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# SENATE BILL 1652: SMART GOVERNMENT, SMART GRID, SMART BUSINESS

## INTRODUCTION

In May 2011, the Illinois Business Roundtable (IBRT) issued a white paper entitled *Smart Regulation for an Illinois Smart Grid: Modernizing Illinois' Energy Delivery Network and Its Regulation*.<sup>1</sup> That paper advocated streamlining electric utility regulatory procedures in order to stimulate investment in modernizing the electricity delivery system, with special attention to the accelerated introduction of "Smart Grid" technologies. The Business Roundtable sees the economic development and consumer benefits of the Smart Grid in the same light as we did in advocating the reform of telecommunications regulation in 2010.<sup>2</sup>

With Illinois' economy and job growth in mind, IBRT contributed to an important policy debate that led to passage by the Illinois General Assembly of Senate Bill 1652. Governor Pat Quinn has vetoed the measure. The continuing debate over SB1652 has focused primarily on three issues:

- whether regulation is being weakened rather than streamlined;
- whether regulatory reform is a key factor in network modernization and deployment of Smart Grid; and
- whether the financial terms, particularly the return-on-equity formula, is out of line with industry and Illinois norms.

This paper, *Senate Bill 1652: Smart Government, Smart Grid, Smart Business*, addresses these three questions in the context of the widespread acceptance of the value of a reliable and intelligent electric delivery network for Illinois business to prosper in a globally competitive market place. ***Only Illinois business can provide the jobs and the tax revenue so needed by the State of Illinois.*** This paper concludes by strongly recommending that SB1652 deserves final enactment into law because the legislation reasonably resolves all three issues. In short, SB1652 is fully consistent with the principles set out in the May 2011 IBRT white paper and incorporates conditions aimed at achieving the objectives enunciated in the bill.<sup>3</sup>

## **I. LEAN REGULATION ISN'T WEAK REGULATION**

SB1652 codifies a careful approach to bringing several longstanding regulatory methods more into line with technologies and markets that are vastly different than those that existed when the Illinois Commerce Commission (ICC) was created in 1913.<sup>4</sup>

### **SENATE BILL 1652 IS WELL-MEASURED REFORM**

The General Assembly-passed SB1652 is different in notable ways from the originally proposed measure. Importantly, the final legislative product adhered to the key principles articulated in the IBRT's May White Paper, which were:

- use of an annual formula rate procedure to implement new rates;
- annual ICC prudence and reasonableness reviews to determine capital and operating expense disallowances on a retrospective basis;
- annual true-up in the next year's rates for any disallowances or other approved adjustments;
- open participation by all interested parties in all annual reviews, with all traditional discovery and evidentiary rights;
- separate, revenue-neutral rate design and cost allocation proceedings at least every three years, or more often if ICC determines, to assure alignment of rates with energy efficiency and other policy goals; and
- standards requiring specific minimum levels of performance improvement in operating areas such as reliability, safety and customer service.

These principles, if followed, align traditional utility regulation to new challenges. These include the need to invest in the strengthening of the electricity delivery system and to accelerate deployment of Smart Grid technologies. SB1652's details for implementing these principles deserve serious discussion to determine if we can expect its approach to support network modernization and Smart Grid technology. This paper addresses the most salient implementation issues.

## **REGULATION IS STREAMLINED TO IMPROVE PERFORMANCE**

Illinois and the nation are in a period of extended economic weakness, manifested in highly volatile and skittish financial markets. Since IBRT issued its Smart Grid paper in May 2011, Illinois unemployment has increased from 8.9 percent to 9.9 percent in September, according to the U.S. Bureau of Labor Statistics. Only investor confidence can bring job growth and investors have a world of investment choices and carefully discern where their dollars can get the highest return in the most secure setting. Illinois' current approach to rate-regulated electricity delivery simply cannot compete for investment. Our regulatory climate is unpredictable, and it consistently receives low marks from knowledgeable industry analysts.

In a time of capital need, this is a critical problem. Substantial debt and equity capital will be committed only to utilities in those states where regulatory conditions provide reasonable assurances that debt can be serviced and that good utility operations and performance are likely to produce reasonably steady returns. Returns must be at least comparable to those available for similar investment in other states. But, in recent years, Illinois has not fared well in the comparative ratings of state regulatory climates. Just within the past year, Regulatory Research Associates (RRA), a major firm advising investors rated Illinois as "Below Average 2," the second lowest rating given. Indeed, Illinois is among the three lowest ranked states from a regulatory standpoint (Connecticut and Maryland are the other two).<sup>5</sup> RRA reported that while Illinois had been reasonably stable for the past couple of years and has improved, recent ICC and court decisions threatened to revive instability and restrict investment.

