APPENDIX C

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

ITC Holdings Corp. ITC Midwest LLC; Interstate Power and Light Company, Midwest Independent Transmission System Operator, Inc.	Docket Nos. EC07-89-000 and ER07-887-000

PROTEST AND REQUEST FOR HEARING OF THE MIDWEST MUNICIPAL TRANSMISSION GROUP, MISSOURI RIVER ENERGY SERVICES, AND WISCONSIN PUBLIC POWER INC.

On May 11, 2007, ITC Holdings Corp. ("ITC"), ITC Midwest LLC ("ITC Midwest"), and Interstate Power and Light Company ("IPL") (collectively, "Applicants") filed seeking Section 203 and 205[1] approvals for the sale of IPL's transmission facilities to ITC Midwest and related tariff sheets and agreements, including a new ITC Midwest Attachment O Formula Rate and true-up procedures, and ITC Midwest Appendix I.[2] On June 5, 2007, Applicants amended that filing.

On May 31, 2007, the Midwest Municipal Transmission Group ("MMTG"), Missouri River Energy Services ("MRES"), and Wisconsin Public Power Inc. ("WPPI"), collectively referred to as the "Municipal Coalition," filed a timely and unopposed "Motion to Intervene and Preservation of Rights to Protest." As recited therein (at 5), Applicants agreed that because they would be amending their filing, the Municipal Coalition could submit their protest on all issues at a later date and remain timely.

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[1] 16 U.S.C. § 824b and 16 U.S.C. § 824d.

[2] Without taking a position on the transaction, as the relevant tariff administrator the Midwest Independent Transmission System Operator, Inc. ("MISO") joined in the filing insofar as it would change its tariffs.

Pursuant to that procedural agreement, the Commission's June 13, 2007 Notice of Filing, and 18 C.F.R. §§ 385.211-212, the Municipal Coalition hereby protests the filing, as originally submitted and as subsequently amended. To the extent Applicants' proposals are not summarily rejected, or extensively modified or conditioned so as to cure the flaws identified herein, Municipal Coalition requests discovery rights, suspension, and a hearing, including and especially with regard to the justness and reasonableness of Midwest ITC's requested rate of return.

I. SUMMARY, OVERVIEW, AND NOTE ON PROCEDURAL TIMETABLE

Applicants seek to portray ITC Midwest as the "white knight" coming in to save IPL's transmission system, in which IPL has lacked the will or wallet to invest. But this knight wears gold-plated armor. The proposed transaction would reward IPL, for having failed to maintain a robust system, with an acquisition premium of some $350 million above book value, *i.e.*, almost twice the book value. The apparent mindset is that in return for having allowed their Iowa public utility system to degenerate while chasing below-the-line riches in Brazil and New Zealand, Alliant's shareholders deserve to extract a hefty acquisition premium — per the Asset Sales Agreement ("ASA"), a 1.7709 multiplier.[3] Once one accounts for the manipulations through which Applicants would have ratepayers fund this payoff, it becomes clear that — as Municipal Coalition witness Joe N. Linxwiler testifies in the affidavit that is attached as Attachment 1 — the proposed transaction is "quite a bad deal" for ratepayers.

Make no mistake: For all the window-dressing concerning governance changes, the core of the proposed transaction is all about funding a payoff to Alliant shareholders by increasing rates far above cost. The Midwest ISO will functionally control the affected facilities both

[3] *See* ASA Section 1.1, at 9 ("'Net Premium Multiple' means 0.7709").

before and after the proposed divestiture. The admirable concept of non-discriminatory system planning will be mortgaged to the Applicants' commitment that ITC Midwest will build facilities identified by IPL, and by IPL alone, in Confidential Schedule C to ITC witness Schultz's testimony, Exh. IT-3. This to-do list was negotiated bilaterally and in secret, filed under seal such that it is shielded from public scrutiny, and has yet to be discussed with other stakeholders or reviewed for its efficiency and fairness in meeting long-term needs. Indeed, the items identified in Confidential Schedule C appear to be focused on the needs of IPL's retail customers, with repairs insufficient to address known problems, much less provide the promised non-discriminatory transmission service for other customers.

Thus, ITC is already betraying any hope that it will be open and inclusive in planning and developing the grid for the benefit of all generators and loads. Municipal Coalition members favor and participate in inclusive transcos, with rates tethered to costs, such as the American Transmission Company LLC. Even now, when it is seeking approvals that include rates bearing little relationship to cost, and presumably is on its best behavior, ITC shows little interest in actually listening to its loads' needs.

