC because Dr. Hadaway testified that his primary cost of equity recommendation came from his DCF analysis (ComEd Ex. 8.0 at 16, L. 349-50), each witness concluded that Dr. Hadaway's cost of equity recommendation was overstated. CCC summarizes the criticisms by CCC witness Mr. Bodmer, Staff witness Mr. McNally and IIEC witness Mr. Gorman of Dr. Hadaway's approach as follows.

Mr. Bodmer -- Mr. Bodmer described Dr. Hadaway's use of GDP growth rate as a proxy for dividend growth as wrong both from a theoretical and quantitative perspective. CCC Ex. 1.0 at 78, L. 2377-78. Mr. Bodmer pointed out that the authors of an article cited by Dr Hadaway to support his use of GDP (ComEd Ex. 8.0 at 28, L. 624-29) "criticize the use **[*380]** of analyst growth rates, but the criticism is that analyst growth rates are too high, not too low" and that the authors recommend use of a 3.5% GDP growth figure, which is significantly lower than the 6.6% figure used by Dr. Hadaway. CCC Ex. 1.0 at 78-79, L. 2402-11, *citing* Chan, L., Karceski, J. and Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, April 2003, p. 649. Most important, CCC stated that Mr. Bodmer testified that Dr. Hadaway's growth rate cannot be sustained. Using Dr. Hadaway's growth rate, his dividend payout ratio and the 32.7% retention rate of the companies in his sample would mean that the utility industry would have to average an astronomical 20.2% **return on equity.** CCC Ex. 1.0 at 79, L. 2424-32. CCC argued that such returns are not realistic.

CCC adds that using a more reasonable growth rate and Dr. Hadaway's other assumptions in his DCF analysis yields cost of equity results comparable to Mr. Bodmer's 7.75% Morgan Stanley estimate. *Id.* at 70, L. 2119-29.

Mr. McNally -- Mr. McNally testified that Dr. Hadaway's economy-wide 6.6% growth rate "is not a reasonable estimate of the sustainable growth of the individual **[*381]** companies in his samples." Staff Ex. 5.0 at 20, L. 378-82. Mr. McNally added that "the GDP growth rate is more than two percentage points higher, an increase of almost 50%, than the highest of the other . . . estimates for either" Mr. Hadaway's local distribution company ("LDC") or electric companies sample. *Id.* at 20, L. 387-89. CCC pointed out that similar to Mr. Bodmer, Mr. McNally testified that using Dr. Hadaway's 6.6% growth rate and the retention rates of his LDC and electric companies sample implies **returns on equity** of 20.54% for the LDC sample and 22.31% for the electric companies sample. *Id.* at 20-21, L. 392-405. Mr. McNally concluded that Dr. Hadaway's use of the GDP growth rate "leads directly to an overstated cost of equity estimate." *Id.* at 23, L. 456-57.

Mr. Gorman -- Mr. Gorman testified that Dr. Hadaway's 6.6% historical GDP growth rate is out of line with economists' projections of GDP growth. Mr. Gorman stated that "consensus economists' projections of future GDP growth over the next five and ten years is 5.5%." IIEC Ex. 3.0 at 41, L. 909-12, *citing* Blue Chip Economic Forecast, October 10, 2005. Mr. Gorman explained that Dr. Hadaway's use **[*382]** of historical GDP as a proxy for future growth rate is inappropriate because it overstates expected future inflation rates. IIEC Ex. 3.0 at 41-42, L. 913-18; March 29, 2006 Tr. at 2039-40.

CCC concluded that the respective testimonies of Messrs Bodmer, McNally and Gorman demonstrated that Dr. Hadaway's use of historical GDP as a proxy for future growth rate is not supportable and inappropriately inflates his cost of equity recommendation.