In August 2011, Moody's Investors Service issued a credit opinion on ComEd that reported, among other things, that the ICC's June 2011 rate case order "...reintroduced uncertainty and less predictability into the regulatory process." However, Moody's said, "The rating can be upgraded if the company continues to produce credit metrics in line with a strong Baa transmission and distribution company and if the regulatory compact in Illinois becomes more predictable." In other words, if both the utility and the State government do their parts of the job, then credit ratings and cost of capital and therefore cost to customers can improve.<sup>6</sup>

To attract the nearly \$3.2 billion identified by SB1652 to improve the ComEd and electric grid, the bill aims to create reasonable levels of certainty and predictability.

***Finally, the changes proposed by SB1652 are built on two traditional principles:***

- ***Utility regulation is a legislative function***
- ***Consumer protection and due process are achieved through the Illinois Commerce Commission***

***Utility Regulation is a Legislative Function***

Utility regulation and rate setting are legislative functions that, for a variety of historical and sound practical reasons, have largely been delegated – or outsourced – to professional regulatory bodies. This means that if the General Assembly determines there should be new policies or that there should be a specific regulatory method used in setting rates, it is perfectly appropriate to do so. The only issue is whether the policy or method is a good one and will have good results.

It is not enough for policy makers or regulators to say they support investment in the electricity network or to claim that Illinois utility regulation instills confidence. The actual record of performance has led to low utility investor ratings for Illinois that would give any investor pause. Only formal change that ends unpredictable regulatory outcomes can begin to instill that confidence.

***Key Regulatory Powers of the Illinois Commerce Commission under SB1652***

SB1652's streamlining goes directly to the heart of the problem – while upholding the ICC's traditional ability to protect customers from imprudent or unreasonably costly investment or out-of-line operating expenses. SB1652 deprives no one of access to Commission proceedings. Nor does it limit discovery by participating parties.

Under SB1652, the ICC remains a professional body exercising expert judgment within broad parameters set by the General Assembly. These include:

- annual ICC review of actual investment and direct job creation mandated under SB1652 with the power to terminate a utility's eligibility for streamlined regulation if the utility fails to meet investment, delivery reliability, and job creation targets;

- annual ICC investigation of the “prudence and reasonableness” of investment and expenditures by utilities, whether part of the SB1652 infrastructure program or for other utility purposes, and to deny recovery of same;
- ICC review and approval of the particulars of the initial performance-based return-on-equity formula in order to assure compliance with the standards in SB1652;
- ICC establishment of protocols for annually determining ongoing attainment of performance standards by the utility set out in the bill; and
- annual ICC review and approval of rates under the very same evidentiary standards of reasonableness and prudence that have long been in use by the Commission.<sup>7</sup>

ICC review and approval of utility customer rate designs no less than every three years in special focused proceedings, thus assuring more attention to aligning prices and costs for specific services and customer classes.

SB1652 upholds the ICC as the centerpiece of protection of consumers from potential monopoly abuse, while restoring its role as a moderating influence on risk, in order to encourage investment in improving utility services

## **II. REGULATORY REFORM AND INFRASTRUCTURE INVESTMENT ARE CONNECTED**

Utilities are businesses and among the most capital-intensive businesses. State utility regulation was originally designed in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries to bring the predictability and stability necessary to elicit long-term investment for deployment of what were seen as new and wondrous technologies.<sup>8</sup>

The Illinois General Assembly in passing SB1652 reached much the same conclusion as did the IBRT in its May 2011 White Paper – Illinois regulation is neither predictable nor stable enough. Conventional regulatory approaches no longer mitigate risk, but add to investment risk. Given the investment requirements of the electricity network for modernization and Smart Grid deployment, there is every reason for policy makers to reform regulation and thereby leverage private resources to improve Illinois’ infrastructure, economy and incomes. Doing so makes Illinois regulation a moderating force over investment risk rather than acting as an obstacle to investment.

Investment and regulatory analysts, who deal with cold, hard facts, have rated Illinois' utility regulatory climate as inferior to almost every other state. Such conclusions channel private technology investment dollars away from Illinois to other, less risky venues.

## **RATE CASE DISALLOWANCES AND INVESTOR UNCERTAINTY**

Rate cases for major utilities are contested proceedings. They are expected to be contentious. SB1652 will not change that.

