STATE OF IOWA

BEFORE THE IOWA UTILITIES BOARD

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

INTERSTATE POWER AND LIGHT COMPANY

REPLY BRIEF

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I. INTRODUCTION

In this reply brief, Interstate Power and Light Company (IPL) will address selected arguments from the Initial Briefs[1] filed by: the Consumer Advocate Division of the Department of Justice (OCA); the Large Energy Group (LEG); and the Iowa Consumers Coalition (ICC).[2]

IPL's Initial Brief anticipated and already rebutted most of the arguments in those briefs. In addition, the other parties' Initial Briefs totaled more than 220 pages in length, yet the procedural schedule allowed IPL only five business days to review those briefs and prepare this reply brief. For those reasons, this reply brief will not respond to each and every opposing argument raised in other parties' Initial Briefs. The absence of a response to a specific argument should not be construed as an indication of IPL's agreement, waiver, or acquiescence.[3]

II. INCOME STATEMENT REVENUE REQUIREMENTS ISSUES

A. MANAGEMENT EFFICIENCY DISPUTE

This issue, perhaps more clearly than any other issue, amply illustrates that IPL's Initial Brief anticipated and already rebutted the other parties' arguments. The OCA's Initial Brief on this issue was little more than a condensation of OCA witness David Habr's direct testimony. IPL's Initial Brief, along with its rebuttal testimony, clearly demonstrated that Dr. Habr's $50 million draconian management efficiency penalty was unprecedented and unwarranted.

In summary, the main points that the OCA relies upon, in support of Dr. Habr's recommendation, can be summarized as follows:

1. IPL's rates are higher than MidAmerican Energy Company (MEC) (OCA 14-17);

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[1] All briefs will be referred to with the party's name and a number for the page referenced; *e.g.*, OCA 68.
[2] The IPL's reply brief does not specifically address the arguments raised by intervenor Ag Processing Inc. since its arguments are consistent with positions advocated by other parties.
[3] See 199 IAC 7.23(8)"c".

2. Up until 2002, IPL's parent Alliant Energy Corporation (AEC) was primarily interested in unregulated, principally foreign activities rather than IPL's utility operations (OCA 18-20);

3. AEC's "failed" foreign activities caused IPL to sell Duane Arnold Energy Center (DAEC) and its transmission assets (OCA 21);

4. The purpose of these asset sales was to fund AEC share repurchases and help management earn short-term incentive compensation (OCA 21);

5. The DAEC purchase power agreement (PPA) is unreasonable (OCA 22-23);

6. The Alternative Transaction Adjustment (ATA), from the transmission sale, is not sufficient to offset increased transmission costs (OCA 23-24);

7. IPL could have saved $94 million in purchased power costs in 2008 if it would have installed wind energy at the same scope and scale as MEC (OCA 24); and

8. MEC enjoys lower fuel costs than IPL. (OCA 24-26).

IPL's Initial Brief addressed each of these contentions. For instance, IPL addressed the differences between MEC and IPL rates (IPL 10-14) and included a discussion of the Iowa Utilities Board's (Board) criteria under 199 IAC 29. IPL noted the differences between IPL's and MEC's customer mix (primarily wholesale sales), service territory (geography), and the impacts of natural disasters on IPL. For the OCA, a rate comparison is only relevant when the utility in question has higher rates so that the comparison can be used as support for a management efficiency penalty.[4]

The topic of AEC's unregulated, foreign activities was also addressed, and as IPL explained, IPL's cost of service did not include any costs associated with AEC's unregulated, foreign activities and AEC had determined, in 2002, to shed its unregulated, foreign investments and focus primarily on its domestic utility operations. (IPL 14-16).

[4] IPL's Initial Brief discussed the case of *Iowa Southern Utilities Company,* Docket No. RPU-91-8, in which the OCA argued that low rates may lead to less reliable service and safety problems. (IPL 13-14).

Issues related to AEC's "failed" foreign activities were not the cause for IPL's sale of DAEC and its transmission assets. (IPL 16-22). Both of these transactions were based on sound policies that the Board noted in its consideration of these sales – Docket No. SPU-05-15 (DAEC Sale) and Docket No. SPU-07-11 (Transmission Sale). IPL's Initial Brief rebutted the OCA's contention that the purposes of these sales were to fund AEC share repurchases and help management earn short-term incentive compensation. (IPL 22-24). These sales were not used in the calculation of short-term incentive compensation for management and AEC's share repurchases had ceased by the time the Transmission Sale was complete.

The OCA's complaints about the DAEC PPA were addressed in IPL's Initial Brief; suffice to say that all aspects of the DAEC PPA were fully considered by the Board in Docket No. SPU-05-15. (IPL 17-19). The OCA's misunderstanding, regarding the purpose of the ATA from the Transmission Sale, was addressed in the Transmission Expense portion of IPL's Initial Brief. (IPL 36-44).

IPL also addressed Dr. Habr's calculation of $94 million in potential purchased power costs savings for 2008 and noted that Dr. Habr did not account for capital costs in his calculation. (IPL 30). IPL does note that unlike Dr. Habr, the OCA's Initial Brief recognizes that "a significant investment would obviously have been necessary on Interstate's part to achieve these savings..." (OCA 25). IPL's Initial Brief discusses the differential between MEC's and IPL's fuel costs. (IPL 12-13). Even simple geography helps to explain MEC's fuel cost advantage and IPL also noted that the OCA had objected to IPL's attempt to add base load capacity that would have reduced its fuel costs. (IPL 12).

Quite simply, IPL's Initial Brief shows that there is no basis for the OCA's $50 million management efficiency penalty. The OCA's Initial Brief does not take any issue with the processes and tools that IPL has employed in managing its corporate and strategic plans as described in IPL's Initial Brief. (IPL 9-10) As discussed in IPL's Initial Brief (IPL 8-9), the

OCA's witness Dr. David Habr did not discuss how his analysis related to the Board's rules relating to management efficiency -- 199 IAC Chapter 29. The OCA's Initial Brief also failed to address the Board's rules under 199 IAC 29.4.

While continuing to rely on Dr. Habr's IPL v. MEC rate comparison, the OCA has conveniently forgotten that the OCA advised the Board that MEC is in a position not enjoyed by almost any other utility in the country. (Tr. 1062) As noted in IPL's Initial Brief (IPL 12), in 2008, MEC had *wholesale* revenues of over $750 million, which is over 70 percent of IPL's entire revenue requirement request in this rate case. Additionally, IPL's evidence shows that fully 42 percent of all electricity sold by MEC is for non-requirement wholesale sales; the equivalent number for IPL is 8 percent.[5] Clearly, MEC's customer mix, with substantial sales to non-requirement wholesale customers, is significantly different than IPL's customer mix. The OCA has simply not addressed this aspect of the Board's management efficiency rules in its IPL v. MEC rate comparison.

There are also significant differences between IPL and MEC in terms of their ability to minimize fuel costs. Many of these factors were based on geography. (Tr. 72-73). In particular, MEC's units will always be closer to the Powder River Basin coal field. The OCA failed to address this difference between MEC's and IPL's service territory and therefore did not address this aspect of the Board's management efficiency rules.[6]

The OCA's Initial Brief does not address IPL's evidence (Tr. 50-57, 571-577) that discusses the 2008 flood and the national recognition that IPL received for its response to that natural disaster. Thus the OCA's Initial Brief ignores the impact of weather disasters on IPL. It is also important for the Board to consider IPL's awards for energy efficiency activities

[5] IPL Exhibit TLA-2, Confidential Schedule A. page 7.

[6] IPL Exhibit TLA-2, Confidential Schedule A. page 4, shows that significant fuel costs differences between IPL and MEC have persisted throughout this decade. Such differences are not of recent origin and are based on geographic differences as opposed to management differences.

because Section 476.52 of the Iowa Code, states, “the board may also consider a public utility's pursuit of energy efficiency programs” in its consideration of management efficiency.

Perhaps nothing better illustrates the weakness of Dr. Habr’s analysis than his failure to examine IPL witness Aller’s direct testimony before preparing his direct testimony. (Tr. 1051) If he had examined that testimony, he would have learned that some of the key drivers for this rate case included: (i) capital costs related to last summer's historic flooding: (ii) five years of investment in IPL’s infrastructure; and (iii) overall increases in expenses since IPL’s last general rate case, which were based on a 2003 test year. (Tr. 12-25). He would have also learned about IPL’s awards for its Flood responses (Tr. 22) and its mitigation efforts for this rate case. (Tr 36-43). As IPL discussed (IPL 27-28), Dr. Habr offered no suggestions for the future but rather was content to focus on past events and complain about the DAEC sale and the transmission asset sale to ITC-M. In essence, the OCA now seeks to penalize IPL for these transactions even though the Board and other utility rate regulatory agencies thoroughly reviewed these transactions before they were consummated.