Plus ça change, plus c'est la même chose. Except for customers' payments, of course: Those will change radically, in one direction.

Applicants take the position that because transcos are consistent with FERC policy, money is no object. Applicants' Iowa testimony explains that IPL had been considering, but turned down, the American Transmission Company's offer to purchase the IPL transmission system at net book value.[4] Instead, IPL gave primacy to shareholder interests by pursuing the

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[4] Given ATC's 12.2% equity return on a 50/50 capital structure, such a transfer would have yielded the benefits of a transco without the adverse rate impacts proposed here. ATC has been clear that incentive returns are not necessary to get facilities built, and may be counter-productive to getting needed transmission constructed. Dale Landgren,

rich acquisition premium offered by ITC. Applicants now ask this Commission to allow rates to rise high enough to fund this premium, even though Commission policy forbids flowing the premium through to ratepayers. *See* Welch at 8, Exh. IT-1. But as we will demonstrate, using the evidence proffered by ITC's own cost of capital witness, the requested exorbitant rates far exceed the zone of reasonableness, once his patent errors are corrected. For example, in generating the sole purported data point underlying their May 11, 2007 claim that the requested 13.88% ROE is within the zone of reasonableness in a standard-methodology DCF study, ITC appears to have committed a cell reference error in constructing a spreadsheet. One proxy company's projected growth was paired with a different proxy company's dividend yields. *See* Part II.A.2 below, the accompanying affidavit and exhibits of cost of capital expert J. Bertram Solomon (Attachment 2 hereto) and ITC's workpapers, as provided in response to discovery in related Iowa state proceedings. Once this transposition is corrected, the zone of reasonableness tops out well below 13.88%.

Applicants apparently assume that the Commission will not look closely at the filing, because if it exercises due diligence or changes anything, ITC may walk away from the deal.[5] But the Commission has, and should utilize, ample time — at least 180 days from the June 5, 2007 amendment — to scrutinize Applicants' intertwined Section 203 and Section 205 proposals.[6] The 180-day clock of amended FPA Section 203(a)(5) does not start until the subject

ATC, testifying at the Transmission Investment Technical Conference *Transmission Independence and Investment*, Docket Nos. AD05-5-000 & PL03-1-000, April 22, 2005 (Tr. 197-98). ATC's strategy has clearly worked, as shown by the $1 billion invested in needed transmission that Applicants tout in their Iowa testimony (IPL witness Collins at 8) as a transco success story.

[5] *See* § ASA 9.2(e). *See also* Application at 8 (mis-citing for this proposition ASA § 9.1(e), which does not exist).

[6] Because Applicants have made the transaction contingent on approval of their Section 205 application, ASA § 9.2(e), this Commission cannot find that the proposed transaction as a whole is consistent with the public interest unless it finds that approval of Applicants' Section 205 application is consistent with the public interest. The June 5 Amendment therefore changes the information that the Commission must analyze before granting any approval

application is completed. Subject to a 180-day extension where appropriate, "[t]he Commission will act on a completed application for approval of a transaction (*i.e.*, one that is consistent with the requirements of this part) not later than 180 days after the completed application is filed."[7] As demonstrated in Part II.A.2 below, the patent errors admitted through the June 5 amendment go to the heart of the filing's merits, or lack thereof. The Commission has and should utilize the full initial 180 days to consider the entire application in light of the amendment.

It is not the policy of this Commission, or of the Congress, that consumers must "pay any price, bear any burden, to ensure the survival and success"[8] of ITC Midwest, L.L.C. This Commission's mission, under Federal Power Act Sections 205, 206, and 219, and under Section 203 and its own merger policy, is to ensure that even incentivized rates remain just, reasonable and not unduly discriminatory or preferential, and that acquisitions are in the public interest. And in making these determinations, the Commission must weigh heavily the fact that giving Applicants what they seek would set up powerful incentives subverting transmission planning and expansion obligations — the very obligations that Order 890 seeks to reinforce. If the

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under Section 203, and so the Commission must have 180 days from the date of the amendment to act on the application.