However, one of Illinois' key areas of uncertainty has been ICC disallowances of costs incurred by utilities, either in operating expenses or in investments made by the utility. Many of the disallowances on investment, or rate base, have been made not because they were determined to be imprudent or unreasonable. Rather, in many cases, the disallowances are for timing reasons. The "timing" problem in question arises when an investment is made during the course of a pending rate case. The timing issue may seem highly technical, but it carries substantial real world consequences that naturally and adversely influence investors about committing capital to Illinois utilities. Disallowances also result from "functionalization" determinations in which actual costs may be assigned by the ICC to a function outside of its jurisdiction, such as for transmission, but which costs federal regulators may not have assigned to transmission, which is in their purview. Again, in these circumstances there has not been a determination of imprudence or unreasonableness.

It is important to note that the issue here is consistency and predictability and not the ability of the ICC to disallow imprudent and unreasonable investments or expenditures. Timing disallowances mean that the utility will be denied recovery of depreciation and recovery of the debt and equity cost of capital for the investment until such time in the future when the investment would be included in the rate base. The forgone recovery during that hiatus will never be recouped and can amount to many millions in denied recovery for investments that will be determined to be prudent and reasonable. Investment denied on the basis of functionalization may or may not be included in rate base in the future, further exacerbating the uncertainty.

Following the 1997 industry restructuring law, the ICC has conducted delivery-only rate cases for ComEd and the Ameren companies. In the five ComEd delivery rate cases since 1999, timing disallowances have totaled approximately \$900 million, while functionalization disallowances have totaled approximately \$665 million.<sup>9</sup> In this same period, Ameren's three separate utilities, much smaller than ComEd when taken together, went before the

ICC three times for delivery rate cases and experienced about \$120 million in similar investment disallowances.<sup>10</sup> Investors facing the prospect of denial of recovery on the basis of timing and functionality will naturally either avoid making the investment or make capital more costly for the utility and therefore its customers. SB1652 would address the timing problem and would direct the ICC to establish protocols for the functionalization and other allocation issues as well as for methods by which the ICC would make prudence and reasonableness determinations with respect to operating expenses.

## **ILLINOIS WOULD NOT BE ALONE IN REFORMING REGULATION**

Many other states are taking steps to attract investment in the grid by reforming regulation. If Illinois fails to move ahead then we will remain at a competitive disadvantage in economic, income and job growth. A variety of specialized arrangements have been forged by other states to encourage private investment in the delivery network. Indeed, a majority of states are moving toward more responsive regulatory models and are pursuing alternative forms of regulation for greater consistency and predictability.<sup>11</sup>

Some states emphasize improved timing of rate changes to minimize regulatory lag. Others center on setting prospective revenue levels that can be adjusted subsequently against actual experience. For example, nearly half the states have put in place or are installing tracking mechanisms that encourage utilities to commit to multi-year capital programs so that regulators and investors may rely on an established plan. A half-dozen of these states have implemented corollary multi-year rate plans that tie rate changes to anticipated investment and operating expenses with provision for adjustments that reconcile for various types of changes. A dozen states are using either formula rate approaches or rate indexing.<sup>12</sup>

Many states are reforming regulation aimed at Smart Grid deployment in recognition of its value in facilitating more opportunity for energy efficiency and renewable energy. In all cases, there is a rising tide of awareness that private investment to modernize critically important electricity infrastructure comes only if adequate regulatory mechanisms are in place.

There are various ways of bringing greater certainty to the regulatory process in order to better attract needed capital investment. There is no single, perfect method. New ideas will emerge with experience. With SB1652, Illinois has an opportunity to make progress and can make further improvements over time.

### III. FINANCIAL TERMS AND PROFIT TARGETS ARE REASONABLE

SB1652 addresses utility regulation's twin goals of allowing utilities a fair opportunity to recover their costs and to earn a reasonable profit in order to attract needed capital investment. The first is using methods that are reasonable and aimed at achieving a fair result. The second is actually achieving those results.

#### THE RATE SETTING FORMULA

Some of the most poorly-grounded criticisms of SB1652 has been aimed at its four provisions intended to bring the predictability and stability the General Assembly identified as important for attracting capital for job-growth improvement of the delivery network. As is shown below, the criticisms are utterly misdirected.

- *Establishing a specific formula for costs of capital, including return-on-equity:*

Critics of SB1652's articulation of a formula for cost of capital neglect three important factors:

First, SB1652 provides that the actual capital structure of the utility, the balance between debt and equity, will be used in setting rates. This approach has been standard ICC practice for the major electric utilities.<sup>13</sup>

Second, the bill requires that the actual cost of debt (loans and bonds) will be used, again standard ICC practice for the major electric utilities.

