STATE OF IOWA
DEPARTMENT OF COMMERCE
BEFORE THE IOWA UTILITIES BOARD

IN RE: INTERSTATE POWER AND LIGHT COMPANY	DOCKET NO. RPU-2009-0002

REPLY BRIEF OF THE OFFICE OF CONSUMER ADVOCATE

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

ARGUMENT

I. INCOME STATEMENT AND RATE BASE ISSUES

A. Transmission Costs

In Docket No. SPU-07-11 Interstate made a commitment to the Board that it would hold its retail customers harmless from any rate increase effects resulting from the transmission sale for at least eight years. The commitment was described in sworn testimony of a company vice president, who testified that the structure of the transaction and commitments by Interstate would essentially "zero out any rate increase effects" over the first eight years of the transaction. (Tr. 911). The commitment was also described in Interstate's initial and reply briefs.

In its initial brief in Docket No. SPU-07-11, Interstate unequivocally stated, "…IPL and ITC Midwest have agreed to a package of refunds, rate discounts, and customer risk mitigation commitments that will, at a minimum, ***hold customers harmless for at least an eight-year period*** until ITC transmission upgrades and enhancements are in place to benefit the customers beyond this eight-year period." (Emphasis added). (Tr. 114-17, 510-11). In its reply brief, Interstate repeated its unequivocal commitment, stating, "The ATA shields IPL's full requirements customers from ***any expected ratepayer impact*** resulting from the sale of IPL's transmission assets to ITC Midwest for at least eight years and potentially for 20 years." (Emphasis added). (Tr. 118).

The commitment outlined by Interstate in Docket No. SPU-07-11 was unqualified. The Board relied on Interstate's commitment in permitting the transmission sale to proceed, referring to it several times throughout its final decision. For example, the

Board observed, "Applicants argued that the proposed sale allows a top-flight company to take over the ownership of IPL's transmission assets ***and holds IPL's retail customers harmless, at least for eight years*** (under the ATA)." (Emphasis added). *Interstate Power and Light Co. and ITC Midwest LLC,* Docket No. SPU-07-11, *slip op.* at 30 (IUB, Sept. 20, 2007).

Now, however, Interstate argues in the instant proceeding that the hold harmless commitment did not mean what its witnesses, lawyers, and the Board said. According to Interstate, the hold harmless commitment was never intended to protect retail electric customers from all of the rate increase effects resulting from the sale to ITC Midwest. For example, Interstate now argues that the hold harmless commitment was never intended to protect retail electric customers from the rate increase effects resulting from such things as (1) the possibility ITC Midwest's actual operations and maintenance (O&M) costs might be higher than the levels assumed by Interstate in the cost-benefit analysis it submitted to the Board, (2) the possibility that ITC Midwest's actual administrative and general (A&G) costs might be higher than the levels assumed by Interstate in the cost-benefit analysis it submitted to the Board, and (3) the possibility that ITC Midwest's expansion of the grid would lead to higher costs than were assumed by Interstate in the cost-benefit analysis it submitted to the Board. (IPL Init. Br. at 38). As a result, Interstate argues that the Board should essentially disregard the commitment made in Docket No. SPU-07-11.

According to Interstate, the cost-benefit analysis it submitted in Docket No. SPU-07-11 was deliberately designed to exclude higher O&M and A&G costs likely to be incurred by ITC Midwest if the sale were approved. (IPL Init. Br. at 41). This, however, was only made clear to the Board during cross-examination in this proceeding. When it was trying to convince the Board to allow the transmission sale to proceed, Interstate steadfastly defended the reasonableness of the projected O&M and A&G costs in the face of a barrage of criticisms by the OCA and Intervenor witnesses that the cost levels assumed by Interstate were grossly understated. Throughout its brief in Docket No. SPU-07-11, Interstate described the assumptions in its cost-benefit analysis, including projected O&M and A&G costs, as "reasonable." *See* IPL Init. Br. in SPU-07-11 at 52-54. As it turns out, the assumptions reflected in Interstate's cost-benefit analysis were far from reasonable. The evidence in this case demonstrates that ITC Midwest's rates include over $30 million in higher O&M and A&G costs for 2009 alone. (Tr. 520-22; Ex. CAH-2, Schs. H-2, p. 3 and H-1, p. 3). Had Interstate included a more realistic level of costs in the cost-benefit analysis in Docket No. SPU-07-11, the Board's decision might have been quite different. [1]