Investment Bank Analysis

As discussed in Section III.E.3 above, CCC witness Mr. Bodmer recommended that the Commission adopt a 7.75% cost of common equity for ComEd. Mr. Bodmer's recommendation was based on his analysis of the valuation conducted by Morgan Stanley of the ongoing Exelon-PSE&G merger.

CCC argues that the Commission should use Mr. Bodmer's investment bank analysis because it represents a more direct means for determining the appropriate cost of common equity for ComEd. CCC asserts that traditional methods for calculating a utility's cost of common equity are fraught with many subjective assumptions, are often opaque and difficult to understand and are designed to overcome significant evidentiary gaps that exist because it is extremely **[*383]** difficult to measure the level of return required by investors to provide capital for a company.

In contrast, CCC claims that Mr. Bodmer's investment bank analysis is a far more reliable indicator of investor needs than the traditional subjective models used by ComEd witness Hadaway, Staff witness McNally and IIEC witness Gorman. CCC added that in determining ComEd's cost of common equity, the investment banks and the Commission share a common goal - to establish "the opportunity cost that measures required returns for investments of similar risk." *Id.* at 17, L. 503-05.

CCC also argues that investment banks have no bias when conducting valuations. According to CCC, investment banks are in a highly competitive business that requires them to keep abreast of new research and to innovate quickly to insure that their valuations are accurate. Failing to determine accurately a company's cost of equity can result in a merger not taking place or, alternatively, acquisitions to be over-priced. CCC Ex. 4.0 at 5, L. 149-54. CCC asserts that traditional methods for estimating a company's cost of equity do not face the same level of real world scrutiny. The CAPM and DCF models are subject to **[*384]** manipulation in terms of selection of financial data used and modeling approaches. CCC Ex. 1.0 at 5, L. 125-26. CCC posits that the persons applying the CAPM and DCF models often are pursuing an agenda that calls into question the impartiality of their analysis. For example, ComEd paid Dr. Hadaway a substantial sum of money to present his cost of common equity testimony. CCC Ex. 4.0 at 6, L. 182-85. As Mr. Bodmer noted, for this sum of money, one can expect that "ComEd will get the most aggressive arguments possible to support a high **return on equity.**" *Id.* at 6, L. 185-86.

CCC argues that recent research demonstrates that the CAPM and DCF models overstate a company's cost of common equity. As to the CAPM model, CCC claims that research indicates that the use of actual realized returns in the market risk premium that is used as an input in the CAPM model inflates a company's required cost of equity. CCC Ex. 1.0 at 16-17, L. 469-89.

As to the DCF model, CCC states that research shows that estimating the cost of equity using analyst growth forecasts in the DCF model results in a cost of equity

that is too high. CCC Ex. 1.0 at 15-16, L. 448-49, 454-56. According to a study cited by **[*385]** ComEd witness Dr. Hadaway, analyst "growth forecasts are overly optimistic and add little predictive power." City Ex. 1.0 at 16, L. 458-60, *citing* Chan, L., Karceski, J. and Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, April 2003, p. 643.

CCC argues that the body of growing research showing that the CAPM and DCF models overstate the required cost of equity for utilities argue for adoption of Mr. Bodmer's investment bank analysis, which represents a more direct and objective method for determining the appropriate cost of equity for ComEd.

Market to Book Ratio

CCC argues that Mr. Bodmer tested his position that traditional methods for measuring a company's cost of capital overstate the needs of investors by analyzing the market to book ratios of 71 utility companies. CCC Ex. 1.0 at 42-43, L. 1277-87; CCC Ex. 1.04. CCC states that it is commonly accepted that a company earning its expected cost of capital has a market to book ratio of one. CCC Ex. 1.0 at 42, L. 1256-58. If a company's market to book ratio is above one, it is earning in excess of its expected rate of return. Conversely, if a company's market to book ratio is below one, it **[*386]** is earning less than its expected rate of return. CCC Ex. 1.0 at 42, L. 1261-64.