Third, SB1652 would peg the allowed return-on-equity at a 6% (600 basis points) premium over the prior twelve-month average monthly rate for 30-year Treasury bonds, traditionally the risk-free benchmark investment. This method is one that has customarily been in evidence in many electric utility rate cases at the ICC and around the United States.

- *Assuring that certain issues decided by the ICC will not be revised retroactively:*

Investors are understandably concerned with unnecessary regulatory uncertainty being introduced when issues that had been fully addressed and decided by the ICC in prior cases are revisited in later ones. While SB1652 does not include a blanket prohibition on revisiting issues it authorizes the ICC to adopt protocols for the treatment of certain items, as long as the specific expenses are prudent and reasonable. The items are those that have been subjected in successive rate cases

to recommendations for widely varying treatment. The very real risk has been that a utility could suffer disallowance of an item previously recognized by the ICC as recoverable, since these have included pension funding, incentive compensation and severance expenses,<sup>14</sup> as well as recovery/amortization of regulatory assets and amortization periods for regulatory expenses.

- *Setting predictable dates and time frames for ICC proceedings:*

Utility rate cases have almost always been initiated at the request of the utility and have usually lasted the full eleven-month period allowed. The regulatory climate has become more bureaucratic and legalistic, rather than focused on financial and economic issues. Two-thirds of utility assets were removed from the rate-making process with the advent of competitively priced supply following the 1997 industry restructuring law. Nonetheless, rate-making proceedings still consume the original eleven-month time line that was set decades ago in the Illinois Public Utilities Act. SB1652 establishes a firm annual schedule for adjusting overall levels under the formula. It requires a review of the rate design and pricing of specific services at least once every three years. These steps should allow all parties to better prepare and schedule. They will also allow utilities and all other parties to allocate regulatory resources realistically for annual revenue review cases lasting eight-and-a-half months and for separate rate design cases which that would occur at least once every three years and that would have flexible schedules determined by administrative law judges at the ICC.

- *Utilizing standardized Federal utility data as the basis for investment and expense filings:*

SB1652 prescribes that the basic data to be used in annual Commission rate procedures is the official Federal Energy Regulatory Commission filing (FERC Form 1). ICC and all other utility commissions have long used FERC Form 1, and the accounting standards on which it is based, with minimal variations, as the basis for annual utility reporting at the state level. This allows for standardized comparisons. SB1652 also establishes that the initial rate setting and the annual rate reviews will provide all parties access to the same information and level of detail they receive under the current process.

The reasonableness of the earnings formula is further indicated by the inclusion in SB61652 of service and reliability performance metrics and requirements for levels

of investment that, if unmet as determined by the ICC, will result in RoE penalties and possible termination of the regulatory reforms.

## **RETURN-ON-EQUITY: REGULATION AND RESULTS**

ICC rate cases normally include many pages of testimony and evidentiary material about return-on-equity (RoE). The RoE level set in a utility rate case is not a guaranteed level of earnings for the utility. It is a target. As such, it serves as factor determining the total estimated revenue level by assigning a value by which to multiply the portion of the capital structure that is equity. So, if the RoE is 10%, and the equity portion of the capital structure is \$1 billion, the estimated target profit is \$100 million for a one-year period.<sup>15</sup>

Investors in a business that operates in a competitive market earn as much or as little on invested capital as the market allows. Utilities, however, are set up as legal monopolies and, as such, are allowed to earn no more than the risks associated with the business would justify. Determining the proper target profit level is a fundamental feature of utility regulation as determined by the legislature. Investors will consider regulatory climate and outcomes when determining whether to invest in an Illinois utility or elsewhere. As discussed further below, Illinois' electricity delivery utilities have consistently earned RoEs far less than authorized.

However, the volume of attention to RoE in a rate case, with numerous competing mathematical models often having widely varying results, may itself suggest that it is "much ado about nothing." If the issue is estimating the riskiness of an electricity delivery business that is no longer combined with generation and supply business, then it may well be that a simpler approach with a time-honored status would be superior. Simplicity can provide greater certainty in the process and create opportunities to direct regulatory and participant resources toward more complex issues such as prudence, technology, rules for competitive supply and rate design.

SB1652 installs a premium-to-Treasuries formula that quite closely approximates the RoE results determined by the ICC in rate cases over the past several years.