Interstate's current explanation does not change the fact that in Docket No. SPU-07-11 Interstate made an unqualified commitment to the Board that customers would be held harmless for at least eight years. Nor does Interstate's current explanation change the fact that the Board relied to a great extent on Interstate's eight-year, hold harmless commitment in deciding to permit the sale to proceed. Finally, the current explanation does not change the fact that Interstate made no effort to bring to the Board's attention in

[1] The Board appeared to rely on Interstate's assertions that the expense levels reflected in the cost-benefit analysis were reasonable. The Board observed, "It is clear that the proposed transmission sale would have some impact on ***reducing*** IPL's A&G expenses, but it is less clear what the amount of those savings might be. (Emphasis added). *Interstate Power and Light Co.*, Docket No. SPU-07-11, *slip op.* at 46 (IUB, Sept. 20, 2007).

a timely manner the fact that customers would not, in fact, be held harmless for eight years as the Board believed. The failure to hold Interstate accountable for the commitment it made in the transmission sale proceeding would send the wrong message to Iowa utilities and unduly burden Iowa customers.

In a last ditch effort to renege on its hold harmless commitment, Interstate argues at length that holding the company to its commitment and adopting the OCA witness Mr. Fuhrman's adjustments would violate the filed rate doctrine. (IPL Init. Br. at 50-60). Interstate's arguments are misplaced. The filed rate doctrine only prohibits state regulators such as the Board from challenging the reasonableness of rates approved by federal regulators. In this case, the OCA is not challenging or in any way contesting the reasonableness of any FERC-approved ITC Midwest rate. The Board's adoption of the OCA witness Mr. Fuhrman's recommendations would simply give effect to the eight-year, hold harmless commitment made by Interstate and relied on by the Board in Docket No. SPU-07-11 when it permitted the transmission sale to proceed.

As outlined in the OCA's initial brief, Interstate's hold harmless commitment essentially contemplated that Interstate's shareholders would absorb, for eight years, any rate increase impact that exceeded the annual ITC Midwest revenue requirement included in the cost-benefit analysis. Requiring Interstate to live up to its hold harmless commitment does not call into question the prudency of any ITC Midwest cost or the reasonableness of any FERC-approved rate. Requiring Interstate's shareholders to bear the cost increases they previously agreed to bear in order to be permitted to sell Interstate's transmission assets to ITC Midwest would not undermine the purposes of federal law and, therefore, does not violate the filed rate doctrine. To the contrary, allowing Interstate to worm out of its eight-year, hold harmless commitment would undermine the reorganization provisions of Iowa Code Sections 476.76 and 476.77 and the integrity of the regulatory process.

B. Management Inefficiency

Interstate's position is that no management inefficiency adjustment should be made in this proceeding because the utility is operating in an efficient manner. (IPL Init. Br. at 9). Its customers, however, do not agree. During one of the consumer comment hearings, Interstate was taken to task by Ted Breidenbach, the general manager of the John Deere Ottumwa Works, one of Interstate's large industrial customers. Mr. Breidenbach stated:

> [i]f you take a look at Alliant, and it's my opinion, and the opinion of Deere, that you haven't taken the necessary steps to improve your total cost structure to better serve both your customers, us, and your shareholders.
>
> * * *
>
> So the conclusion that I've drawn from this, supported by fact, is that Alliant is just a very poorly run business.

(May 13, 2009, Consumer Comment Hearing Tr. 27-28).

An obvious sore point with Interstate is the fact that its retail prices are significantly higher than MidAmerican's. According to Interstate, the price differences result from such things as "decisions on critical generating units to serve Iowa load" and MidAmerican's "ability to generate revenues from wholesale electric sales." (IPL Init. Br. at 11). Interstate's attempt to explain the differences only reinforces the OCA witness

Dr. Habr's finding that Interstate's higher prices are largely the result of strategic management decisions made over a period of years. Such decisions have long-term consequences.

One such management decision involved the sale of Interstate's Duane Arnold Energy Center (DAEC). Other management decisions involved the speed at which Interstate has deployed generation (both wind and coal) and the effect of that speed on the cost of new generation.[2] Related decisions involve Interstate's heavy reliance on purchased power rather than lower cost, self-generated power. While Interstate complains that it "does not have any generating capacity which it can consistently use in the wholesale market as an additional revenue source to offset upward cost pressures on Iowa retail electric rates," it has no one to blame but itself. (IPL Init. Br. at 11).