B. ITC MIDWEST, LLC TRANSMISSION EXPENSES

The OCA’s arguments regarding the proper level of transmission costs to be included in IPL’s revenue requirement (OCA 2-9) were also anticipated and rebutted in IPL’s Initial Brief. (IPL 31-60) The primary argument that the OCA advances is that IPL’s proposed level of transmission expense is “wholly inconsistent with a critically important and unconditional commitment made by Interstate in Docket No. SPU-07-11.” (OCA 3). In particular, the OCA discusses at length its contention that IPL, through the ATA, committed to “hold its retail customers harmless from any rate increase effects resulting from the transmission sale for at least eight years.” (OCA 4).

In its Initial Brief, IPL responded to this contention in two ways. The first was to thoroughly explain the purpose of the ATA. IPL’s Initial Brief pointed out that the ATA was designed "to make sure that IPL's customers were not financially harmed from the transfer of IPL's existing transmission assets from the jurisdiction of the Board to FERC." (IPL 38). IPL also discussed that the ATA cost-benefit study specifically excluded any consideration of additional transmission assets that ITC-Midwest LLC (ITC-M) may place in service. (*Id.*) Quite simply, the purpose of the ATA was not to shield customers from the rate impacts of ITC-M's capital expansion and related operations and maintenance expenses. (*Id.*)

IPL's second argument was related to whether OCA's witness Charles Fuhrman was confused about the purpose of the ATA and the ATA cost-benefit study. (IPL 41-42) In response to IPL witness Chris Hampsher's explanation, in his rebuttal testimony, regarding the true purpose of the ATA and the basis of the ATA cost-benefit study, Mr. Fuhrman claimed that he genuinely believed IPL's commitment was "to hold customers harmless for eight years, and that there would be a 'zero' rate increase effect, meant just that." (Tr. 918). However, as noted in IPL's Initial Brief, Mr. Fuhrman advised the Polk County District Court that ITC-M's 2009 rate would have a "substantial adverse impact" on IPL's customers. Mr. Fuhrman did not advise the court that IPL had promised to hold its customers harmless from ITC-M's 2009 increase in rates. (IPL 41-42). Clearly, the OCA's interpretation of the ATA arose only after the OCA lost its appeal of the Board's Order in Docket No. SPU-07-11.

The ICC states that IPL has double-counted the $46.9 million of true-up costs. (ICC 2, 13-14). That is not the case. In support of this assertion, the ICC incorrectly claims that the $58.4 million increase in 2009 in ITC-M costs, over the 2008 level, is comprised of the $46.9 million true-up plus $11.5 million of increases related to sales and costs (see explanation of line 3 in ICC Exhibit MEB-4, page 1, Iowa Electric Retail). However, the fact is that the $58.4 million increase that Mr. Hampsher shows on IPL Exhibit CAH-1, Schedule B-9 does not include any of the 2008 true-up; it includes only the increases associated with the sales and costs. During the hearing, Mr. Hampsher indicated that, while he agreed with the numbers presented on ICC Exhibit MEB-4, page 1, he did not agree with the explanation (Tr. 538).

Additionally, the ICC's Initial Brief continues with its mistaken argument that IPL's level of transmission expenses (IPL Adjustment B-9, B-25 and B-26) fail to meet the Board's "known and measurable" standard. (ICC 8-10). IPL's Initial Brief (IPL 48-50) addressed these arguments and point out that once ITC-M's rate has been approved by the FERC, it is "known and measurable" and reflects the only rate that ITC-M can collect in 2009 and rate that IPL must pay in 2009. ITC-M's 2009 rate has been known since September 2008, and has been in effect since January 1, 2009, and "must be accepted by the Board in order for IPL to make a legitimate adjustment to the test year transmission expense." (IPL 49). Likewise ITC-M's 2010 rate meets the Board's "known and measurable" standard since the 2010 rate was known in September 2009, which is within nine months of the test year, and will be incurred within 12 months of IPL's March 17, 2009 filing.

IPL's testimony placed the OCA and ICC on notice that their proposed level of transmission costs "are confiscatory and in violation of the law." (Tr. 48). However, other than the ICC's discussion of the Board's general statutory authority to set "just and reasonable" rates, neither the OCA's nor the ICC's Initial Briefs contain any discussion of the Board's legal authority to disallow FERC-approved rates.[7]

IPL's Initial Brief (IPL 50-60) contained an extensive legal discussion regarding the "filed rate doctrine" and why that doctrine compels the Board to use IPL's transmission expense adjustments (IPL Adjustment B-9, B-25 and B-26) to establish IPL's revenue requirement in this case. IPL's Initial Brief (IPL 56-57) also demonstrated that "reasonable and just" rates require that IPL recover its actual transmission costs. In its purest sense, recovery

[7] In particular, the ICC urges the Board "to act on its consumer-protection mandate" and cites the requirement, under Section 476.8 of the Iowa Code "to ensure rates are 'reasonable and just.'" (ICC 7-8).

of ITC-M costs are “now vested in FERC and are, as a matter of law, prudently incurred costs on the part of IPL and the Board is obliged to allow IPL to recover these prudently incurred costs.” (IPL 60).

C. REVENUE LAG DAYS – CASH WORKING CAPITAL

IPL believes it has thoroughly and adequately addressed the issue of the appropriate number of revenue lag days in its Initial Brief. However, IPL would take the opportunity to reiterate that the current Iowa Administrative Code requirements require periodic late payment forgiveness. For example, one requirement provides that all electric utilities grant customers on a first payment agreement forgiveness of at least one late payment that is made four days or less after the due date. In other words, while the customer may still be assessed a late fee, the customer shall stay on the payment agreement. 199 IAC 20.4(11)"c"(4). This is in addition to the requirement that an electric utility forgive at least one late payment penalty for each electric service account annually. 199 IAC 20.4(12)"d".

As IPL previously noted, its "existing payment and collection systems are integrated; payment due dates trigger steps in the collection process, including the default of payment agreements." (IPL 62). Requiring IPL to discontinue the four-day grace period will require significant readjustment of its computer programming payment and collection systems. In the alternative, IPL would have to develop some method to manually review all payments that fall outside the current grace period to determine whether they complied with either of the above-cited provisions of 199 IAC 20.4. Either method would require significant expenditures of time, funds, and labor. However, continuing the four-day grace period will allow IPL to remain in compliance with the Iowa Administrative Code without the extra cost of re-coding its computer systems or developing methods of manually segregating these accounts.

D. COMPENSATION ISSUES

IPL continues to maintain that its workforce is an integral part of its provision of efficient and sufficient service to its Iowa customers. However, the OCA and ICC continue to proffer compensation adjustments that at best, do not recognize the importance of one of IPL's greatest assets and, at worst, denigrate IPL's workforce directly. IPL continues to affirm that it has done what it can to mitigate the effects of its rate case for its customers, without undue injury to the loyalty and morale of its people actively involved in providing service to its customers.

1. SALARIES & WAGES

IPL may have inadvertently created some confusion between what it has been calling its 401(k) match and its enhanced 401(k) plan.

To clarify, the Company has one 401(k) plan. The Company makes two types of contributions to this plan for employees. First, IPL makes a Company cash contribution regardless of employees' contributions to their 401(k). This is in lieu of a five percent benefit credit previously made to the Cash Balance Pension Plan. This has been referred to as the "enhanced" plan, and was effective starting in August 2008. (Tr. 346). This contribution has remained in effect throughout all of 2009 (the "on-going contribution").

The Company also matches employee contributions. The 401(k) match is a component of the 401(k) plan. This part of the Company's contributions was temporarily suspended in June of 2009.

For purposes of this Reply Brief, IPL will refer to the on-going contribution as the "enhanced plan." The matching contributions will be referred to as the "401(k) match."

The OCA's recommended exclusion of the $1,280,761 relates to IPL's enhanced 401(k) plan for its employees, which primarily relates to the cash contribution which began in August 2008.

Some of this confusion stems from the OCA's initial confusion between the 401(k) match component and the new cash contribution component of the 401(k) plan (the “enhanced” feature). In its recommended exclusion of the $1,280,761, the OCA stated that these enhanced levels have not in fact occurred in 2009. However, the OCA has confused the enhanced 401(k) plan with the 401(k) match. They are not the same as can be seen on IPL Exhibit CAH-1, Schedule B-1b. On Schedule B-1b, the first nine lines pertain to the 401(k) match, whereas lines 10 through 14 pertain to the enhanced 401(k) plan (primarily the new cash contribution in lieu of the old five percent benefit credit). The enhanced 401(k) plan was in full force and effect throughout 2009. It was not the enhanced 401(k) plan, but rather the 401(k) match that was temporarily suspended in June 2009.

IPL apologizes for not drawing more attention to and clear demarcation of these issues in its Initial Brief. The references in Section 1, Salaries & Wages, in the Compensation Section of the Initial Brief should have discussed the OCA's exclusion of the "enhanced" 401(k) plan rather than the "401(k) match," and should have drawn this distinction more clearly up front.

With regard to the OCA's other arguments raised regarding the enhanced 401(k), IPL believes it has thoroughly rebutted the faulty underlying assumptions in its Initial Brief. However, a few areas do merit clarification given the assertions contained in the OCA's Initial Brief.