[7] *See* 18 C.F.R. § 33.11(a) (promulgated by Order 669, Transactions Subject to FPA Section 203, Order No. 669, 71 Fed. Reg. 1348 (Jan. 6, 2006), [2001-2005 Regs. Preambles] F.E.R.C. Stat. & Regs. ¶ 31,200 (to be codified at 18 C.F.R. pts. 2 and 33), *order on reh'g*, Order No. 669-A, 71 Fed. Reg. 28,422 (May 16, 2006), III F.E.R.C. Stat. & Regs. ¶ 31,214 , *order on reh'g*, Order No. 669-B, 71 Fed. Reg. 42,579 (July 27, 2006), III F.E.R.C. Stat. & Regs. ¶ 31,225, *corrected*, 71 Fed. Reg. 45,736 (Aug. 10, 2006)). *See also* Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement, Order No. 592, 61 Fed. Reg. 68,595 (Dec. 30, 1996) [1996-2000 Regs. Preambles] F.E.R.C. Stat. & Regs. ¶ 31,044, 30,127 ("Merger Policy Statement") (cited in Order 669 at n.123):

> We also emphasize that applicants should not expect speedy action if their merger proposals change, as has frequently happened in the past. The Commission cannot be expected to act quickly on a moving target. If applicants change the mechanism or terms under which they intend to merge or supplement the supporting information in their application, the Commission's review process will restart.

[8] We paraphrase, of course, from President Kennedy's inaugural address. One could add that ITC Midwest has not asked the Municipal Coalition, as prospective ratepayers, what it can do for them, but it has certainly asked this Commission how much it will require ratepayers to do for ITC Midwest.

Commission rushes to approve this acquisition as proposed, the lesson taught will be clear: **vertically integrated utilities who neglect their transmission systems will be richly rewarded with high acquisition premiums funded by supersized rates, even where the record is devoid of substantial evidence supporting <u>any</u> rate increase.**

Thus, the Municipal Coalition requests that the Commission neither reward Alliant for starving its transmission system nor sanction a customer-funded end-run around the bar against recovery of acquisition premiums. The transaction should be rejected, and if not rejected, should be conditioned or modified as follows:

- The formula rate as proposed by Applicants should be modified such that its end result is kept within an empirically supported zone of reasonableness, with
  - the rate of return on equity set no higher than the currently-applicable last clean rate of 12.38%;
  - the capital structure for use in rates made reflective of the highly leveraged capital structure of ITC Holdings; and
  - The ADIT balance, through which ratepayers have pre-funded the payment of income taxes imputed to transmission income, carried forward as an ADIT balance on ITC Midwest's books, and if not carried forward then counted as incentive enough, obviating any above-cost rate of return on capital;
- The rates, terms, and conditions of the Section 205 rate filing, including its Appendix I, should be suspended until 60 days plus five months after the filing was completed, which did not occur before June 5, 2007;
- A full trial-type evidentiary hearing, with discovery rights, should be convened; and
- The remedies discussed below regarding Schedule C, and Appendix I, and the other aspects of Applicants' filing, should be ordered, or at least considered at hearing.

II. APPLICANTS HAVE FAILED TO DEMONSTRATE THAT THE TRANSACTION IS CONSISTENT WITH THE PUBLIC INTEREST AND THAT THE RESULTING RATES WOULD BE JUST, REASONABLE, AND NON-DISCRIMINATORY

Because increasing rates is the heart of the proposed transaction, we begin by addressing the overlapping requirements of ratepayer protection in dispositions (under FPA Section 203, 16 U.S.C. § 824b and Order 642[9]) and just, reasonable, and non-discriminatory ratemaking (under FPA Section 205, 219, 16 U.S.C. § 824d, 824s, and Order 679[10]). *See* Part II.A, below. These issues require extended discussion, both because Applicants have been disingenuous and opaque in describing their rate proposals, *see* Part II.A.1, and because those proposals, when unhidden, are so extreme, *see* Parts II.A.2-4. We then briefly turn to the proposed transaction's effect on regulation. *See* Part II.B. Next, we address the proposed transaction's effect on competition, and show that it does not live up to its billing — much less its bills. *See* Part II.C. We conclude this section with a discussion of the fundamental question posed by FPA Section 203: consistency with the public interest, as framed by Commission policy. *See* Part II.D.