Another sore point is AEC's disastrous foreign investments. Interstate attempts to defend itself by asserting that no costs associated with foreign investments were assigned or allocated to Interstate and included in the 2008 test year. (IPL Init. Br. at 15). What this ignores, however, is that the foray into non-regulated activities demonstrates that senior management's strategic focus was on increasing earnings through foreign investments instead of on investing in Interstate, finding ways to operate Interstate and its Iowa utility operations more efficiently, and keeping Interstate's electric prices from

[2] The evidence in this proceeding shows that MidAmerican's first wind farm had an installed cost of $1,143 per kW while Interstate's first wind farm is expected to have an installed cost of $2,125 per kW. (Tr. 1021). Similarly, MidAmerican's most recent coal plant, Walter Scott Energy Center-4, had an installed capacity cost of approximately $1,001/kW (Tr. 1004), while Interstate's proposed coal plant, SGS-4, had an estimated cost of approximately $4,300 per kW. (*Interstate Power and Light Co.*, Docket No. RPU-08-1, *slip op.* at 70 (IUB, Feb. 13, 2009). Clearly, the lower installed cost gives MidAmerican much more flexibility to deal with such issues as future carbon costs.

rising. The disastrous foray into foreign investments clearly led to a reluctance of Alliant to make additional utility investments, which is evidenced by Interstate's unwillingness (or lack of capital) to make improvements in its transmission system for reasons other than safety and reliability.[3]

Interstate criticizes OCA witness Dr. Habr for using "stale information on what, in his view, AEC has done wrong in the past–unregulated investments, the DAEC and ITC-M transactions." (IPL Init. Br. at 27). Interstate's criticism is misplaced. Dr. Habr did not rely on "stale" information. Rather, he analyzed and relied primarily on strategic decisions made in the recent past by company management that have contributed to Interstate's high prices. The fact, as Interstate complains, that the results of these strategic decisions cannot be easily rectified emphasizes the importance of making a management inefficiency adjustment to protect customers from some of the harm resulting from poor strategic decisions made over the years and to provide a sufficient incentive to Interstate and its shareholders to make the systemic changes needed to improve Interstate's operations. Unless a strong incentive is given, Interstate and its parent will continue to make poor strategic decisions.[4]

While Interstate opines on page 30 of its initial brief that OCA witness Dr. Habr's recommended management inefficiency adjustment is unprecedented in the Board's history, it is important to note that Dr. Habr's $50 million adjustment is actually quite

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[3] Interstate describes ITC Midwest as a company with "a proven track record in providing reliable transmission service, ***and capital available to invest in needed infrastructure."*** (Emphasis added). (IPL Init. Br. at 21). This clearly suggests that the sale of transmission assets to ITC Midwest was made because Interstate lacked either the will or the capital to invest in needed infrastructure.

[4] Since its disastrous sale of its transmission system, AEC has managed to lose a lot of money as a result of its decision to move PHONES from AER to the parent company. (Tr. 1079).

conservative. Dr. Habr's adjustment reflects only 20 percent of the 2008 rate differential between MidAmerican and Interstate, which is a mere fraction of the cost that Interstate and its shareholders would experience if Interstate were operating in a competitive environment. In a competitive market, Interstate's customers would likely flock to MidAmerican with its significantly lower prices, leaving Interstate with no revenues to cover its enormous costs. OCA witness Dr. Habr's recommended management inefficiency adjustment is reasonable and should be adopted.

C. SGS-4 Cost Recovery

Interstate argues that Ratemaking Principle No. 4, the cost recovery ratemaking principle approved in Docket No. RPU-08-1, can and should be used in this proceeding to allow Interstate to recover the approximately $26.5 million in costs incurred in pursuing SGS-4. (Ex. CAH-2, Sch. B-34). According to Interstate, the principle should be applied in this case even though Interstate (1) never accepted the ratemaking principles approved in Docket No. RPU-08-1 and (2) cancelled the plant before beginning construction. Interstate apparently considers these to be unimportant details. It is mistaken.

These are, however, important details. Principle No. 4 explicitly states that it applies "if IPL cancels ***construction*** of the proposed SGS Unit 4 for good cause…" (Emphasis added). (Tr. 30). Interstate itself proposed this language, but now seeks to ignore it. Since Interstate did not begin construction, Principle No. 4 does not apply and cannot be used to justify charging retail electric customer for costs that will never benefit them.

Furthermore, Interstate never accepted the ratemaking principles before cancelling the plant. Interstate cannot reject the principles as a whole and at the same time rely on them for cost recovery purposes. Interstate's brief clearly demonstrates the fact that Interstate never accepted the principles approved by the Board. For example, Interstate stated that one of the factors for cancelling SGS-4 was the "risks associated with the Board's approved ratemaking principles." (IPL Init. Br. at 80). Interstate also referred to a Robert W. Baird & Company release expressing its belief that the Board's decision on SGS-4 "effectively kills the project." Interstate also referred to Baird as downgrading Interstate's investment rating "citing the Board's oral decision as one of the primary drivers." (IPL Init. Br. at 80-81). According to Interstate, "[t]hese negative fallouts indicated that IPL's ability to attract the needed capital for SGS-4 could be hindered." (IPL Init. Br. at 81). On page 82 of its initial brief, Interstate stated that "[t]he Board's decisions in Docket Nos. GCU-07-1 and RPU-08-1 created several potential risks for IPL and its customers regarding to SGS Unit 4."