First, OCA continues to contend (OCA 31) that because of the workforce reduction, the number of employees available to participate in the enhanced 401(k) is "much less" (Tr. 1126-1128) and, therefore, "IPL's proposed 2009 increase for an enhanced 401(k) will not materialize." IPL concurs that the enhanced 401(k) adjustment was not refined to reflect the impacts of the workforce reduction. But as demonstrated in its Initial Brief (IPL 64-65), refining the effects of the workforce reduction on the enhanced 401(k) in consideration of the proper allocations results in an adjustment of only $45,058. (Tr. 1149-1150).

Further, the OCA asserts that no enhanced 401(k) contributions for 2009 were identified in the discovery process, and proffers OCA Confidential Exhibit No. 102 in support of this proposition. The OCA's reliance on its Confidential Exhibit No. 102 for this particular assertion is specious. As can be clearly seen in the wording of the data request, the OCA requested the impacts of the 401(k) match suspension, as discussed on pages 5 – 6 of Mr. Hampsher's Rebuttal Testimony. (Tr. 434-435). As discussed above, these are not the same as the cash contributions associated with the enhanced 401(k) plan. Much of the OCA's discussion (OCA 31) is in fact inapplicable to the point it has proffered.[8] The OCA also attacks this data request as providing only 2008 figures. However, as can be clearly seen from the Data Request response, beginning at line 4, adjustments are made through the remainder of the response to reflect 2009 figures. (Tr. 1150-1151).

The OCA also continues to assert, even after examination of irrefutable evidence, that the enhanced 401(k) "was not shown to be established in 2009." (OCA 32). This assertion ignores IPL's clear demonstration that the enhanced 401(k) plan was indeed in place and in full effect beginning in August 2008 and through the end of the test year (Tr. 345), as acknowledged by the OCA's own witness (Tr. 1146), and that the enhanced 401(k) continues to be in full force and effect throughout 2009. (OCA Exhibit FK-2, Confidential Schedule A.)

2. WORKFORCE REDUCTION

The OCA also continues to extend certain temporary adjustments beyond what is reasonable in light of these more permanent workforce reductions by excluding the severance costs necessary to achieve these reductions, and arguing these can simply be "offset" by other short-term adjustments. (OCA 32). IPL continues to maintain that allowing the OCA's adjustment would flow the benefits to IPL's customers of the overall salary and benefits

[8] The OCA additionally attempts to argue that its Confidential Exhibit No. 102 demonstrates there were no enhanced 401(k) plan payments in 2009. However, as mentioned here, the OCA is confusing the suspended 401(k) match with the enhanced 401(k) plan.

reductions without allowing IPL to recover any of the costs associated with achieving those benefits. While IPL believes it has covered this issue sufficiently (IPL 65-67), it is still important to reiterate here that using temporary cost savings measures to offset the costs of a measure that creates long-term benefits is illogical, and ultimately punishes IPL for taking prudent long- and short-term cost-cutting actions for its customers' benefit.

3. PENSION COSTS AND OPEB

IPL believes it has adequately discussed the majority of the issues raised by the OCA in its Initial Brief regarding the proposed Pension Cost and OPEB adjustments. However, one matter in particular bears further clarification. The OCA maintains that its two-year average for both of these adjustments is more appropriate than IPL's five-year inflation-adjusted adjustments because IPL's five-year period will incorrectly include DAEC employees and transmission employees no longer employed by IPL. (OCA 39).

IPL notes that, again, the OCA makes a blanket statement regarding how costs should be lowered without producing any numbers to support its statements. The OCA simply notes that certain DAEC and ITC employees may no longer be with the company without addressing, through questioning or discovery, whether these employees have been replaced because they may have enjoyed a dual employment capacity, without examining whether other workforce amplifications were occurring at the same time, and without even ever putting a number on the employees lost or quantifying the difference in OPEB and Pension Costs this difference creates. Additionally, the OCA waited until hearing to make these assertions, allowing IPL to present no evidence of any offsetting factors.

Regardless, the point of IPL's five-year inflation-adjusted average is not to capitalize on prior employees, but to even out undue fluctuations that would not be appropriate smoothed over by a two-year average. (Tr. 438). While in the instant matter, the OCA's adjustment and the IPL's adjustment do not significantly differ, IPL is concerned with the precedential value of adopting the OCA's two-year average, and the improperly levelized effect that adoption could have in the future.

4. VARIABLE PAY PLAN (VPP)

The OCA and the ICC continue to attack IPL's proposed VPP recovery, both claiming at the core of their arguments that the requested recovery is merely "speculative." The OCA notes (OCA 33-34) that IPL did not budget for VPP awards for 2010 and beyond, while the ICC argued (ICC 19-20) that IPL's employees did not meet the performance objective, and consequently, IPL's customers "should not incur a cost for a benefit they did not receive." Both of these arguments mischaracterize the evidence in this proceeding.

First, with regard to the OCA's arguments, IPL feels it is important to clarify that IPL does not currently and has not traditionally budgeted for VPP awards. The OCA drew forth the fact that IPL has presented testimony dealing "with VPP plans which were applicable to 2008 test year or prior years," while no testimony "deals with 2009 or thereafter." (OCA 33). The OCA's statement creates the implication that, because IPL does not budget for VPP awards, it must not anticipate VPP awards. IPL's lack of VPP award budgeting is simply a reflection of its past budgeting practices, and not its anticipation for VPP payouts in future years.

Because IPL has not previously budgeted for VPP awards, AEC has itself incurred approximately 75 percent of the target expense from 1999 - 2008. (Exhibit LCS-2, Schedule A). AEC currently operates on a funded plan where the pool is accrued for after financial measures have been achieved, verses an additive plan where the expenses could be anticipated at the start of the fiscal year. This means that AEC's shareholders, and not its customers who also receive a benefit from IPL's workforce, have shouldered the majority of that expense.

IPL again expresses its displeasure for the disparaging remarks ICC has made, through testimony and briefing, regarding its workforce. As clearly stated in IPL's testimony and its Initial Brief, the employee's performance is only one of two prongs in the determination of a VPP award. The other is the company's overall performance. (Tr. 597). As previously noted, 2008 was a very difficult year for both IPL and its customers, in light of economic conditions and a major natural disaster, and this scenario resulted in no VPP awards attributable to that year. (Tr. 605). Either the ICC has failed to examine the record sufficiently to determine that VPP's awards are dependent upon a two-prong test, or the ICC is proffering the position that IPL's employees can personally perform in a manner to overcome global recession and natural disaster. Either assertion calls the ICC's credibility into question.

As consistently noted, AEC is aware that its customers, and its employees serving those customers, are an integral part of its success. AEC's benefits package, including its VPP, is specifically designed to focus on the attraction, retention, and engagement of highly performing employees. This allows AEC's utility subsidiaries to focus on safety, reliability, and customer satisfaction, which are very tangible benefits to the customers. As demonstrated by IPL's recent storm response, and the stellar performance of its employees, it can be clearly seen how engaged and highly performing employees respond. (IPL Exhibit No. TLA-1, Schedule A and Schedule B.)

E. SUTHERLAND GENERATION STATION UNIT 4 CANCELLATION RECOVERY

With one exception, IPL’s Initial Brief adequately anticipated and responded to all the parties’ arguments concerning issues related to the recovery of Sutherland Generating Station Unit 4 (SGS Unit 4) cancellation costs. (IPL 75-88). However, IPL feels it needs to respond to one aspect of the OCA’s Initial brief regarding its argument that the Board should consider its 50/50 sharing alternative. On page 30 of its Initial Brief the OCA argues that its 50/50 sharing alternative “recognizes that the decision to cancel SGS-4 was probably good for both shareholders and customers. (Tr. 895). Since both shareholders and customers benefit from the cancellation of SGS-4, it is reasonable for both to absorb some of the costs. In no event, however, should customers be required to pay 100 percent of the cancellation costs."

IPL believes that the OCA's 50/50 alternative is a tacit admission that SGS Unit 4 was cancelled for "good cause." Consequently, there is no support for any conclusion other than the application, in this case, of Ratemaking Principle No. 4 from Docket No. RPU-08-1.[9] Additionally, as IPL noted in Initial Brief (IPL 85), OCA witness Fuhrman conceded that Ratemaking Principle No. 4 does provide for sharing between IPL and its customers. (Tr. 942).

III. COST OF CAPITAL REVENUE REQUIREMENTS ISSUES

A. CAPITAL STRUCTURE, DOUBLE LEVERAGE, AND DEBT ISSUES

IPL believes it has already fully briefed the rationale for denial of the OCA's double leverage adjustment. Pursuant to the OCA's own cited orders and case law, IPL qualifies for an exemption because: 1) AEC's assumption of AER's debt in November 2008 generated no cash; 2) AEC's subsequent debt issuance in October 2009 generated no new cash, only replacement cash for that used in the tender offer; and 3) no cash was, or could have been, infused into IPL by virtue of either the 2008 or 2009 transactions. It cannot be shown in any way, then, that this parent company debt is demonstrably supporting the utility's capital structure. (Docket Nos. RPU-02-3, RPU-02-8, ARU-02-1, Final Decision and Order issued April 15, 2003, pp. 57-60 (RPU-02-3 Order)).