A. Effect on Rates

To hear Applicants tell it, the proposed disposition will maintain existing IPL-based rates through 2008. *See, e.g.,* Application at 5. In fact, however, the trued-up rates would skyrocket, and do so without pausing on the launch pad. Effective long before the end of 2008, the return on equity ("ROE") would rise to 13.88%, and (under the anticipated 60/40 equity/debt capital structure) would be weighted more heavily than it is now in determining the return on total capital. The rate base that would be multiplied by the resulting doubly-increased return would

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[9] Revised Filing Requirements Under Parte 33 of the Commission's Regulations, Order No. 642, 65 Fed. Reg. 70,983 (Nov. 28, 2000), [1996-2000 Regs. Preambles] F.E.R.C. Stat. & Regs. ¶ 31,111 ("Order 642").

[10] Promoting Transmission Investment through Pricing Reform, Order No. 679, 71 Fed. Reg. 43,294 (July 31, 2006), III F.E.R.C. Stat. & Regs. ¶ 31,222 (to be codified at 18 C.F.R. §§ 35.34-35.35), *on reh'g*, Order No. 679-A, 72 Fed.

expand dramatically, whether or not ITC Midwest actually built any new facilities, mainly (but not only) because the large ratepayer-funded ADIT offset against rate base would disappear.

But as demonstrated below, there is no genuine dispute of material fact that the proposed ROE increase to 13.88% would raise rates far above the zone of reasonableness, and even further above that zone once combined with the other requested rate concessions. Accordingly, the filing's deficiency in meeting Order 679 and Federal Power Act standards is patent, and the Commission should reject the ROE increase as a matter of summary disposition. If summary disposition is not granted, then at the very least, the Commission should convene a full evidentiary hearing before an Administrative Law Judge, with ample time to conduct discovery into ITC Holdings' and ITC Midwest's finances and actual cost of capital, present pre-filed testimony, and conduct cross-examination.

1. The Application Is Unjustifiably Opaque In Identifying Its Huge and Discriminatory Ratepayer Impacts

Order 642 adopts the NOPR's proposal "that all merger applicants demonstrate how wholesale ratepayers will be protected and that applicants will have the burden of proving that their proposed ratepayer protections are adequate. Specifically, … applicants must clearly identify what customer groups are covered (*e.g.*, requirements customers, transmission customers, formula rate customers, etc.), what types of costs are covered, and the time period for which the protection will apply."[11] Order 642 "emphasize[d] … that if applicants do not offer any ratepayer protection mechanism, they must explain how the proposed merger will provide adequate ratepayer protection."[12]

Reg. 1,152 (Jan. 10, 2007), III F.E.R.C. Stat. & Regs. ¶ 31,236, *clarified*, 119 F.E.R.C. ¶ 61,062 (2007).

[11] *See* Order No. 642, at 31,914.

[12] *Id.*

Applicants address ratepayer protection in a way that is at best confusing, if not outright misleading. At page 5 of the Application, Applicants state "the proposed implementation of the Attachment O formula rate with a true-up mechanism to recover ITC Midwest's revenue requirement will produce *no change in charges for transmission service before January 1, 2009*" (emphasis added). Applicants repeat that declaration at page 8: "under the proposed forward-looking application of Attachment O, *ITC Midwest's charges for transmission service will not change until January 1, 2009*" (emphasis added). These same words are repeated in the heading of III.C.1. *See* Table of Contents and page 20. ITC CEO Welch also testifies (Exh. IT-1 at 9): "... ITC Midwest charges for transmission service will not change until January 1, 2009." Presumably Applicants intend the Commission and customers to rely on this claim in assessing the transaction's effect on rates. Indeed, in closing that section, Applicants assert that their proposed rate treatment "further mitigates any potential for adverse rate effects as a result of this Transaction." *See* Application at 20.

In fact, Applicants' purported ratepayer protection would leave consumers as nakedly exposed as if they were wearing only the Emperor's New Clothes. Applicants' Iowa filing[13] — and the fine print in their filing here — makes clear that notwithstanding Applicants' claim to the contrary, ITC's collections commencing January 1, 2008 *are* subject to true-up, with interest, such that ITC will ultimately collect a 2008 revenue requirement that is inflated by the proposed 13.88% return on equity, 60% equity ratio, ADIT adjustment, *etc.* The Application details the proposed regimen at 20:

> ... ITC Midwest proposes to maintain the charges for IPL's transmission facilities that will take effect on June 1, 2007, pursuant to IPL's currently applicable Attachment O formula rate,

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[13] *See* Linxwiler Affidavit at 23.

> in effect through December 31, 2008. Beginning January 1, 2008, these charges will become subject to true-up when ITC Midwest's actual revenue requirement is known.