These statements hardly evidence an acceptance by Interstate of the principles approved by the Board. Rather these statements demonstrate that Interstate did not like and did not accept the ratemaking principles approved by the Board. In the absence of Interstate's acceptance of the principles, it cannot rely on them as justification for charging SGS-4 costs to customers. Furthermore, Interstate's perception that the Board's decisions involved too much risk for shareholders does not constitute good cause to saddle Iowa retail electric customers with 100 percent of the cancellation costs of the magnitude proposed by Interstate.

It is important to keep in mind that customers will never see any real benefit from the costs incurred by Interstate for SGS-4. At a minimum, to the extent that the Board's decisions in Docket Nos. GCU-07-1 and RPU-08-1 "created several potential risks for IPL and its customers" as Interstate argues, both shareholders and customers equally benefitted from cancelling the plant, and they both should equally share the costs incurred to date.

D. Wages and Salaries

IPL, in its initial brief at pages 63-67, argues there was a post-test year increase for an enhanced 401(k) plan of $1,280,761. This argument is without merit.

OCA Exhibit 102 shows there was no post-test year increase whatsoever for an enhanced 401(k) plan. OCA Exhibit 102 asked for the amount of 401(k) plan contribution that was paid from January 1, 2009 to June 21, 2009, and the amount that would have been paid between June 21, 2009 to December 19, 2009 had the 401(k) plan not been suspended. The IPL responses were virtually identical and were based on the "IPL portion of ***2008*** guaranteed match on 401(k) employee matching contributions." (Emphasis added). The only adjustment was for the 2009 work-force reduction. It is clear from OCA Exhibit 102 that there was no post-test year increase whatsoever for an enhanced 401(k) plan.

IPL's argument that its one-time nonrecurring severance cost associated with its workforce reduction should not be offset by precisely known and measurable reductions of "$1.1 million of total discontinued matching funds" and "[t]he total effect of the one-week furlough, after appropriate Iowa electric allocations, is approximately $1.3 million" totaling $2.4 million. These facts are undisputed and the $2.4 million offset must be made to IPL's claimed $3.3 million of one-time nonrecurring severance costs. The $900,000 difference should be amortized over four years.

E. Variable Pay Plans

IPL, in its initial brief at pages 68-70, totally ignores the evidentiary record and Board precedent.

The evidentiary record is clear that there are no variable pay plans (VPP) awards associated with test year 2008 or 2009. (Tr. 501, 1181; Confidential OCA Exhibits 103 and 104). Under identical facts, the Board has found that no VPP awards should be included in the revenue requirement. *See Interstate Power and Light Co.*, Docket No. RPU-02-3, *slip op.* at 36 (IUB, Apr. 15, 2003) and *Interstate Power and Light Co.*, Docket No. RPU-02-7, *slip op.* at 16 (IUB, May 15, 2003).

As to IPL witness Hampsher's five-year average, if at all considered by the Board, updating the five-year average for 2009 is necessary and should supercede Mr. Hampsher's outdated five-year average. (Confidential OCA Ex. 105). This also mitigates Mr. Hampsher's dated and unrepresentative five-year average which relies on former IPL transmission employees who are no longer on IPL's payroll. (Tr. 502). However, as discussed above, no VPP awards should be recognized in this proceeding.

F. Pensions and OPEBS

IPL, in its initial brief at pages 67-68, argues that its five-year average for pensions and OPEBS is preferable to the OCA's two-year average. This argument is without merit.

IPL's five-year average included several years of IPL DAEC employees who no longer work for IPL. Similarly, IPL's five-year average included several years of IPL transmission employees who no longer work for IPL. Finally, IPL never adjusted earlier years within the five-year average for pension and OPEBS plan design related, and plan law related, changes that occurred in later years of the five-year average. (Tr. 503-04, 557-59).

The OCA's two-year average is far superior. The two-year average is much more in line with what IPL has experienced in the past and will experience in the near term. The drop in value of IPL's pension plan assets due to the recession is not permanent. The stock market has already significantly recovered. (Tr. 1176; OCA Ex. 114).

The OCA's two-year average should be utilized by the Board in this proceeding.