The OCA attempts, through over-complicating the matter, to cloud these simple facts. The OCA jumps through hoops in 20 total pages of briefing in order to address fungibility, monetary displacement, market competition, comparative calculations, precedent, and other sundry scenarios in order to bolster its case. (OCA 64-84). Ultimately, the OCA appears to be

[9] Ratemaking Principle No. 4 is discussed in detail in IPL's Initial Brief. (IPL 75-76).

simply attempting to draw attention away from the fact that IPL's specific situation matches the "rare exception" from the Board's typical double leverage adjustment. (OCA 65).

Additionally, the OCA has proffered the double leverage theory as "a generally accepted ratemaking tool throughout the United States." (OCA 66). However, outside of Iowa, the OCA fails to provide any recent case law supporting this theory, with the majority of its cited cases dating from the early to mid-1980s. Notably, OCA's citation of "at least 21 state commissions" that have adopted or recognized the validity of the theory dates back to 1984. There is no subsequent referral to the current acceptance of double leverage even as a valid theory, let alone a frequently adopted one.

IPL avers that the OCA's dated case law is due largely to the fact that the credence of a double leverage adjustment is not as currently and completely accepted as the OCA would imply. As recently as 2006, the state of Washington rejected proposed double leverage adjustments, in part, because:

> If the risks and costs of activities at the parent-level are born exclusively by shareholders – because customers are insulated from them by the ring fence – then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities…. Without the proposed double leverage adjustments, customers are held harmless from the consequences of the acquisition – they pay a return on capital that is no higher than they would have paid if PacifiCorp was a stand-alone utility.

Washington Utilities and Transportation Commission v. PacifiCorp dba Pacific Power & Light Company, Docket No. UE-050684, Docket No. UE-050412, Order 03 Order 04, 1006 WL 1517095, p. 50 (Wash. U.T.C. 2006).

In fact, there are numerous cases nation-wide over a long time span that reject the double leverage adjustment. A sampling of said cases includes:

- 1980 – Florida Public Service Commission, *Re United Telephone Company of Florida*, Docket No. 780777-TP(CR), Order No. 9208, January 14, 1980, 34 PUR 4th 421, p. 440.

The combination of a low return on book equity and a lower interest coverage level could affect the quality of subsidiary debt, and it is probable that the resultant increasing cost of embedded debt to the subsidiary would further decrease the residual return available to book equity, and further lower the quality (and raising the cost) of market exposed debt. These considerations support the use of the subsidiary capital structure in lieu of a consolidated capital structure even in light of any apparent double leverage advantages to the parent.

- 1988 – *Associated Natural Gas Company v. Arkansas Public Service Commission*, 25 Ark.App. 115, 121, 752 S.W. 2d 766.

  …An elementary premise on which the application of double leverage depends is missing from this case, i.e., that a parent corporation has debt-funding available to it which may be used to purcahse the subsidiary corporation's stock.

  While we agree that, as a general proposition, all dollars in a company's capital structure are fungible, we cannot accept the argument that the concept of fungibility should be recognized in this particular case because doing so would be absolute fiction. We hold that, because it is a factual and legal impossibility for double leverage to exist between this parent and this subsidiary corporation, as proven by the unrefuted evidence, the application of the concept of double leverage to this subsidiary corporation to ascertain its cost of equity for ratemaking purposes is inappropriate.

- 1991 – *Hartigan v. Illinois Commerce Commission*, 214 Ill.App.3rd 222, 573 N.W.2d 858, 158 Ill.Dec. 45.

  The Commission held that a hypothetical capital structure should only be used "when the utility's actual capital structure is found to be unreasonable, imprudent or unduly affected by such circumstances as double leverage as so to unfairly burden the utility's customers." The Commission found that Illinois Power had failed to demonstrate that use of its actual capital structure was unreasonable, imprudent or unduly burdened the ratepayers.

- 1995 – Maine Public Utilities Commission, *New England Telephone and Telegraph Company dba NYNEX*, Docket No. 94-254, May 15, 1995, 162 PUR 4th 110, 1171995 WL 389272.

  We will not use the double leverage approach in this case because there is no evidence to suggest that: (1) the Company's actual capital structure is unreasonable; (2) NYNEX Corp.'s policies (such as its payout ratio policy) have been inappropriate; or (3) that the capital structure does not strike an appropriate balance between low cost and financial integrity.

- 1997 – FERC, *Williams Natural Gas Company*, Docket No. RP93-109-011, 80 FERC P 61158, 61682-61682, 1997 WL 451415 (August 1, 1997) (*dicta*).[10]

> As one commentator has stated, "double leverage is untenable in both theory and practice." [Footnote omitted.] The rate of return to a pipeline should not depend on who owns the pipeline, nor on how that owner, whether a holding company or individual stockholders, financed its investment. For example, if an adjustment were made here to lower WNG's rate of return based on the double leverage theory, and subsequently TWC decided to spin-off this subsidiary to its shareholders, WNG, under Kansas Cities' theory, would be entitled to a higher rate of return simply because it had new owners. Kansas Cities also provides no rationale for limiting the double leverage inquiry to the situation when the owner of the pipeline is a holding company. There is no reason why it should not apply equally as well if the owner of the operating company is one wealthy individual or a group of investors. In the latter case, the Commission would have to inquire into the leverage used by the individual investors to finance their stock purchase in order to arrive at a reasonable rate of return.

- 1999 – FERC, *Williams Natural Gas Company*, RP92-109-014, 80 FERC P 61232, 6159, 1999 WL 116504 (March 5, 1999).

> The Commission's example in the August 1, 1997, order was intended to point out a weakness in the double leveraging theory. It is not speculative that under Cities' proposal, a reasonable rate of return to the pipeline would be greater if it were owned directly by shareholders rather than by a parent holding company. The Commission affirms its conclusion that it is not appropriate for the level of a reasonable return to the pipeline to differ depending on who owns the pipeline, and the Commission will not reject the use of the capital structure of the pipeline simply because it is owned by another corporate entity….

Clearly, the imputation of a double leverage adjustment is not a foregone conclusion. The mechanical imputation of a double leverage adjustment, especially in recent years, has come under more skeptical scrutiny and been increasingly rejected, as has the theoretical premise of the adjustment itself. What is not subject to dispute, however, are the actions of AEC leading up to the OCA's proposed adjustment; as outlined above, and consistent with past Board precedent, IPL has clearly demonstrated that AEC's November 2008 and October 2009 transactions did not, and could not, produce funds available for contribution as equity to its utility subsidiaries.

[10] The footnote omitted from this quotation is to the May 4, 1974, edition of Public Utilities Fortnightly, specifically an article by James E. Brown entitled, "Double Leverage: Indisputable Fact or Precarious Theory."

B. WEIGHTED AVERAGE COST OF CAPITAL

The primary contentions between IPL and the OCA regarding the weighted average cost of capital relate to (a) the use of an updated test year based on a 13-month historical test year average versus a 2008 year-end capital structure adjusted for post-test year financings, and (b) the OCA's adjustments to the preferred equity portion of IPL's capital structure. While IPL finds that it fully and sufficiently briefed these issues previously, the OCA's Initial Brief did raise issues regarding these two contentions that bear clarification.

First, IPL again affirms that a 2008 year-end capital structure adjusted for post-test year financings, as proffered by its witness Mr. Enrique Bacalao, is the more appropriate of the two methods. While in this particular case, there was little difference in the resulting capital structure ratios (OCA 50, Tr. 1235-1236), there is no guarantee that the two methods will bear out similar capital structures in the future. IPL reiterates: While the 2009 updates to the 13-month test year average are helpful, the issue still remains that a 13-month average capital structure requires a steady state for it to be fully accurate. (IPL 94, Tr. 653-655, 700-701).

Additionally, the OCA’s implication that IPL may attempt to artificially increase the weighted average cost of capital for any internal gain is specious reasoning. The optimal capital structure serves the best interests of both customers and the company by helping the company secure adequate funding at the lowest cost of capital. (Tr. 653-654). Any attempt by IPL to artificially increase the weighted average cost of capital would therefore be counterintuitive and counterproductive by destroying shareholder value.

The OCA alleges that use of IPL's method would violate "the matching principle," because it "is not representative of the actual capital that was invested in the rate base…" (OCA 55). However, the OCA itself ignores other major rate base components which are computed using Mr. Bacalao's same method: accumulated depreciation, accumulated deferred income tax, and utility plant in service. (Tr. 741). Additionally, as further noted by Mr.

Bacalao, "in Iowa, the post-test year adjustments look at the first nine months of the following year, precisely to be able to accommodate events that occur after the test year, whether those are capital expenditures or financing." (Tr. 741-742). The OCA's contention that to do otherwise would violate the matching principal ignores the fact that the Board often looks at the appropriate calculation of expenses "on a case-by-case basis." (Tr. 719). In this case, IPL simply advocates for the same treatment for its weighted average cost of capital as other major rate base components, because it will more appropriately address, long-term, IPL's existence in a non-steady state.