While ratepayers may initially be billed pursuant to IPL's Attachment O for the period January 1, 2008 to January 1, 2009, the effective revenue requirement for that period will be the trued-up one reflecting ITC Midwest's Form 1 for 2008. The resulting revenue target for 2008 will be collected from ratepayers, with interest, starting January 1, 2010, on top of ITC Midwest's estimated revenue requirement for 2010.[14] Thus, Applicants' references to maintaining IPL charges are simply a smokescreen, in which Applicants attempt to hide an immediate rate increase behind the delay that separates initial bills from the true-up. Notwithstanding their repeated suggestions to the contrary, Applicants propose, through true-up with interest, to make ITC Midwest's increased revenue requirement effective as of January 1, 2008.

Nor is it clear that either IPL's Attachment O or ITC Midwest's proposed Attachment O will achieve the result explained in the Application (as quoted above, and further explained by ITC witness Neff (Exh. IT-2 at 7-8)). IPL's Attachment O, which is the source of the charges that took effect on June 1, 2007, which ITC Midwest proposes to continue through January 1, 2009, has *no* true up. ITC Midwest's Attachment O (*see* Attachment 6 to the Application) is proposed to be effective January 1, 2008, and includes ITC's proposed 13.88% equity return (rather than IPL's 12.38% return), as well as true-up mechanism. It is frankly difficult to ascertain from Applicants' filing what rates ITC Midwest will be applying in issuing initial bills for service rendered on and after January 1, 2008, much less the level to which those charges will be trued up. This vagueness is itself a fatal deficiency in the present Section 205 application:

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[14] *See* Neff, Exh. IT-2 at 7-8 (explaining that the projected unit price that ITC Midwest will charge commencing January 1, 2008 will be the same as the unit price charge that will be in effect from June 1, 2007 through December

The inner core of Section 205 (even more central than its core rate-regulating purposes) is to ensure that the rates for service are defined before service is rendered, but here consumers can only peer through ITC's looking glass, darkly.

Significantly, the Application is devoid of *any* calculation of the proposed Transaction's impact on rates. While such omission is consistent with Applicants' evasive approach to ratepayer protection, it is surprising given the availability of Applicants' own studies of the rate impact, as submitted to the Iowa and Minnesota state commissions. Those studies show a five-year adverse impact on retail customers (assuming ITC Midwest constructs only the projects IPL was already committed to construct (*e.g.*, not the projects in Confidential Schedule C to ITC witness Schultz's testimony, Exh. IT-3, which ITC Midwest states it is committed to build)) that is barely offset by $60 million net present value of anticipated AFUDC offsets plus $30 million in reduced IPL capital cost. While the impact on transmission customers is not quite as dramatic because we are already paying IPL's 12.38% return, it is quite substantial. **Applicants' retail cost-benefits study (with its rather artificial assumptions as to construction) adapted to measure the impact on wholesale transmission customers, would produce a wholesale transmission rate increase of more than 20%.** *See* Linxwiler Affidavit (Attachment 1 hereto). However, Applicants have offered transmission customers no share of the $90 million cushion being provided to IPL's retail customers, even though the money is both generated from the sale of transmission assets TDUs have long supported and funded from the transmission revenues they will pay ITC Midwest in the future. Because Applicants have helped themselves to a

31, 2007. It will be trued-up to the 2008 actual revenue requirement and the true-up amount will be in the unit price charged to customers commencing January 1, 2010.)

waiver of 18 C.F.R. § 33.2(c)(6) rather than comply therewith, it is not even clear that wholesale requirements power customers will share in this kickback.[15]

Applicants argue (Application at 21) that the Transaction's undisclosed impacts on jurisdictional transmission rates are consistent with *ITC Holdings* and *METC*. However, both involved multi-year rate freezes, sought smaller ADIT adjustments, involved incentive equity returns that when sought were closer to the then-current cost-based level and were within the then-current range of proxy returns, and met with little intervenor protest as to the effect on transmission rates.[16] Similarly, in accepting the ADIT adjustment by METC on rehearing, the Commission gave significant weight to the *uncontested* nature of the proposal, noting "Applicants have avoided costly litigation, and the delay associated with protracted disputes, by entering into stipulations with the affected transmission-dependent utilities and state-commission and that these entities support the transaction."[17] The Merger Policy Statement encourages