G. Revenue Lag Days in Cash Working Capital

IPL, in its initial brief at pages 61-62, makes a post-hoc rationalization concerning IPL witness Hampsher's $1.6 million revenue adjustment. Throughout this proceeding until hearing, the $1.6 million revenue adjustment was purportedly to ***increase revenues*** to reflect additional late payment fee revenue not collected during the 2008 test year. (Tr. 470-71). However, Mr. Hampsher's $1.6 million revenue adjustment is actually an adjustment to ***increase expenses*** which would increase, not decrease, the revenue requirement. (Tr. 1166-67).

Having been confronted with this, he totally changed his position at hearing and made the post-hoc rationalization for the first time in this proceeding that IPL ***might*** have some undefined increase in cost to account for the four-day grace period. (Tr. 545-46). IPL continues this disingenuous argument in its initial brief.

In light of the above, the Board should use 20 days for IPL's revenue collection period and disallow IPL's $1.6 million mislabeled revenue adjustment. (Tr. 1160-61, 1166-67, 1878-79, 1903-904).

H. Accelerated Depreciation on IPL's Existing Meters

IPL, in its initial brief at pages 70-75, argues for accelerated depreciation on its existing meters. IPL's argument is without merit.

It is entirely premature to allow accelerated depreciation on existing meters since Advanced Metering has not, and may never be, implemented by IPL. (Tr. 1106-07).

Moreover, other than certain vague, cursory and potentially illusory allegations of Advanced Metering benefits, IPL has performed no cost benefit analysis whatsoever. This is fatal to IPL's position. As the OCA witness Mr. Turner testified:

> [U]ntil IPL demonstrates that the deployment of AMI is beneficial to ratepayers (*i.e.*, the benefits exceed the costs) and AMI is actually deployed, IPL should not be allowed to increase rates to recover accelerated depreciation on meters that are not obsolete and are being used by its ratepayers.

(Tr. 1106-107).

II. RATE OF RETURN ON RATE BASE

A. The Cost of Capital

IPL and the OCA dispute the following issues concerning the proper determination of the rate of return on rate base: (1) determination of the capital structure using 13-month average or year-end capital account balances; (2) preferred equity adjustments; (3) accounting for the use of double leverage in the utility's capitalization; and (4) determination of IPL's cost of common equity capital.

B. Capital Structure

IPL concedes the differences in the capital ratios in Ms. Parker's proposed 13-month average capital structure (with annualized pro forma adjustments) and Mr. Bacalao's snapshot one-day capital structure are "not terribly significant." (IPL Init. Br. 95). IPL argues, however, the differences in the methodologies used by Ms. Parker and Mr. Bacalao "have the potential to cause much greater rifts in the future." (IPL Init. Br. 95). If IPL means there is a potential for much greater differences between a one-day capital structure and a 13-month average capital structure in the future, the OCA agrees. IPL is attempting to lay the groundwork for manipulation of its capital structure to obtain a return on capital in excess of the cost of the capital it has actually invested during 99.97% of the year. (OCA Init. Br. 54-57).

The Board has explicitly rejected such efforts:

> The test year is designed to match revenues with expenses and if a year-end capital structure is adopted there is a mismatch. It is undesirable to adopt a single date as the time for determining a Company's capital structure. It affords an opportunity to alter the structure to the Company's advantage should it choose to do so. We have considered the arguments advanced by Company in support of the year-end capital structure but find them unpersuasive and shall adopt the 13-month average proposed by OCA.

Interstate Power Co., Docket No. RPU-83-27, *slip op.* at 11 (ISCC, Apr. 11, 1984).

IPL's ***desire*** to establish precedent to obtain excess profits in future rate cases does not justify the Board's use of a one-day capital structure.

C. Preferred Stock Adjustments

IPL argues Ms. Parker's proposed series of preferred stock adjustments should not be made, but IPL does not mention Ms. Parker's associated adjustment to common equity to eliminate hypothetical common equity capital booked by Interstate Power Company in connection with its 1979 preferred stock exchange. (IPL Init. Br. 95; OCA Init. Br. 50-53). ***The so-called miscellaneous paid in equity capital simply does not exist except on the books of IPL.*** *E.g., Interstate Power Co.,* Docket No. RPU-91-7, *slip op.* at 23-24 (IUB, Jul. 13, 1992). The adjustment to eliminate this non-existent common equity capital is necessary regardless of any other decision the Board makes concerning the rate of return on rate base. IPL's customers should not be forced to pay IPL a profit and income taxes on capital that does not exist.