Second, IPL addresses the matter of the OCA's adjustments capital structure resulting from the preferred stock exchange. The history of this stock is important, and is addressed in the live testimony of Mr. Bacalao:

> THE WITNESS: The seven series of preferred stock were composed of four that were originally issued by Interstate Power Company out of Dubuque, and three that were issued by IES Utilities out of Cedar Rapids.
>
> Interstate Power Company was a relatively small--the smallest of the three companies that merged into each other.
>
> And in the late '40s, early 1950s, it went through a capital reorganization, reflecting difficulties at that time.
>
> The few remaining characteristics of that difficult period were lodged in the covenants that were in the preferred stock.
>
> They reflected the situation of Interstate Power Company at that time. It also reflected market conditions at that time.
>
> And among the various provisions were one that limited the amount of unsecured debt that Interstate Power Company could issue.
>
> That survived over the decades.
>
> When the merger occurred between IPC, that is to say, Interstate Power Company, and IES Utilities, the surviving entity, IES Utilities that was renamed Interstate Power and Light, assumed those obligations and immediately was subject to those covenant requirements.

It would have meant that we were limited, Interstate Power and Light, to issuing our debt either as secured debt or how much of it could be unsecured.

We had a number of rather challenging constraints that we had to be very sensitive to.

We had four heirloom first mortgage indentures. We had these various series of preferred stock. They required us to ensure that we were in compliance across different pools of assets, which in realty had been merged, but in theory were kept separate, in separate pools, and they were inconsistent among themselves.

So it led to a situation where for us to be in compliance would require us to work in a suboptimal fashion as far as financing, and would also mean that we could spend an inordinate amount of time making sure that we were ticking and tying everything according to these various indentures.

So what we did over time was to simplify that structure by being able to retire and then discharge these various heirloom indentures, and we had this remaining constraint that we had to deal with the preferred stock.

Now, we had already had the experience when merging the two companies that convening the holders of the preferred stock was an extremely difficult thing to do.

I believe, if memory serves, that there were two attempts before we were able to get a quorum for them to vote on the merger, even though 100 percent of the common stock was owned by Alliant Energy in both cases. The holders of the preferred stock in Interstate Power Company had the right to vote, and just getting a quorum together was extremely difficult, expensive, and it took three tries before we finally got that together.

So the idea of tendering for consensus from these preferred noteholders, how long that would take, and how expensive it would be, and at the end of the day how successful that would be was very much in doubt.

So the decision was, we had the right to call them and we called them.

Now, this was in 2002 at the beginning of 2002.

The plan at that stage was to refinance them using what was then a competitive concern, which are so-called trust preferred stock--or debt. In effect these instruments at that time were attractive because they were treated for certain purposes as equity and for other purposes as debt, so they were tax deductible.

And it would have meant that we could retire those seven series at a cost below what they were costing us, and it would have been totally non-controversial.

But 2002 turned out to be a bit of a challenging year as well. Among other things, that was the year that Enron became famous for the wrong reasons, among them for abusing trust instruments by way of financing.

> So that alternative of refinancing the preferreds became unattractive, both for costs and for other reasons.
>
> So we were left with a situation where we had called the preferreds and had to refinance them somehow, and the somehow ended up being using preferred stock.
>
> Ms. Parker correctly points out that this was done at a higher cost than the ones that we had before.
>
> If I were to summarize my argument, net/net, everything considered, in a real-world basis, we had to make the best of a bad situation. (Tr. 722-727).

The “bad situation,” however, was unavoidable, given the complications arising from satisfying various and sundry indentures, making IPL's financing position difficult. (Tr. 724). While it may have been, as pointed out by the OCA and as acknowledged by IPL, a refinance at a quantifiable higher cost, it was not a refinance without significant benefits. "We were not just being careless and wanton…" (Tr. 727). As again noted by Mr. Bacalao:

> How does one quantify avoiding being out of compliance with outdated covenants?
>
> How does one quantify opportunities missed in terms of financing on an unsecured basis when you otherwise would have to go on a secured basis, and you're limited by what you can issue? (Tr. 726).[11]

If Mr. Bacalao suffered from any confusion regarding the OCA's proposed adjustments, it was because, as Mr. Bacalao stated, the OCA's logic was flawed. Mr. Bacalao went through the numbers and, as demonstrated above, has intimate knowledge of the series of transactions. It was the OCA's underlying logic that caused confusion. The OCA's logic did not appear in any context of the series of transactions themselves. As noted by Mr. Bacalao, "it needs to be looked at in the context of what you're doing and why you're doing it." (Tr. 729). A simple mechanical calculation recognizing only detriments and no benefits cannot ever properly quantify any transaction or properly evaluate the transaction’s merits.

[11] As also noted in IPL's Initial Brief, Mr. Bacalao has refuted these adjustments, noting a "full range of reasons that motivated the retirement" of the preferred stock. (Tr. 701-702). Mr. Bacalao further noted numerous benefits that, while not easily quantified and exclusively attributable to the retirement in all cases, are nevertheless very much real and tangible, accruing to the benefit of IPL and its customers. (Tr. 702-703).

C. RATE OF RETURN ON COMMON EQUITY

As previously noted in IPL's Initial Brief, IPL witness Mr. Frank J. Hanley is the only witness in this proceeding to submit a complete, fair, supportable, and up-to-date approach to the ROE determination in this proceeding. However, the ICC and the OCA, the only other parties in the proceeding to submit evidence regarding ROE recommendations, raised various arguments in their briefs that require further clarification. This Reply Brief will address the requisite general clarifications first, followed by clarifications regarding the various modeling methods used.

1. GENERAL CLARIFICATIONS

IPL believes that four general matters in particular merit clarification: 1) the ICC's continued reliance on IPL's supposed "senior secured" debt merits; 2) the need for a size adjustment; 3) the need for a financial risk adjustment; and 4) the use of the discounted cash flow (DCF) model versus other modeling methods.

i. IPL's "Senior Secured Credit Rating"

Although the issue was corrected at hearing and was evident from pre-filed testimony (Tr. 1931; IPL Exhibit EB-1, Schedule B-1, p. 94; IPL Exhibit EB-1, B-3, p. 19), the ICC continues to rely on IPL's "current senior secured credit ratings." (ICC 31-32). IPL, very simply stated, has no senior secured credit rating because it has no senior secured debt. Rather, IPL holds unsecured debt with a negative pledge provision. This was fully explained and clarified in IPL's Initial Brief. (IPL 99-100). The ICC's continued reliance on and utilization of IPL's *prior* secured debt ratings and/or provisional shelf debt ratings, given the covenants created by the negative pledge provisions for the senior unsecured debt, results in an improper reflection of IPL's risk relative to the proxy group.

ii. Size Adjustment

Both the ICC and the OCA continue to unjustly and inaccurately attack IPL's proposed size adjustment. Additionally, the ICC's and the OCA's arguments demonstrate a misunderstanding of IPL's proposed adjustment.

First, both the ICC and the OCA allege that a size adjustment is not warranted because the proxy groups utilized are sufficiently analogous to mitigate any size concerns. Specifically, the ICC argues that, "[t]he proxy group … captures IPL's small company risk," (ICC 57) while the OCA argues that "[t]wo of IPL's sample utilities are smaller than stand-alone IPL." (OCA 104). Both of these assertions, however, miss the point.

To assume that a proxy group can properly reflect the size risks associated with a given entity assumes that "the same proxy group would be identical to IPL." (Tr. 1577). However, "similar is not identical." (Tr. 1578). With regard to the ICC's proxy group, which was also utilized by Mr. Gorman as well as the inclusion of AEC in its proxy group, "IPL is significantly smaller than the proxies…" (Tr. 1578). With regard to the OCA's proxy group, two sample utilities may be smaller than IPL as a stand-alone utility, but the *average* of the group is much larger. The purpose of using a group is to base results upon the *average* of the group. In either case, when the entire proxy group or the average of the proxy group is larger than the utility at issue, a size adjustment is proper and warranted. (Tr. 1577-1579).

The OCA further contends that "established Board precedent" supports its proposition that a size adjustment is not warranted. However, the OCA has only cited an incomplete portion of the Board Order at issue. Specifically, the OCA cited the Board's Order in Docket No. RPU-02-3 at page 63, issued April 15, 2003, where the Board found:

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

The OCA neglected, however, to further cite the Board's Order, also at page 63, which clarified:

> Based on the testimony, the Board is concerned the proxy companies used by IPL in determining cost of equity may be more risky than IPL, offsetting any need for an adjustment due to size.

Significantly, the OCA has presented no evidence in this case that any similar offsetting concerns regarding the proxy groups' risks may be present. (*See also*, Tr. 1598-1599).

The OCA then attempts to argue that no size adjustment is warranted through reliance on a Morningstar publication. According to the OCA, this publication, the 2009 Ibbotson SBBI Classic Yearbook, states that "returns are not normally distributed." (OCA 104). The OCA, however, has paraphrased a statement in that publication in such a way that it appears to support a proposition it does not actually support. In reality, the portion of the Morningstar Publication reads, "the historical returns of large company stocks are *not exactly* normally distributed…"[12] (OCA Vitale Workpapers, p. 166). As demonstrated by Mr. Hanley, all indications are that the returns covering the period from 1926 through 2007 are essentially normally distributed and hence have a serial correlation factor of essentially zero, which means the returns (and hence equity risk premia) are random. (IPL Exhibit FJH-1, Schedule L, p. 6 of 8).