[15] A data response provided in the Iowa proceedings states that IPL's wholesale requirements customers will be included in the partial offset to the transaction-related rate increases. *See* IPL's response to Office of Consumer Advocate Data Request 77, Attachment 3 hereto. Curiously, however, Exhibit F to Applicants' filing merely asserts that "The Transaction for which approval is sought here will have no effect on wholesale power sales by any affiliate of IPL. For this reason, information on such sales will not assist the Commission in making its determination of whether the Transaction is consistent with the public interest," and seeks waiver of the requirement in 18 C.F.R. § 33.2(c)(6) to provide information regarding such sales. *See also* Application at 35. IPL has not stated to this Commission — the one with jurisdiction over power sales for resale — its commitment to include wholesale requirements power customers in the partial offset. That reticence casts doubt on the commitment. To remove this doubt, the Commission should deny Applicants' for waiver of 18 C.F.R. § 33.2(c)(6). The Commission and interested customers should receive full information on how IPL wholesale customers would be treated, and on how this treatment would compare with that of IPL retail customers.

[16] *See Trans-Elect, Inc.*, 98 F.E.R.C. ¶ 61,142, 61,419 (2002) (finding no evidence that rates will increase as a result of the proposed transaction and noting the lack of intervenor protests), *order on reh'g*, 98 F.E.R.C. ¶ 61,368 (2002) ("*METC*"); *ITC Holdings Corp.*, 102 F.E.R.C. ¶ 61,182 at P 97 (noting that no intervenor has raised concerns about the adverse impacts on wholesale power rates and while questions have been raised about certain post-freeze rate treatments, no one has sought a hearing regarding the effect of divestiture on rates or proposed any other type of ratepayer protection), *reh'g denied*, 104 F.E.R.C. ¶ 61,033 (2003).

[17] *METC*, 98 F.E.R.C. ¶ 61,368 at 62,590.

proactive applicant efforts to reach accommodations with intervenors,[18] but Applicants have opted to disguise their rate increase instead.

Finally, Applicants' claim that they are not seeking to recover the acquisition premium in rates (Application at 19) is belied by ITC CEO Welch's testimony (Exh. IT-1 at 8) in support of rates that fund ITC's payment to IPL of a premium amounting to nearly twice book value – *i.e.*, indirect recovery of the rate premium through excessive returns:

> Congress recognized that transmission would not be sold at book value and that there would be a capital gain on such sales. ... Under Commission policy, however, a buyer of such assets, including ITC Midwest. may not seek recovery of the acquisition premium. The only way that such transactions can occur, therefore, is if the independent transmission company buyer is able to earn a return that makes the acquisition economically rational, despite the inability to recover the acquisition premium.

Exh. IT-1 at 8. Given the demonstration below of the excessive nature of the requested return on equity, which far exceeds the zone of reasonableness using Applicants' own studies with obvious errors corrected, failure to seek direct recovery of the acquisition premium is cold comfort for ratepayers.

Thus, Applicants have not met their burden to demonstrate that the proposed Transaction will not have adverse impacts on wholesale customers who now purchase transmission and/or power from IPL, and that their proposed mitigation is adequate.[19] Given Applicants' evasive treatment of this issue, it would seem appropriate to hold Applicants to their repeated representations that until January 1, 2009, transmission rates will not change from IPL's Appendix O rates that become effective June 1, 2007, with no fine print providing for those rates

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[18] Merger Policy Statement, 61 Fed. Reg. at 68, 595 [1996-2000 Regs. Preambles] F.E.R.C. Stat. & Regs at 30,111-12.

[19] *See* Order 642, at 31,914. Applicants' pledge (Application at 19) not to include transaction-related costs that do not exceed demonstrated savings for fix years do not begin to address the concerns raised here about rate impacts.

to change through true-up (with interest) to ITC's actual revenue requirement (including the excessive equity return and ADIT adjustment), threatening severe rate shock (which Applicants make no effort to estimate) in 2010 when imposed in conjunction with ITC Midwest's projected 2010 revenue requirement.

Municipal Coalition members also question why unbundled transmission customers, who must compete with IPL to serve load on the IPL system,[20] are excluded from sharing in the $90 million earmarked for IPL's retail customers as mitigation of Transaction-induced rate increases. The funding for this mitigation derives from the acquisition premium value of transmission facilities that embedded TDUs have long supported, and will fund through future transmission rates. That value is also the source of the acquisition premium whose indirect recovery through rate increases necessitates mitigation. Excluding transmission customers from any share of those benefits therefore adds insult to competitive injury.