IPL offers this rationale for rejecting Ms. Parker's series of preferred stock adjustments:

> Because the preferred stock has been retired, because the preferred stock is undated and the financing is not fixed into perpetuity, an adjustment to IPL's capital structure to accommodate the prior preferred stock exchange and its subsequent retirement is unwarranted.

(IPL Init. Br. 95). Such reasoning is circular and totally ignores the issue. The series of preferred stock transactions had one significant effect with respect to the amount of preferred equity capital that was replaced in those transactions: ***they increased the cost of preferred equity capital nearly 50% by 2009***. (OCA Init. Br. 58-61).

IPL cites Mr. Bacalao's testimony asserting the "not easily quantified" but "very much real and tangible" benefits to "IPL and its customers" of the 2002 retirement of all existing preferred stock as justification for rejecting Ms. Parker's adjustments to reverse the 50% increase of the cost of the replaced preferred equity capital. (IPL Init. Br. 94-95). The benefits alleged by Mr. Bacalao may not be easy to quantify, but neither is it easy to ***assume*** those alleged benefits even come close to offsetting the $1.7 million annual cost to customers of a Board decision to reject Ms. Parker's adjustments which effectively reverse the preferred equity cost increase for ratemaking purposes. (OCA Init. Br. 63-64). An allegation of offsetting savings does not constitute evidence of the amount or validity of such alleged savings, and therefore, does not justify rejection of the preferred stock adjustments.

D. Double Leverage

IPL begins its argument against accounting for its use of double leverage with a diversion: "The problem with the OCA's position lies in the fact that double leverage imputation is a form of ring-fencing intended to protect a regulated utility subsidiary from the malfeasance or financial recklessness of its holding company." (IPL Init. Br. 88).

The OCA does not propose "imputing" double leverage. AEC's use of double leverage is documented in the accounts of AEC and its subsidiaries. The OCA proposes the Board account for that actual use of double leverage in the Board's determination of IPL's rate of return on rate base to assure that rate of return is based on the actual cost of the invested capital.

Mr. Bacalao asserted "the ***attribution*** of double leverage is not an appropriate regulatory tool ***if the objective sought is to protect a utility subsidiary*** from any adverse financial effects resulting from its parent company's activities." (Tr. 689, emphasis added). In response to Mr. Bacalao's statement, Ms. Parker explained that was not the purpose of accounting for double leverage:

> Q: Is it your objective that the Board recognize and account for double leverage in order to "protect a utility subsidiary from any adverse financial effects resulting from its parent company's activities"? (Mr. Bacalao Rebuttal Testimony, page 25, lines 9-12).
>
> A: No. The Board's recognition of and accounting for double leverage does not protect IPL's Iowa customers from any adverse consequences of Alliant Energy's non-regulated activities. Rather, the Board's accounting for double leverage simply recognizes the reality of the capital financing of Interstate and its parent, Alliant Energy.

(Tr. 1246-47).

The Board correctly accounted for AEC's use of double leverage in Docket No. RPU-02-3, and then, in reference to a four factor test it used to reject to the recognition of double leverage in two IPL rate cases, stated: "The Board recognizes that there may be appropriate exceptions to the application of double leverage other than one based on the four-factor test the Board has used." *Interstate Power and Light Co.*, Docket No. RPU-02-3, *slip op.* at 59 (IUB, Apr. 15, 2003). IPL argues "the instant matter presents another appropriate exception to the application of double leverage." (IPL Init. Br. 89). IPL does not explain the exception it seeks, but its argument and testimony make it clear that IPL is attempting to use the ***tracing*** of dollars to avoid the Board's recognition of and accounting for double leverage.

IPL's argument and Mr. Bacalao's testimony represent a misguided attempt to ***trace*** dollars through a series capital transactions beginning with AER's issuance of senior notes (guaranteed by AEC) in 2000, and culminating in AEC's issuance of $250 million senior notes just prior to the hearing in this case. (IPL Init. Br. 89-91). Mr. Bacalao testified IPL wanted to:

> make it really clear that Alliant Energy Corporation was not using any money of the utilities in any form or fashion, for example, accrued, advanced payments on tax or anything like that. We just made it really clinically separate.
>
> So we borrowed 170 [million], used 68 million of our own money, and then three days later we settled the issuance of the bond. The money came in. We repaid the bridge, and the cash that we could use got repaid out of the cash we received.

(Tr. 736-37). Mr. Bacalao's explanation ignores the fungibility of dollars and relies on an impossible distinction between dollars transferred between AEC, IPL, WPL and AER.