CCC asserts that Mr. Bodmer's analysis of the 71 utilities found that on average, these companies have a market to book ratio of 1.75. That is, these utilities are earning in excess of their allowed cost of capital. *Id.* at 43, L. 1286-87; CCC Ex. 1.04. CCC states that Exelon -- ComEd's parent corporation -- had the highest market to book ratio of all of the utility companies analyzed -- 3.38. CCC Ex. 1.0 at 43, L. 1285-86; CCC Ex. 1.04. CCC pointed out that no party challenged Mr. Bodmer's conclusions on these points.

CCC avers that Mr. Bodmer's graph of market to book ratios and **returns on equity** for the 71 companies examined showed a strong positive relationship between a utility's market to book ratio and its **return on equity.** CCC Ex. 1.0 at 43, L. 1298-99, 1307-17. CCC added that Mr. Bodmer's regression analysis on the information presented in his graph showed that the only significant variable affecting market to book values is the cost of equity. *Id.* at 44, L. 1329-30. That is, a higher the cost of equity translates into a higher market to book value.

CCC concluded that Mr. Bodmer's analysis **[*387]** invalidated ComEd witness Dr. Hadaway's risk premium approach. *Id.* at 45, L. 1363. According to CCC, if Dr. Hadaway's approach were valid, the utility commission rates of return he included in his analysis would have market to book ratios nearing one. *Id.* at 45, L. 1365-67. According to CCC Mr. Bodmer's analysis showed that the market to book ratios have consistently been far above one. CCC argues that this confirms Mr. Bodmer's point that utility commissions have been setting returns in excess of utilities' actual cost of capital. *Id.* at 45, L. 1367-70.

IIEC

IIEC argues ComEd overestimated its required return on common equity when it requested an authorized equity return of 11%. IIEC, through its witness Mr. Gorman, recommended a return on common equity ("ROE") of 9.9%, which Mr. Gorman found

adequate to support ComEd's credit rating and its financial integrity.

IIEC's recommendation was based on Mr. Gorman's multi-faceted analysis, which considered the results of a constant growth discounted cash flow model ("DCF"), a risk premium model ("RP"), and a capital asset pricing model ("CAPM"). IIEC's recommendation is based on these results of Mr. Gorman's models: DCF **[*388]** (9.7%); RP (10.2%); and CAPM (10.2%). According to IIEC these three analytical models, each of which was used by at least one other ROE witness in this case, have been employed regularly in Illinois regulatory proceedings.

IIEC states ComEd's witness Dr. Hadaway, also conducted multiple studies, but IIEC says virtually every cost estimate made by Dr. Hadaway was overstated and flawed. IIEC asserts that its witness Mr. Gorman showed that using reasonable estimates, and excluding Dr. Hadaway's unreasonable add-on premiums, Dr. Hadaway's own analysis would support a **return on equity** under 10.0% as reasonable for ComEd.

IIEC argues the DCF model posits that a stock is valued by summing the present value of its expected future cash flows, discounted at the investor's required rate of return ("ROR") or cost of capital. The model's basic equation can be arranged to estimate the investor required **return on an equity** investment. The constant growth rate DCF model, which assumes dividends grow at a constant rate, is expressed mathematically as follows:

K = D1 P0 + G

where: K = the investor's required return;

D[1] = dividends in the first year;

P0 = current stock price; and

G = expected constant **[*389]** dividend growth rate.

IIEC says the primary disputed DCF model input in this case is the growth rate. To estimate "G" (the expected constant growth in dividends), IIEC witness Gorman used the consensus estimate of investment analysts of the expected growth rate. With this input, his constant growth DCF model yielded a range of 9.3% to 9.4% for the return on common equity. Mr. Gorman selected 9.4% from that range as his DCF return on common equity. Consistent with past Commission practice, Mr. Gorman then adjusted the results of his constant growth DCF formula to recognize quarterly compounding. As adjusted, his DCF analysis produces a recommended return on common equity of 9.7%.