The ICC also attempts a pointed attack on one aspect of IPL's size adjustment. Specifically, the ICC attempts to compare the significantly higher beta factors of the respective deciles with the proxy group median beta of 0.70. However, the ICC neglects to acknowledge that the proxy companies' betas are five-year betas; the proxy companies' betas are calculated by Value Line over a recent 60-month period of time. (Tr. 1575). The ICC performs a mismatch when it attempts to compare these five-year betas to the companies in the third and

[12] The Morningstar article cited by the OCA for this proposition is also not on point for the consideration of a size adjustment. Rather, the cited portion of the article addresses how to employ a slightly different method to make probabilistic forecasts for the return on an asset or portfolio.

fourth deciles, which had beta factors well above 1.0. The ICC makes this comparison in order to demonstrate that the small company beta factor "is well in excess of IPL's beta factor…" (ICC Initial Brief, p. 56). The ICC's assertion ignores, however, that these third and fourth decile companies are associated with beta factors based on the entire 81-year period from 1926 to 2007. (IPL Exhibit FJH-1, Schedule A). The ICC's attempt to discredit IPL's size adjustment based on the "comparative" betas only reveals that the ICC is comparing 5-year apples to 81-year oranges.

The simple fact that neither the ICC nor the OCA can overcome is that IPL has properly proffered and supported a size adjustment for IPL. Mr. Hanley's proposed size adjustment is derived from industry-specific data and represents more reliable statistics. In fact, Mr. Hanley's ultimate adjustment is conservative, given the achieved result of 65 – 75 basis points versus the actual recommended adjustment of only 19 basis points. (Tr. 1576-1578, IPL Exhibit FJH-2, Schedule J).

It is also important to note the evidence in the record that neither the ICC nor the OCA can overcome with any number of theoretical arguments – IPL did show a distinct and real impact due to its size during the 2008 test year. As noted in the 2006 *New Regulatory Finance* regarding the size adjustment:

> The relationship between firm size and return cuts across the entire spectrum but is most evident among smaller companies that have higher returns than larger ones on average. (IPL Exhibit No. 11, p. 182).
>
> In addition to earning the highest average rates of return, small stocks also have the highest volatility, as measured by the standard deviation of returns. (IPL Exhibit No. 11, p. 185).
>
> Smaller companies are less able to deal with significant events that affect revenues and cash flows than large companies. (IPL Exhibit No. 11, p. 187).

IPL itself is in this rate case, in part, as a result of the 2008 flooding, the costs of which, when combined with other costs, could not be absorbed by the company due to its size. (Tr. 24-25, 1661). This is an obvious demonstration of IPL's correlative need for a size adjustment, as anticipated in *New Regulatory Finance*.

iii. Financial Risk Adjustment

Neither the OCA nor the ICC can proffer any argument to refute IPL's proposed financial risk adjustment other than one already proffered for the size adjustment -- namely, that the similarities of the proxy group are sufficient to mitigate any risks. As stated before, to assume that a proxy group can properly reflect the financial risks associated with a given entity would require one to also assume that "the same proxy group would be identical to IPL." (Tr. 1577). However, once again, "similar is not identical." (Tr. 1578). IPL senior unsecured ratings are Moody's A3 and S&P's BBB+ versus the proxy group's Moody's A2 and S&P's A. (IPL Exhibit FJH-2, Schedule B, p. 1 of 8). IPL will not further reiterate the remainder of its argument addressing this point in section ii above, but will instead adopt the same by reference.

iv. Over-Reliance on the DCF Methodology

At page 93 of its Initial Brief, the OCA espouses the virtues of the DCF to the exclusion of any other analysis for any purpose except a "check." Again, however, the OCA cites old texts to support its proposition, ignoring any revisions to the statements in those texts found in later editions. As Morin states in his 2006 edition *New Regulatory Finance,* which succeeds the earlier edition cited by the OCA:

> While it is certainly appropriate to use the DCF methodology to estimate the cost of equity, there is no proof that the DCF produces a more accurate estimate of the cost of equity than other methodologies. Sole reliance on the DCF model ignores the capital market evidence and financial theory formalized in the CAPM and other risk premium methods. The DCF model is one of many tools to be employed in conjunction with other methods to estimate the cost of equity. *It is not a superior methodology that supplants other financial theory and market evidence. The broad usage of the DCF methodology in regulatory proceedings in contrast to its virtual disappearance in academic textbooks does not make it superior to other methods. The same is true of the Risk Premium and CAPM methodologies*.

[Emphasis added]. Tr. 1493). Mr. Hanley further supports this proposition with other cited studies in his rebuttal testimony. (Tr. 1588-1589).

2. Clarification of Comparable Earnings Model (CEM) Issues

IPL is puzzled regarding the ICC's continued attack on its CEM model, given that IPL has not proffered it in any way as part of its ultimate ROE recommendation. (ICC 53-54). IPL simply wants to clarify once again for the Board that IPL's CEM modeling need not be excluded from consideration because it was never offered for consideration in the first place. Mr. Hanley conducted this modeling on behalf of IPL for the purpose of a thorough analysis, and nothing more. Once the result was seen to be an outlier, it was rejected by Mr. Hanley himself, and never offered as part of the ultimate ROE recommendation. (Tr. 1478).

3. Clarification of DCF Modeling Issues

Aside from the DCF issues addressed as part of the general concerns above, IPL will address two additional concerns in this section: 1) the OCA's mischaracterization of IPL's position regarding market reflection of investors' cost of equity when prices differ from book value; and 2) the OCA's criticism of reliance on analyst forecasting.

i. Market Reflection of Investors' Costs

The OCA alleges that "IPL erroneously asserts that markets fail to reflect investors' cost of common equity when prices differ from book value." (OCA 87). This statement, however, is a mischaracterization of IPL's position. IPL more specifically stated, "when market values depart from book values, a market-based DCF cost rate applied to the book value of common equity will not reflect investors' expected common equity cost rate based on market prices." (Tr. 1496). In other words, it is the DCF model itself that does not properly measure investors' cost of common equity capital in this situation, as opposed to a failure of the market to do so. This illustrates simply one more failing of the DCF model, and why other modeling methods should be implemented in addition to the DCF model in order to gain the best insight possible into the true cost of equity.

ii. Reliance on Analyst Forecasting

The OCA continues to attack IPL's reliance on analyst forecasting, suggesting that investors disregard analyst forecasting in favor of a firm's historical data. (OCA 106). This, however, is a narrow view of the facts. IPL acknowledges that a firm's earnings are a significant factor influencing market prices, but this is by no means the *only* factor affecting market prices. As noted by Mr. Hanley, "Myron Gordon, the 'father' of the standard regulatory version of the DCF model, recognized the significance of analysts' forecasts of growth…" (Tr. 1600). IPL has provided significant evidence that reliance on analyst forecasting is a significant factor for investors (Tr. 1600-1602), while the OCA has provided only limited, anecdotal evidence that it should be discarded altogether.[13] (OCA 106).

4. CLARIFICATION OF CAPITAL ASSET PRICING MODEL (CAPM) ISSUES

IPL takes issues with several assertions regarding its CAPM analysis conducted in this proceeding. Specifically, IPL will address the following below: 1) the arithmetic mean is more appropriate than the geometric mean; 2) it is not redundant to use an ECAPM in conjunction with the CAPM; 3) risk premiums are not currently declining; 4) and Mr. Hanley's analysis is not "fundamentally flawed."

i. Arithmetic Mean Versus Geometric Mean

The OCA continues to proffer the geometric mean as the "best measure of past performance." (OCA 94). IPL agrees that the geometric mean is the best measure of past

[13] Notably, the OCA's citation of a Wall Street Journal Article (OCA Exhibit GV-2, Schedule E) is dated April 17, 2002, and spends significant time specifically analyzing the dotcom bust. All paragraphs immediately preceding the OCA's quote deal with internet analysts' push for dotcom investment. The remainder of the article is a criticism of vertically integrated investment firms, i.e., firms that are "putting investment advice and stock merchandising under the same roof." Examining the context of this reference, it's apparent that the quote proffered so heavily by the OCA is aimed at one particular industry.

performance; however, it is not valid to estimate the cost of capital which is forward-looking. As noted by Mr. Hanley, "only the arithmetic mean of historic returns will appropriately reflect the expected volatility in the market in a manner meaningful to investors looking forward." (Tr. 1590).

The arithmetic mean is an ordinary average – the numbers in a list are added, then divided by the number in the list. In calculating the geometric mean, the numbers are multiplied and then the root of the numbers (the square root for two numbers, cube root for three numbers, etc.) is taken. The use of a geometric mean in the case of a volatile market, therefore, will inappropriately smooth over that volatility and therefore provides no insight to investors as to potential volatility, i.e., risk.