Had the ICC relied exclusively on the method contained in SB1652, the Commission would have arrived at much the same decisions as it did interpolating from the widely varying models offered by many different parties. This is the case in the most recent ComEd case, decided in May 2011, in which the authorized RoE was 10.5 percent. That is 27 basis points higher than the 10.22 percent produced by adding the 6 percent premium in SB1652 to the

average monthly rate of 4.22 percent for 30-year Treasuries during the period June 2010 through May 2011. Thus, the authorized RoE set by the ICC was higher than that indicated by the SB1652 formula. It is consistency and predictability that is the goal of reform -- not a higher RoE.<sup>16</sup>

Further, the reasonableness of that 10.22 percent RoE figure is indicated by a range of comparative data. First, 10.22 percent is just below the 10.29 percent mid-point of the range of RoE levels set by the ICC in the eight electric rate cases covering five separate Illinois electric delivery utility companies that preceded the most recent ComEd order.<sup>17</sup> That range was 9.9 percent to 10.68 percent.

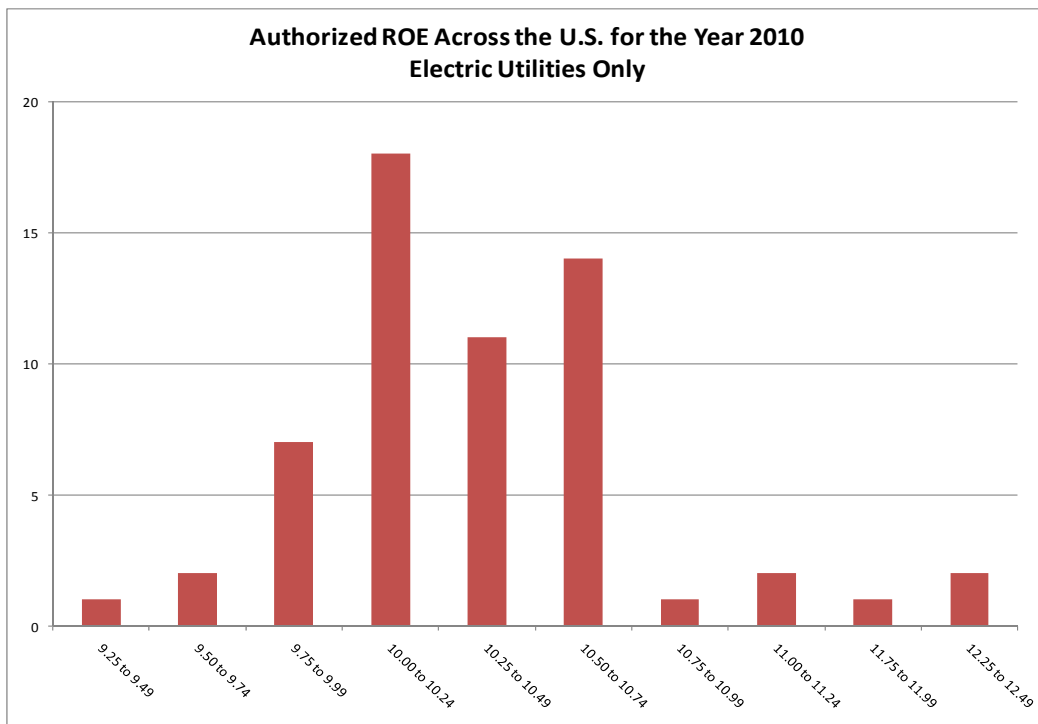
Second, as the two charts below indicate, the 10.22 percent figure is not at all out of line with the overwhelming majority of rate setting decisions by utility regulators across the country, whether the time period is the 2010 one-year snapshot or a decade long time-series for 2000 through 2010.<sup>18</sup> This is illustrated in the two bar graphs below.