IIEC opines that in ComEd's view, the alleged problem with Mr. Gorman's analysis can be traced to his sole reliance on analysts' growth rate estimates to determine the growth rates for his DCF model, giving no weight to long-term growth forecasts. However, Mr. Gorman explained that security analysts' growth estimates have been shown to be more accurate predictors of future returns than growth rates derived from historical data and are the most likely growth estimates that are built into stock prices.

IIEC **[*390]** asserts that Mr. Gorman's consensus analysts' growth rates (4.67% and 4.42%) for the proxy groups he and ComEd used were reasonably consistent

with five-year projected GDP growth of 5.3%, and considerably higher than the five-year projected GDP inflation growth of 2.4%. Utilities' dividend growth cannot sustain a growth rate exceeding the growth rate for the economy. Therefore, growth rates for the economy in the utility's service territory are a good proxy for a sustainable long term growth rate for earnings.

IIEC says Mr. Gorman used a conservatively high growth estimate, based on virtually every logical and verifiable assessment of long-term sustainable DCF growth. He describes the input as conservative because historically these utilities' dividend growth have not exceeded the rate of inflation, projected growth but his analysis approaches two times the projected rate of inflation of 2.5%. IIEC says Mr. Gorman was conservatively high because historically, utility earnings and dividends have grown at a rate much slower than GDP growth.

IIEC says Mr. Gorman's conservative growth variables reflect the conditions most likely to prevail while the rates determined in this case will be **[*391]** in effect. It reasons that over the longer term, ComEd is unlikely to suffer inadequate returns, since the utility can be expected to file for changes in its authorized return and its delivery service rates if there is a significant variance from current growth projections.

On the other hand, IIEC says, ComEd's proposed analysis uses historical data that unreasonably denies its customers any benefit of today's (and likely tomorrow's) reality. IIEC says the Commission should accept Mr. Gorman's analysis estimating ComEd's required return on common equity.

IIEC also points out its witness used a risk premium model in estimating ComEd's required **return on equity.** The risk premium model is based on the principle that investors require a higher return to assume a greater risk. Common equity is viewed as having greater risk than corporate bonds. Under the RP model, the risk premium representing the greater risk of equity in comparison to bonds may be calculated in two different ways: (a) as the difference between the required return on utility common equity investments and a U.S. Treasury bond; and (b) as the difference between the **return on equity** approved for utilities by regulatory commissions **[*392]** and the return on contemporary utility bonds. IIEC says its witness, Mr. Gorman, used both methods and developed an RP return on common equity recommendation of 10.2%, which was considered along with his DCF and CAPM model results in determining his final ROE recommendation.

IIEC says ComEd questioned Mr. Gorman's analysis because he declined to make several baseless adjustments that inflate Dr. Hadaway's RP Estimate. Mr. Gorman used a combination of current and projected interest rates. Dr. Hadaway relied entirely on projections according to IIEC. IIEC says ComEd's reliance on projections is misplaced because the accuracy of projected interest rates is highly problematic. In addition, IIEC says Dr. Hadaway increased his claimed equity risk premium from 3.08% to 4.4% based on an alleged inverse relationship between interest rates and risk premiums, thus increasing ComEd's recommended equity cost. Mr. Gorman rejected this adjustment because it has been shown to be questionable by academic studies. IIEC also states Mr. Gorman relied on actual observable bond yields, while Dr. Hadaway's RP study used his own idiosyncratic projection of bond yields. IIEC argues Mr. Gorman's RP analysis **[*393]** is more reasonable and merits the Commission's reliance.

IIEC states that Mr. Gorman's use of a combination of projected and current, observable interest rates was carefully considered and fully justified. It says Mr. Gorman conducted an extensive analysis of interest rate data to answer the question whether the Commission should follow Dr. Hadaway's lead and accept interest rate projections over "observable and verifiable" interest costs. While projected interest rates should be given some consideration, the determination of ComEd's cost of capital today should be based primarily on observable and verifiable actual current market costs, because projected changes to interest rates are highly uncertain and the accuracy is at best problematic. Mr. Gorman chose to be conservative in his analysis by considering both current and projected interest rates, thus reflecting a range of possible interest rates during the period rates set in this proceeding are in effect.