IPL, for example, paid an extraordinary dividend of $400 million to AEC following the sale of IPL's transmission assets. (Tr. 1207-208). IPL dividends and repayments of capital to AEC have dwarfed the dividends and capital repayments of AER. (Ex. SJP-1, Sch. C; Confidential Ex. 111). Even if AEC placed dollars from IPL, WPL, AER, banks, note holders, and others in properly-labeled separate cookie jars, keeping track of, *i.e.*, tracing, those dollars is meaningless because dollars are fungible. Tracing is no more and no less than an attempt by IPL to avoid the ratemaking consequences of its use of double leverage.

The Board has flatly disavowed engaging in the tracing approach advocated by IPL as a new exception to the recognition of double leverage. In Docket No. RPU-91-9, Iowa Electric Light and Power Co. (IE), a predecessor of IPL, correctly argued that capital funds are not traceable, and claimed in its application for rehearing that the Board had erroneously relied on capital tracing to account for IE's use of double leverage in the Board's determination of IE's revenue requirement. *See Iowa Electric Light and Power Co.*, Docket No. RPU-91-9, *slip op.* at 4 (IUB, Sept. 16, 1992). In that order the Board explained that its decision was based on its determination that funds are fungible.

AEC and IPL can avoid having the Board account for the use double leverage in the determination of IPL's revenue requirement merely by avoiding the use of any debt capital by the parent corporation. IPL and WPL are able to lever AEC's equity in the respective utilities. AER can, at least, attempt to do the same; the result will be determined by the capital markets and that is as it should be.

Finally, IPL suggests it is discriminatory if the ratemaking treatment of double leverage is not the same for Iowa's two rate-regulated electric utilities. The rates of Iowa's other rate-regulated electric utility are the product of Board-approved settlements between the OCA and the utility. A settlement is not precedent as it is the result of compromises to conclude the case. The disparity in the electric rates of IPL and the other utility will be even greater if double leverage is not accounted for in this case. (*See* OCA Init. Br. 15).

Consistent with its precedent, the Board should account for double leverage in its determination of IPL's rate of return on rate base.

E. Return on Common Equity

Many of IPL's arguments concerning return on equity in its initial brief have already been fully addressed in the OCA's initial brief. The OCA's reply brief will address those IPL arguments not fully addressed in whole or in part in the OCA's initial brief.

IPL, in its initial brief at page 96, states that IPL witness Hanley is the superior return on equity witness in this proceeding. Based upon the OCA witness Mr. Vitale's extensive well-reasoned and thoroughly documented testimony, exhibits and workpapers, it is clear Mr. Hanley is not. It is, rather, Mr. Vitale who is the more credible, comprehensive, and thorough return on equity witness in this proceeding.

IPL, in its initial brief, cites Mr. Hanley and ICC witness Mr. Gorman's DCF samples. These samples are erroneous. These DCF samples include distribution and transmission-only utilities, while Alliant and IPL generate much of their electricity. Others are electric-only utilities which are not comparable to Alliant and IPL, a combination gas and electric utility. (Tr. 1696-97).

IPL, in its initial brief at pages 97, 102-103, argues for IPL risk adjustments for smaller size and lower bond rating.[5] These adjustments are erroneous. The OCA witness Mr. Vitale thoroughly discredits these adjustments. (Tr. 1704-1708). Mr. Vitale summarizes IPL's errors by referring to well-established Board precedent recently

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[5] IPL cites author Morin in this regard. It is to be noted that author Morin is not a disinterested party since he has testified on behalf of numerous utilities including MidAmerican Energy Company before this Board in IUB Docket No. RPU-01-9.

enunciated in *Interstate Power and Light Co.*, Docket Nos. RPU-02-3, *slip op.* at 63 (IUB, Apr. 15, 2003):

> Because the various models consider so many factors, it is difficult to isolate any one item, such as size, and make that the basis for an additional adjustment.

IPL, in its initial brief at pages 97, 105-106 and 108, cites Mr. Hanley's unilateral and unsupported risk premium range of 400-500 basis points above A-rated utility bonds rather than the Board's 250-450 basis point risk premium range. This IPL argument, like IPL's comparable earnings method, is not market-based and cannot result in an estimate of investors' expected premium over bonds or their cost of equity. Investors determine their expected return on common equity in capital markets. (Tr. 1741). Mr. Hanley erroneously relied on a review of authorized returns determined by regulators as his only alleged support for increasing the Board's risk premium range. IPL noted, but then ignored, the fact that authorized returns on equity of other regulated firms should not be relied upon to establish a cost of equity because this is not market based but instead an exercise in circularity. IPL's proposed use of authorized returns to determine a higher risk premium without any reference to market prices determined by investors that reflect their expected returns is incapable of estimating the cost of common equity. The Board has already stated the fundamental flaws of the comparable earnings approach which are equally applicable to the regulatory authorized return approach used by IPL to erroneously argue for an unjustified and unwarranted increase in the Board's risk premium range. *See Davenport Water Co.*, 76 PUR3d 209, 241 (ISCC 1968). (Tr. 1744).