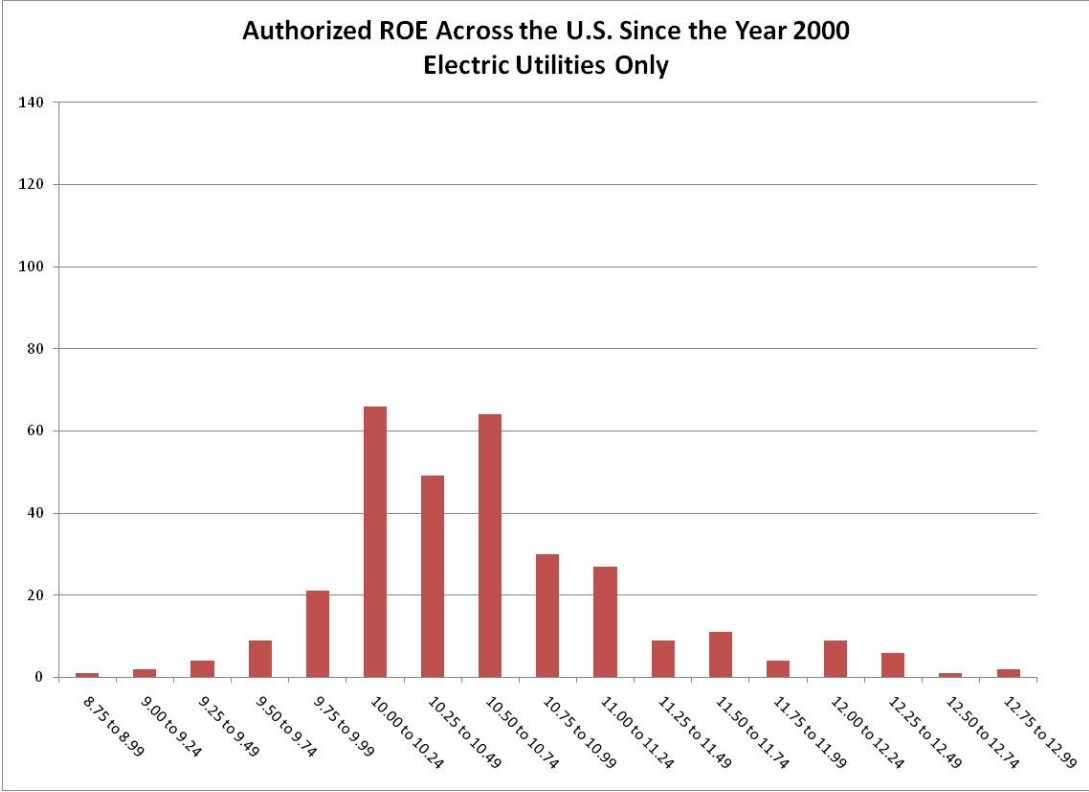
*Average RoE – 2010*

Median (mid-point)	10.26
Mean (average)	10.35
Total Decisions	59

*Average RoE – 2000-2010*

Median (mid-point)	10.50
Mean (average)	10.55
Total Decisions	315





Third, returns on equity for other major Illinois businesses tended to be higher, on average, than the RoE level implied by the formula in SB1652. The average earned RoE of the 35 Illinois based companies in the S&P 500 were consistently higher than the 10.22 percent allowed return that the SB1652 formula would have produced in the May 2011 ComEd rate case.<sup>19</sup>

**Average Earned RoE – 35 Illinois S&P 500 Firms**

2006	15.5%
2007	18.2%
2008	13.7%
2009	16.8%
2010	17.3%
5-Year Avg	16.6%

Fourth, when looking beyond Illinois' own boundaries for comparative return data, once again, the RoE levels produced by the formula must be regarded as fair and reasonable when compared to the individual sector and composite averages across the thousand of publicly traded firms in the United States.<sup>20</sup>

It should be clear enough that both the return-on-equity implied by SB1652's formula and the authorized returns by the ICC are reasonable. However, there may be a big difference between the "allowed" return-on-equity set by the Commission, which is a signal to investors, and the realized return-on-equity earned by a utility, which is the actual experience for an investor. Over the past decade, earned returns for the major electric utilities in Illinois, ComEd and the three Ameren utilities, Central Illinois Light, Illinois Power and Central Illinois Public Service, have often been at significant variance from allowed returns, as can be seen in the chart in the appendix to this paper.

Those variations are generally the result of two factors, one occurring in the business environment and the other a product of regulation. First, storm response costs, electric demand below expectations due to economic downturns and any number of other factors can increase expenses or revenue. Second, however, the Commission may disallow recovery on investments that have already been made or going-forward expenses that the company may see as essential. In the case of disallowed investment, the nominal allowed return-on-equity set by the Commission does not apply. The result is that the target is based on a smaller investment level than the actual level made by the utility.

The experience of Illinois utilities earning returns below authorized levels is the opposite condition needed to attract the substantial capital investment to modernize the network, deploy Smart Grid, increase Illinois competitiveness and produce more jobs. Since 2007, for example, ComEd's earned returns have averaged 340 basis points (3.4 percent) below the authorized RoE – about one-third less than the ICC authorized return.<sup>21</sup>

The three Ameren delivery utilities, which are combination gas and electric companies, have had a similar recent history. These three utilities have averaged about 300 basis points (3 percent) below their authorized RoE, again one-third less than the target.<sup>22</sup>

It is impossible to reasonably expect that \$3.2 billion in incremental investment capital will be forthcoming to these utilities if investors believe Illinois is failing to address the regulatory roots of the problem. That is what SB1652 is intended to do.