IIEC says considerable protection against increasing costs of capital is inherent in a utility's right to initiate ratemaking proceedings. This provides an effective hedge against increasing costs and is additional reason why **[*394]** there was no need to inject uncertain capital costs into rates. IIEC argues the Commission can be confident that ComEd will act if actual interest rates diverge significantly from current projections. Accordingly, IIEC says Mr. Gorman's RP model, which recognized the reality of today's economic conditions and today's investor's expectations should be accepted as the superior analysis by the Commission.

IIEC says its witness Mr. Gorman also performed a CAPM analysis, which is a specialized form of risk premium analysis. Mr. Gorman developed a CAPM analysis as well as DCF and bond yield RP analyses. According to IIEC, Mr. Gorman's CAPM results varied only modestly from his other models; in fact, his CAPM and RP results were identical.

IIEC opines that Mr. Gorman's CAPM results were also well inside the range defined by the CAPM result extremes of CUB on the low end and Staff on the high end. Accordingly, IIEC says the debate on CAPM issues has focused on other witnesses' application of this model.

Commission Analysis and Conclusion

ComEd asserts its cost of equity should reflect the costs of equity recently approved for electric utilities in the United States. The cost of equity **[*395]** appropriate to ComEd, however, is specific to that utility. ComEd may not simply adopt the cost of equity set for other utilities scattered around the country, for which the facts and circumstances are not necessarily similar. Rather, pursuant to Section 9-201 of the Act, ComEd must prove that its proposed cost of equity is just and reasonable.

ComEd also asserts that it faces additional financial risk if it does not receive its requested capital structure. The Commission disagrees that the just and reasonable capital structure imposes extra risk on the Company, regardless of whether it is the one proposed by ComEd or another.

The parties have raised three considerations that impact their respective estimates. We turn first to those issues.

The first is whether ComEd's use of GDP growth rates to estimate long-term growth expectations of individual companies in the DCF model improperly overestimates the model's results. ComEd asserts that GDP growth rates should be used to model long-

term growth for the DCF analysis. Staff, CCC, and IIEC criticize ComEd's approach.

Staff states that ComEd's inappropriate application of the economy-wide GDP growth rate as an estimate of the growth of **[*396]** the individual companies in the samples being modeled accounts for almost all of the difference between the cost of equity estimates advanced by Staff and ComEd. Staff points out that ComEd witness Hadaway's 6.60% GDP growth rate is 200 to 300 or more basis points higher than the expected company-specific growth rates for the companies in his samples. Furthermore, the application of the economy-wide GDP growth rate assumes that the utilities will grow at the same rate, but the empirical evidence suggests below-average growth based on below average risk shown by betas of less than 1.00. Staff also contends that, even if GDP growth rates were accepted as a general matter, ComEd's rate of 6.60% is unsustainable and overstated compared to published GDP growth expectations cited by Staff and IIEC.

CCC argues that ComEd witness Hadaway used an unsustainable 6.60% rate of GDP growth, that this vastly overstates their cost of equity, and implies **returns on equity** in excess of 20%. IIEC extends this by observing that utility earnings and dividends grow substantially more slowly than GDP growth. Furthermore, IIEC points out that ratepayers bear the risk of exaggerated rates under ComEd's proposal, **[*397]** while the Company may seek rate relief in the event that there is a significant variance from current growth projections.

The Commission finds that the use of GDP growth rates to estimate long-term growth leads to an improper and overstated estimate of the cost of capital. Furthermore, the Commission does not find merit in the Company's assertion that a five-year period fails to adequately consider long-term growth expectations. Accordingly, ComEd's use of GDP growth rates is rejected.