IPL, in its initial brief, cites Mr. Hanley's DCF dividend yield. Mr. Hanley's DCF dividend yield is erroneous. Mr. Hanley improperly adjusted the indicated dividend yield with his own unsubstantiated and arbitrarily inflated forecast of future dividends leading to an unfounded and inflated dividend yield. The OCA witness Mr. Vitale, on the other hand, properly used the indicated dividend, *i.e.*, the most recently declared dividend multiplied by four, in his DCF analysis. (Tr. 1699-702).

IPL, in its initial brief at pages 98-99 and 104, cited Mr. Hanley's use of five-year growth projections. Such projections are erroneous for a number of reasons. Mr. Hanley arbitrarily and speculatively only considered estimated growth over the next five years. Mr. Hanley mechanically used five-year projected short-term earnings, earned returns, or other forecasts which are unreliable. Mr. Hanley's exclusive focus on five-year forecasts creates a fundamental mismatch between the five years considered and the perpetual life of the investment. Moreover, five-year forecasts generated by analysts without any support are consistently higher than actually achieved growth rates. Investors also do not rely on such forecasts because such forecasts are known to be overstated. (Tr. 1709-19).

IPL, in its initial brief at pages 102-103, briefly and unfairly criticizes the OCA witness Mr. Vitale for a sole insignificant error. The data reflected in Mr. Vitale's Exhibit GV-1, Schedule E, page 2, was correctly taken from the *Value Line* data which is based on end-of-year book value to derive an average price. There was a minor error in the formula used for the 1999 average book value, but the error was immaterial. (Tr. 1800). It is clear that IPL's entire argument concerning Mr. Vitale is nothing more than an ad hominem attack.

Finally, IPL, in its initial brief at page 104, argues for the use of the arithmetic average. This argument is erroneous. The geometric mean is the proper measure of the long-run market return. As Morningstar, who IPL cites, has noted, the geometric mean is the best measure of past performance for long-lived assets like common equity stocks. The geometric mean always correctly measures the average rate of return from an initial investment to its cumulative value, and is not distorted by unrepresentative returns. (Tr. 1726-27). The geometric mean is commonly used in finance. Investors, financial publications, and academicians rely, at least in part, on the geometric mean to measure actual growth, compounded returns, and expected returns, especially for long-lived assets like common equity. (Tr. 1727). The arithmetic average return IPL relies on is overstated and erroneous. As Morningstar noted, returns are not normally distributed. (*Ibbotson SBBI 2009 Classic Yearbook,* Morningstar, p. 135). The arithmetic average is consequently greater than the geometric average and is not representative of typical returns. Unlike IPL, investors do not ignore market volatility, including recent events, in forming their expectations. Recent volatility underscores how returns differ from a normal distribution. (Tr. 1727-28).

III. RATE DESIGN AND TARIFF ISSUES

The Large Energy Group (LEG) argues the Board should prescribe IPL rates based on IPL's filed class cost of service study (CCS) with three modifications proposed by LEG. (LEG Init. Br. 13-18).

LEG is affiliated with the Community Coalition for Rate Fairness (CCRF). (Tr. 1364). CCRF was a party in the case in which the Board initiated IPL's rate equalization. In that proceeding the Board carefully considered the various proposals for equalization of IPL's rates and ultimately adopted the plan IPL is continuing to implement. *Interstate Power and Light Co.*, Docket No. RPU-04-1, *slip op.* at 21-27, 40-44 (IUB, Jan. 14, 2005).

The Board has made it clear that it would not use any CCS to prescribe IPL's rates until the rate equalization process initiated in 2005 is complete. *Interstate Power and Light Co.*, Docket No. RPU-05-2, *slip op.* at 2-3, 5, 11 (IUB, Apr. 28, 2006) and *slip op.* at 7-8, (IUB, Jun. 7, 2006) (Order on Rehearing). IPL has not completed the rate equalization process. (Tr. 243, 754, 849-50). The Board should not rely on any CCS in its determination of IPL's rates in this case.

CONCLUSION

The Office of Consumer Advocate urges the Board to determine Interstate Power and Light Company's revenue requirement, to prescribe electric rates, and to order rate refunds in accordance with the conclusion and for the reasons stated in the OCA's initial and reply briefs.

Respectfully submitted,

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