## CONCLUSION

Senate Bill 1652 is neither revolutionary nor radical. Rather, SB1652 reforms traditional utility regulation and updates Illinois' approach in ways entirely consistent with economic and financial principles to achieve consistency and predictability and attract capital investment for the delivery network – a principal goal of all utility regulation. The newness of this approach is that Illinois regulation has become less amenable to attracting substantial investment essential to modernization of the network and Smart Grid deployment.

Other states are moving ahead. They are reforming regulation to support Smart Grid technologies. Illinois should not anchor itself in the past. Neither should it fail to take the opportunity presented by SB1652 to assure an electrical grid suitable for a successful, globally competitive regional economy and the job growth it will bring.

## ENDNOTES

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<sup>1</sup> This paper and the May 2011 paper can be found on the Illinois Business Roundtable website at <http://www.illinoisbusinessroundtable.com/>

<sup>2</sup> In April 2010 the Business Roundtable issues *Modernizing the Illinois Telecommunications Act: A Rationale for Renewal* in support of successful legislation entitled *The High Speed Internet Services and Information Technologies Act* passed by the Illinois General Assembly in June 2010.

<sup>3</sup> In the opening “findings” section of the new Public Utilities Act section (16-108.5) entitled “Infrastructure, investment, modernization; regulatory reform” the General Assembly is clear about the connection between streamlining regulation and attracting investment to the network. “The General Assembly further finds that regulatory reform measures that increase predictability, stability, and transparency in the ratemaking process are needed to promote prudent, long-term infrastructure investment and to mutually benefit the State’s electric utilities and their customers, regulators, and investors.”

<sup>4</sup> The Illinois Public Service Commission was created by the General Assembly and commenced operation in January 1914 with the first appointments of commissioners by Governor Dunne. In 1921, the name of the agency was changed to Illinois Commerce Commission.

<sup>5</sup> Regulatory Research Associates, an independent utility finance research and advisory firm, is owned by SNL, Inc, which publishes a wide range of industry newsletters and databases.

<sup>6</sup> Moody’s Investors Service, August 25, 2011 ComEd Credit Opinion.

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<sup>7</sup> SB1652 states with respect to the setting of the initial rates under the formula that prior to their taking effect, “Such review shall be based on the same evidentiary standards, including, but not limited to, those concerning the prudence and reasonableness of the costs incurred by the utility, the Commission applies in a hearing to review a filing for a general increase in rates under Article IX of this Act.” (Section 16-108.5 (c) (6))

<sup>8</sup> Electricity regulation is based directly on the model originally created to bring order to chaotic markets in the financing and development of the railroad industry. As new technology-based industry arose that shared with railroads the characteristics of capital intensiveness and low incremental costs, the railroad model was adapted and railroad commissions were given new duties. These included not only electricity but also gas, telephone, trucking and airlines. As technology and conditions changed, much of the economic and pricing regulation of these industries gave way to competitive forces and industry restructuring. There is extensive literature on the evolution of utility and financial regulation from the original creation of expert agencies to oversee railroads, banks and insurance. One of the best known works is Thomas K. McCraw’s 1984 Pulitzer Prize winning book, *Prophets of Regulation: Charles Francis Adams, Louis D. Brandeis, James M. Landis, Alfred E. Kahn*.

<sup>9</sup> These aggregate figures were computed based on figures contained in a filing ComEd made with the ICC at the request of Commission staff (Data Request HR 14.6).

<sup>10</sup> This aggregate figure was calculated based in information provided by Ameren at IBRT’s request for this paper.

<sup>11</sup> One indication of how widespread the movement to Smart Grid and regulatory reform is around the country can be found in the *Chicago Tribune* story on the veto of SB1652 by Governor Quinn, in which a leading firm in Smart Grid technology, Silver Spring, states that 44 other states are implementing Smart Grid programs. See “Quinn vetoes Smart Grid bill” *Chicago Tribune*, September 13, 2011.

<sup>12</sup> This information is drawn from several sources, including the Electric Power Research Institute (EPRI), the National Regulatory Research Institute (NRRI) and from ComEd at the request of IBRT for use in this paper.

<sup>13</sup> The legislative prescription in SB1652 for the use of the actual capital structure of utilities participating in the rate setting formula would be a codification of the ICC’s decision in the two most recent ComEd general rate cases that use of the company’s actual capital structure was appropriate. The ICC’s decision came after a series of rate cases since the restructuring legislation of 1997 in which there was substantial conflict over capital structure.

<sup>14</sup> Pension plans, severance programs to adjust employment levels to economic realities and incentive compensation tied to performance are, by their nature, complex and multi-year. However, over the past decade, although the ICC had approved various approaches in prior rate cases, participating parties often strongly advocated and occasionally succeeded in obtaining Commission decisions that effectively denied recovery by ComEd of costs incurred under previously approved decisions.