As explained by Mr. Hanley:

> [I]nvestors are currently buying and selling stocks. Potential investors require insight into the degree of risk they will experience before they can determine whether to purchase the common stock of a firm and the price they are willing to pay. Such insight is critical because the degree of risk mandates the rate of return required in accordance with the basis financial precept of risk and return, i.e., greater risk means a greater rate of return is required and vice versa….
>
> [E]quity risk premia are random…. It is precisely because the equity risk premium is random that the use of the arithmetic mean of long-term premia is the best expectation for the next year or period. (Tr. 1590-1591).

IPL is confused by the OCA's reliance on IPL Exhibit FJH-1, Schedule L, page 2 (Morningstar – Ibbotson SBBI 2008 Valuation Yearbook) for the proposition that "the geometric mean is the best measure of past performance." (Tr. 1727). Page 2 of IPL Exhibit FJH-1, Schedule L states nothing more with regard to the geometric mean than, "The geometric average is more appropriate for reporting past performance, since it represents the compound average return." IPL Exhibit FJH-2, Schedule Q (Morningstar – Ibbotson SBBI 2009 Valuation Yearbook) however, contains the clarification of that statement. Specifically, as noted by Mr. Hanley, IPL is not simply attempting to quantify historical figures. These historical figures are being used to predict future cash flows, that is, the cost of capital. (Tr. 1589-1590). The issue then is not determining the historical compound average return, but projecting cash flows using historical information. As noted by Morningstar in IPL Exhibit FJH-2, Schedule Q:

> For use as the expected equity risk premium in either the CAPM or the building block approach, the arithmetic mean or the simple difference of the arithmetic means of stock market returns and riskless rates is the relevant number. This is because both the CAPM and the building block approach are additive models, in which the cost of capital is the sum of its parts….
>
> The geometric mean, when compounded, results in the median of the distribution…
>
> *The arithmetic mean equates the expected future value with the present value; it is therefore the appropriate discount rate.* [Emphasis added]. (IPL Exhibit FJH-2, Schedule Q, pp. 3-4).

ii. ECAPM and CAPM

Contrary to the OCA's contention, there is no redundancy in IPL's use of both a CAPM and ECAPM analysis in reaching its recommendation for an appropriate ROE. Mr. Hanley noted that the ECAPM represents a return adjustment, and does not affect beta. (Tr. 1572). Specifically, Mr. Hanley cited Morin's *New Regulatory Finance* at p. 191, where it specifically states:

> Fundamentally, the ECAPM is not an adjustment, increase or decrease, in beta. This is obvious from the fact that the expected return on high betas securities is actually lower than that produced by the CAPM estimate…. The ECAPM and the use of adjusted betas compromised two separate features of asset pricing. *Even if the company's beta is estimated accurately, the CAPM still understates the return for low-beta stocks. Even if the ECAPM is used, the return for low-beta securities is understated if the betas are understated… [T]he ECAPM is a return (vertical axis) adjustment and not a beta (horizontal axis) adjustment. Both adjustments are necessary*. [Emphasis added]. (Tr. 1572).

iii. Risk Premiums Are Not Declining

The OCA also inaccurately suggests that "Investors are aware that risk premiums are declining." (OCA 98). The OCA ignores, however, the inverse relationship between interest rates and equity risk premia. As noted by IPL in its Initial Brief, Mr. Hanley has provided empirical evidence of this inverse relationship via a study covering a 20-year period, 1989 through 2008, in IPL Exhibit FJH-1, Schedule N. Mr. Hanley utilized the ICC's own data in order to accomplish the same empirical demonstration in IPL Exhibit FJH-2, Schedule D. Finally, Exhibit 22, an excerpt from *New Regulatory Finance*, also discusses the inverse relationship, and within its text cites studies through 2005 providing additional academic support for the relationship. As noted by Mr. Hanley, "With interest rates at relatively low levels, it is clear by reviewing [Exhibit FJH-1, Schedule N, p. 1] and [Exhibit FJH-2] Schedule D [p. 7], that the equity risk premium is substantially higher now than when interest rate levels on A-rated public utility bonds were much higher." (Tr. 1605).

iv. IPL's Analysis Is not "Fundamentally Flawed"

The ICC contends that IPL's CAPM analysis is "fundamentally flawed." Specifically, the ICC contends that IPL's use of adjusted betas double-counts the risk and return adjustment. (ICC 52). As noted above, however, Morin's *New Regulatory Finance* clearly refutes this contention. (Tr. 1572). As additionally noted in the Morin text, "The ECAPM and the use of adjusted betas compromise *two separate features* of asset pricing." (Tr. 1573). The ICC's allegations otherwise are misinformed.

5. CLARIFICATION OF THE RPM ANALYSIS

IPL maintains, despite the ICC's contentions to the contrary, that the following statements are correct regarding its RPM analysis: 1) IPL's A3 bond rating is more risky than the proxy group's A2 average bond rating; 2) only the income return is appropriate in the calculation of equity risk premium; and 3) the use of beta as a means of allocating equity risk premium is correct.

i. IPL's A3 Bond Rating Makes It Riskier Than the Proxy Group

The ICC compared its ROE results with the Board's RPM approach in justification of its ROE recommendation. IPL maintains, however, that the evidence presented clearly demonstrates its A3 bond rating is more risky than the proxy group's A2 average rating. This is particularly important during this admitted period of "flight to quality." The investors' flight to quality is reflected in the widened yield spreads between A and Baa rated public utility bonds. As noted by Mr. Hanley:

> IPL has a split rating; that is, Moody's rating is at the bottom of the A category, or A3, while the S&P rating is in the lower category, with a rating of BBB+. This puts IPL in a very precarious position in light of the aforementioned widened spread between these bonds rating classes. (Tr. 1557-1558).

When investors partake in a "flight to quality," they will move to higher quality securities. If those investors continue to flock to stable utility investments, they are still going to invest in the "quality" core of those investments. With IPL's split rating, it may not be seen by these investors as sufficient "quality." If IPL falls to the other side of the gap with the current wide spreads, there is little opportunity for an upgrade. (Tr. 1557).

ii. Utilization of the Return on Bonds

The ICC contends that IPL's RPM analysis is flawed because "it is based on the total achieved return on common stocks, and only the yield component, or income, return on bonds." (ICC 47-48). However, IPL maintains that it is simply complying with financial literature in doing so.

As specifically stated by Morningstar, found in Exhibit FJH-2, Schedule G, pp. 2 - 4:

> The income return is defined as the portion of the total return that results from the periodic cash flow, or in this case, the bond coupon payment. The capital appreciation return results from the price change of a bond over a specific period. *The income return is thus used in the estimation of the equity risk premium because it represents the truly riskless portion of the return.* [Emphasis added]. (*See also*, Tr. 1564-1565).

Additionally, as noted by Mr. Hanley:

> …in the ratemaking paradigm, only the income return, that is, yield, is relevant in establishing the cost of capital. The paradigm holds that the bonds are to be outstanding for their life and any changes in their value are only relevant to the bondholders trading in secondary markets. (Tr. 1565).

Mr. Gorman's contention that the total investment return on bonds should be used actually creates an income mismatch that artificially suppresses the resulting return.

iii. The Use of Beta in Allocating Equity Risk

The ICC maintains that IPL's methodology is flawed "because it does not properly apply the beta factor to total market risk…" (ICC Initial Brief, p. 49). The ICC's argument, however, is without merit. As explained by Mr. Hanley:

> Under beta theory, beta is a measure of relative risk to the market as a whole. Consequently, it is logical to apportion a market equity risk premium by beta, which is derived from regression analysis of market prices, which reflect investors' expectations over a long-term future investment horizon.

(Tr. 1569). Mr. Hanley further supports his conclusion with a citation to Morin's *New Regulatory Finance.* (Tr. 1569, IPL Exhibit FJH-2, Schedule H, p. 4).

6. CONCLUSION

IPL reiterates its proposition from its Initial Brief: Mr. Hanley's ROE analysis is the only one to have offered full candor before the Board. In consideration of IPL's current A3 bond rating which currently enjoys a 12-month average public utility bond yield of 6.92, and risk premium range of 400-500 basis points, 11.4 percent is well within the range of 10.92 – 11.92 percent. IPL's recommended ROE is well within the range of reasonableness, and should be approved by the Board.