The second issue concerns CCC's use of investment bank analysis in calculating the cost of equity for ratemaking purposes. CCC witness Bodmer analyzed the valuation conducted by Morgan Stanley and other investment banks for the ongoing merger of Exelon and PSE&G, and used this as a basis for his 7.75% cost of equity recommendation. CCC alleges that the investment bank analysis provides a more direct assessment of the cost of equity for ComEd, and that it is not subject to the assumptions made in modeling the cost of equity of a non-traded subsidiary such as ComEd. Finally, CCC contends that the CAPM and DCF models can be manipulated, while the competitive market in which the investment banks compete **[*398]** forces their analyses to be unbiased.

ComEd asserts that CCC's use of investment bank analysis for use in calculating a discount rate for ratemaking purposes is not appropriate due to various methodological differences that do not necessarily estimate the utility's reasonable return on rate base. Staff concurs that the investment bank cost of equity estimates are inappropriate due to a variety of assumptions with respect to the instant case that may or may not match those used by the banks themselves.

The Commission agrees with ComEd and Staff that, for purposes of this case, the problems inherent with the use of the investment bank analyses outweigh their contribution to the entire body of evidence.

The third issue concerns CCC's theory for the market-to-book ratio. CCC alleges that companies earn exactly their cost of capital when the market-to-book ratio is 1.00.

CCC further contends that their analysis of 71 utilities shows they typically earn more than their cost of capital, and ComEd parent Exelon earns most of all.

Staff criticizes CCC's theory, asserting that it is oversimplified and not readily applicable. Staff notes that certain ratemaking practices can account for variation **[*399]** in the market-to-book ratio, so a ratio in excess of 1.00 is not necessarily too high. Staff also points to a wide range of risk in the 71 companies analyzed, implying a range of required rates of return rather than a uniform cost of equity derived from a single "correct" market-to-book ratio. Finally, Staff avers that the components of the market-to-book ratio are inconsistent in terms of time and construction, rendering application for ratemaking problematic. ComEd also criticizes CCC for suggesting that the cost of equity should reflect the market-to-book ratio. ComEd points out that there are legitimate reasons for variance from market-to-book, and that such variance does not necessarily signify over-earning by the utility.

The Commission declines at this time to impose a strict market-to-book regime in the determination of the cost of equity. The Commission believes that such a model is too inflexible and may not adequately reflect a utility's cost of equity. Accordingly, it is rejected.

In light of the determination of the foregoing issues, the Commission finds that the ComEd proposal is excessively high due to its improper application of the GDP growth rates, and the CCC proposal **[*400]** is inadequately low due to its application of the latter two issues just rejected. This leaves the proposals of Staff and IIEC. The Commission notes that the results of the analyses produced by Staff and IIEC are relatively close, and that the amount of argument from either against the other is minimal. Although the Commission has rejected the CCC proposal in this case, the Commission finds the observed equity return requirements of ComEd's investment banks compelling. Therefore, the Commission finds that the CCC analysis justifies adoption of a cost of equity in the lower portion of the range of reasonable return levels for ComEd. Accordingly, the Commission adopts a 10.045% cost of equity, which is slightly lower than Staff's proposal of 10.19%.

4. APPROVED RATE OF RETURN ON RATE BASE

Upon incorporation of the conclusions stated above, the Commission finds that ComEd's capital structure and cost of capital, resulting in overall cost of capital of 8.01% may be summarized as follows:

Class of Capital	Proportion	Cost	Weighted Cost
Long-term debt	57.14%	6.48%	3.70%
Common Equity	42.86%	10.045%	4.31%
TOTAL	100.00%		8.01%

The Commission finds that this **[*401]** overall cost of capital to be reasonable and should be used for purposes of ComEd's authorized rate of return on rate base in this proceeding.

VI. COST OF SERVICE ISSUES