<sup>15</sup> Law and practice require that the effect of income taxes be taken into account, so \$100 million in RoE must have added to it approximately another \$67 million to gross up for taxes. This general calculation was provided by ComEd in response to a request by IBRT for this paper.

<sup>16</sup> The calculation of return-on-equity under the formula in SB1652 can be easily performed by accessing the Federal Reserve website and clicking the “monthly” tab under “Treasury Constant Securities Nominal 30-Year” at

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<http://www.federalreserve.gov/releases/h15/data.htm> and doing a few minutes of addition and long division. For the first time, there would be an approach to RoE regulation accessible to any member of the public, as opposed to the complex, arcane process buried in reams of testimony, yet producing much the same result.

<sup>17</sup> Between September 2008 and May 2011, the Illinois Commerce Commission has issued nine electricity general rate orders for five utilities, two for ComEd, two each for the three Ameren utilities (Central Illinois Light – CILCO, Central Illinois Public Service – CIPS, Illinois Power – IP) and one for Mid-American. The authorized electric returns on equity were as follows:

September 2008: ComEd 10.3%; Ameren (CILCO, CIPS, IP) 10.65%;

March 2010: MidAmerican 10.13%

April/May 2011: Ameren – CILCO 9.9%, CIPS 10.16%, IP 10.26%; ComEd 10.5%

<sup>18</sup> These bar graphs were constructed on the basis of publicly available SNL data received from ComEd at the request of IBRT for purposes of this paper. The information from ComEd, in turn, was drawn from utility industry analysis firms using publicly available regulatory commission orders.

<sup>19</sup> The Illinois firm data was drawn from the S&P 500 and was supplied to IBRT by ComEd on request for purposes of this paper.

<sup>20</sup> Comparing costs of capital or of earned returns-on-equity across industry sectors is a topic that occupies considerable effort in both academia and within the investor research community. One especially interesting database that is publicly available is one that is hosted by the Stern School of Business of New York University. Interestingly, the return-on-equity section that was updated in early 2011 to reflect 2010 Value Line data, shows an average 10.28% earned RoE across nearly 6000 publicly traded companies in all industry sectors. This RoE level is slightly above the RoE that would be indicated by the formula in SB1652. The NYU site can be accessed at [http://people.stern.nyu.edu/adamodar/New\\_Home\\_Page/datafile/roe.html](http://people.stern.nyu.edu/adamodar/New_Home_Page/datafile/roe.html).

<sup>21</sup> The gap between authorized and earned RoE for ComEd have been significant according to information provided by ComEd in response to a request from IBRT for this paper. In December of 2006 the ICC set 10.45% as the allowed RoE for ComEd and set 10.3% in its September 2008 order. ComEd's earned returns were 4.54% in 2007, 5.21% in 2008, 9.26% in 2009 and 8.17% in 2010.

<sup>22</sup> The calculations of the gap between authorized and earned RoE are less precise for combination electric/gas utilities. Regulators sometime determine capital cost for the two functions provided by a single firm. The ICC has assigned lower RoE for gas than for electricity delivery for the three Ameren utilities. The chart below shows allowed RoE as an interpolated figure giving somewhat greater weight to the electric RoE since the asset base is greater than for gas. The chart is based on information provided by Ameren in response to a request from IBRT for this paper. The composite allowed RoEs were calculated by IBRT and should be considered weighted estimates.

Ameren Utility	Period Ending	Weighted Allowed RoE	Earned RoE	Difference (negative)
Ameren CIPS	December 2009	10.76%	5.03%	(573bp 5.73%)
Ameren CILCO	December 2009	10.67%	7.3%	(337 bp 3.37%)
Ameren IP	December 2009	10.67%	5.86%	(481bp 4.81%)
Ameren CIPS	March 2010	10.67%	5.5%	(517bp 5.17%)
Ameren CILCO	March 2010	10.67%	7.37%	(330bp 3.3%)
Ameren IP	March 2010	10.67%	6.22%	(445bp 4.45%)
Ameren CIPS	June 2010	10.06%	7.84%	(222bp 2.22%)
Ameren CILCO	June 2010	10.06%	8.06%	(200bp 2% )
Ameren IP	June 2010	10.06%	7.07%	(353bp 3.53%)
Ameren CIPS	September 2010	10.06%	8.89%	(117bp 1.17%)
Ameren CILCO	September 2010	10.06%	9.35%	(71bp .71%)
Ameren IP	September 2010	10.06%	8.03%	(203bp 2.03%)
Average				(317bp 3.17%)



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