IV. RATE DESIGN ISSUES

A. AUTOMATIC ADJUSTMENT CLAUSE FOR TRANSMISSION COSTS

In its initial brief, LEG has advocated that the Board reject IPL's automatic adjustment clause due, in part, to LEG's claim that IPL's proposal is similar or identical to the automatic adjustment clause proposed recently by Black Hills Energy(Black Hills), which the Board rejected. In support of IPL's belief that its proposal is significantly different than the proposal put forth by Black Hills, IPL will review each of LEG's arguments in the table below.[14]

<u>**LEG Brief on Automatic Adjustment Clause**</u>	<u>**Black Hill's CAT tracker**</u>	<u>**IPL's RTS Rider**</u>
Historically, automatic adjustment mechanisms such as the TAC have been allowed only on a very limited basis. These automatic adjustment mechanisms are typically limited to costs that are beyond the control of management, are subject to sudden changes in level, and are an important factor in determining the total cost to serve. (LEG 8).	Black Hills "CAT" tracker was based upon incremental "system integrity" capital investments with a carrying charge. (IUB order RPU-08-3, page 17). Such investments were in the direct control of management, and therefore sudden changes could be managed.	IPL addresses rider costs in its Initial Brief. (IPL 114-115). IPL does not control these costs, including both the size and the timing of expenditures.
The TAC is an automatic adjustment mechanism (Tr. 230-231), and it is evident that the TAC does not meet the criteria normally required for an automatic adjustment mechanism. The evidence in this case shows that the transmission costs to be recovered through the TAC can be projected fairly accurately (Tr. 1291-1292, 1372) and will not fluctuate dramatically from year to year (*Id.*), that IPL has a significant degree of control over the amount of the transmission costs (Tr. 1291, 1373, 1385, 1404-1405), and that transmission costs are not an important factor in determining the total cost to serve. (Tr. 1374). (LEG 8).	The Black Hills investments could be projected fairly accurately, investment did not fluctuate dramatically year to year, and Black Hills had significant control over the investment decisions. (IUB order RPU-08-3, page 18).	IPL outlines how it met each of the five criteria in its Initial Brief. (IPL 115-119).
The TAC would allow IPL to increase rates for electric service and generate increased revenue outside of a rate case without any risk of non-recovery and without matching those costs against reduced expenses. (Tr. 258, 969, 971, 1293, 1385). (LEG 9).	Black Hills under their CAT proposal would be able to receive incremental revenues and returns above that approved in a rate case. (IUB order RPU-08-3, pages 19-20).	There is no "incremental return" available to IPL. The Black Hills clause was for ***capital additions***. IPL's proposed rider reflects ***expenses*** and would match expenses and related revenues one-to-one with an annual reconciliation that would include oversight from the Board. (IPL 113 -114).
For the Board to approve a mechanism such as the TAC, it would have to find that there was an extraordinary need for the	The Black Hills CAT projected expenditures were not extraordinary and require extraordinary treatment. IUB	IPL addresses expense projections in its Initial Brief. (IPL 119). Further, it is clear that the costs in question are

[14] In its brief, LEG referred to the Black Hills proposal as a CAT, and IPL's proposal in this case as a "TAC." For consistency, these same references are used in the table.

LEG Brief on Automatic Adjustment Clause	Black Hill's CAT tracker	IPL's RTS Rider
mechanism or the benefits outweighed the cost of this significant deviation from regulatory policy. (LEG 9).	considered it prudent regulatory policy to review the projected expenditures. (IUB order RPU-08-3, Page 20).	"extraordinary" in a number of ways: • IPL purchases 100% of its transmission service. • The rates paid by IPL (costs incurred) are regulated by the FERC.
The evidence does not show that the projected expenditures are extraordinary and require extraordinary regulatory treatment. (LEG 9).	Black Hills had not had a complete test year of managing the utility. IUB considered it prudent to wait before considering a mechanism that guaranteed revenues. (IUB order RPU-08-3, Page 23).	The costs that IPL will incur for transmission service are significant and vary significantly. (IPL 113).
The TAC would have a true-up each year where the Board could review the costs recovered; however, this review would either be limited, or it could turn into a miniature rate case without customer notice and other procedural protections. (Tr. 230, 237, 271-272, 1385). (LEG 9).	The IUB still has a responsibility to review capital expenditures and this review would be limited under Black Hills CAT proposal. (IUB order RPU-08-3, Page 20).	The process would be analogous to the annual Energy Efficiency Cost Recovery filing. (IPL 109). Further, it is the FERC that determines the rates IPL must pay in this scenario, not the Iowa Utilities Board. The IUB can clearly control the administration it wishes to use for auditing purposes. Other reconciliation processes currently in effect in Iowa have not turned into "mini rate cases."
The expectation that IPL will file a rate case while the TAC is in effect (Tr. 259, 133-134) removes another potential benefit of the TAC that could have been provided to ratepayers. Customers would be faced with the yearly increase in rates from the TAC and the additional rate case expenses from the next rate case. The benefits of the TAC do not outweigh the costs. (LEG 9).	The cost-of-service study shows that there may be more appropriate, and less drastic, means to achieve Black Hills Energy's objective of earning its authorized rate of return, such as an increase in customer charges. (IUB order RPU-08-3, Page 21).	Annual rate cases to recover transmission expenses are not a realistic solution. (IPL 120). Further, it is clear in this case that lack of an automatic adjustment clause will prevent IPL from earning its authorized returns, all other things equal. The clause would not enhance IPL returns compared to its authorized return. The rate case approach causes both regulatory lag and significant costs of administration for all parties.
Even if the Board were to determine that the TAC is justified, the TAC proposed in this docket is not reasonable since it does not include	Black Hill's CAT proposal allowed the recovery of the system integrity investments through depreciation and a recovery on	The IPL transmission rider does not include a return component since it is only for recovery of expenses. IPL outlines the

LEG Brief on Automatic Adjustment Clause	**Black Hill's CAT tracker**	**IPL's RTS Rider**
an adjustment of the return on equity for the reduced risk that the TAC provides. (Tr. 184, 236, 1533). The lack of a reduced return on equity and the statements of IPL witnesses that another rate case will be filed next year weigh against approval of the TAC. Without an adjustment of the return on investment to reflect the reduced risk that would be associated with recovery of transmission costs and without an agreement to delay the next rate case filing, the TAC provides no benefits that offset the costs of this deviation from traditional regulation and is not reasonable. The evidence in the record does not support the need for a remedy outside of the traditional regulatory process.	the system integrity investments through a return on equity of 10.1 percent and an overall rate of return of 8.71 percent, the same as agreed to for the revenue issues. CAT will use the same return on equity agreed to for the revenue issues. Again, no adjustment in the return has been made to reflect the reduced risk associated with guaranteed recovery each year outside of a general rate case. (IUB order RPU-08-3, Page 21).	transmission expenses in its Initial Brief. (IPL 109). The CAT was a capital additions tracker. The TAC is an expense tracker. Further, IPL's risk has increased without a clause, (versus comparable vertically integrated utilities) since it cannot directly control the timing or level of costs incurred.

B. REVENUE ALLOCATION

IPL finds the ICC's Initial brief's discussion regarding the interruptible credits for Bulk Power to be confusing. To clarify IPL's position, IPL agrees that the class cost of service study (CCS) should reflect the interruptible credits for the Bulk Power class credited back to this class. However, since revenues are not proposed to be allocated on a CCS basis for this proceeding, it does not impact IPL's proposed revenue allocation on a non-fuel basis.

C. RATE DESIGN AND TARIFF ISSUES

In its initial brief, LEG contends that IPL's automatic adjustment clause for transmission charges will not recognize primary voltage discounts for large general service customers. As IPL has stated throughout this proceeding, that is not IPL's proposal. Consistent with the commitment IPL made during the hearing, IPL will add the following language to the bottom of the RTS Rider Tariff Sheet No. 86 "* Large General Service RTS charges shall be included with base rate demand charges in the application of primary service and power factor provisions of the Large General Service tariff."

V. CONCLUSION

IPL is not unique in the need to increase its rates and its rate level is consistent with other national and regional utilities. This case is IPL's first increase in base rates in five years. Since that last rate case (RPU-04-1), IPL has provided exemplary, award-wining service through two major ice storms and a flood that went beyond the 500-year flood plain in Cedar Rapids.

The primary drivers for the decision to seek rate relief included capital costs related to last summer's historic flooding, five years of investment in IPL's infrastructure, the increased transmission costs assessed by ITC-M, and overall increases in expenses since IPL's last general rate case, which was based on a 2003 test year. For example, IPL has invested in its energy delivery and generation infrastructures, Flood-related restoration efforts, new customer growth, and environmentally-focused investments. IPL also undertook numerous attempts, however, to mitigate the impact of the requested rate relief on its customers. (IPL 3-5).

As noted in its Initial Brief, the OCA presented a number of illogical and inconsistent arguments in an attempt to demonstrate that IPL's efforts warrant a rate decrease; not a rate increase. (IPL 132-133). If the Board accepts the OCA's recommendation for a $30 million rate reduction, IPL's final rates would be set at a level of approximately $115 million less than the interim rates that IPL made effective on March 27, 2009. IPL would be obligated to make a refund of approximately $85 to $90 million dollars. However, the OCA as well as the other parties did not identify any material level of expenses that are imprudent. As a consequence of reducing revenues, without a commensurate reduction in expenses, IPL will be prevented from earning its authorized return. The only logical result will be: reductions in stock price; increased capital costs; reduced spending on services for customers; and reduced reliability and safety in both the short and long term.

IPL's presentation is the only logical and consistent outcome for the contested issues in this proceeding. The evidence and arguments that IPL has presented show that the record supports an increase of $145.8 million in IPL's revenue requirement.

Respectfully submitted,

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