For similar reasons, there is no non-discriminatory weight to Applicants' claim (Application at 22) that the economic benefits of the transaction "must be taken into account in assessing net impact on rates." Applicants point to IPL's commitment of some of the proceeds to generation development. But that claim hardly justify rate increases to transmission customers for whom the rate impact is not "netted" against the benefits of IPL's new generation investments. Transmission customers merit protection comparable to IPL retail customers. Otherwise, the Transaction will be nothing more than a vehicle for extracting and legitimating the value to IPL of a non-level, unduly discriminatory, transmission playing field.

Finally, given Applicants' effort to hide the ball on ratepayer impacts of the Transaction (including ITC Midwest's 13.88% ROE), a hearing would be appropriate to identity and fully explore the extent of ratepayer impacts. For example, the Commission needs to know more about the rate shock that ratepayers will face in 2010. That is when consumers will be hit with at least a double whammy: the true-up from the IPL June, 2007 rates (based on IPL's 2006 costs) to the ITC Midwest 2008 actual above-cost revenue requirement, plus interest, on top of ITC Midwest's projected 2010 rates, which according to Applicants will include aggressive upgrades far beyond what IPL has included in its 2006 rates.

2. No Substantial Evidence Supports Any Increase in Equity Return, Much Less the Supersized 13.88% Return ITC Seeks

Federal Power Act Section 219, and the implementing Order 679 regulation, clearly require that rates of return on equity, including those enjoyed by transcos, be kept within the zone of reasonableness. The Commission considered and explicitly rejected calls for allowing ROEs above the high end of the zone of reasonableness, as developed through a traditional Discounted Cash Flow ("DCF") study of proxy-group equity costs. In Order 679 at P 206, the Commission held that any heightened ROEs for transcos must "fall[] within a zone of reasonableness." *See also id.* at P 2 ("an incentive rate of return sought by an applicant must be within a range of reasonable returns and the rate proposal as a whole must be within the zone of reasonableness before it will be approved"); *id.* at P 93 ("Though some commenters assert that the incentive need not be cost-based and therefore can justifiably be above the upper-end of the zone of reasonableness, we believe a return within the zone will be adequate to attract new investment and consistent with the intent of Congress in section 219.").

As shown below, the new 13.88% ROE that ITC and IPL's shareholders seek to have collected by MISO for access to the transferred facilities would soar high above even the very

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[20] Although Iowa and Minnesota are not retail access states, there is still yardstick, fringe area, and franchise competition as between embedded municipals and IPL.

top of the potentially reasonable range. *See also* the accompanying affidavit and exhibits of cost of capital expert J. Betram Solomon, which are Attachment 2 hereto.

a) ITC's Own "FERC DCF-Electric" Study of Transmission Owners with a Direct Link to the Midwest ISO Is the Controlling Study Under Commission Precedent, and its Arithmetically Corrected Result Shows that the Zone of Reasonableness Tops Out Well Below 13.88%

Commission policy requires that an ROE for use in RTO rates be based on "a proxy group … comprised of transmission owners with a direct link to the same RTO or ISO in which the applicant is located," and allows for deviation from this policy only if there is "compelling evidence," vetted through a trial-type evidentiary hearing, for adding or subtracting DCF proxies. *Commonwealth Edison Co.,* 119 F.E.R.C. ¶ 61,238, PP 78-79 (June 5, 2007) ("*ComEd*"); *Trans-Allegheny Interstate Line Co.,* 119 F.E.R.C. ¶ 61,219, P 40 (May 31, 2007) ("*TrAIL*"). As the Commission explained, this policy is based on its Midwest ISO precedent (as established in Docket No. ER02-485, hereafter "*Midwest ISO ROE*"):

> In *Midwest Independent Transmission System Operator, Inc.*, [77] the Commission accepted a proxy group of Midwest ISO transmission owners in setting an ROE applicable to the participating transmission owners in the Midwest ISO.[78]
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> [77] 100 FERC ¶ 61,292 (2002) (*Midwest ISO ROE Order*), *order on reh'g*, 102 FERC ¶ 61,143 (2003), *order on remand*, 106 FERC ¶ 61,302 (2004), *aff'd, Public Service Comm'n of Kentucky v. FERC*, 397 F.3d 1004 (D.C. Cir. 2005).
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> [78] *See Midwest ISO ROE Order*, 100 FERC ¶ 61,292 at P 32.

ComEd at P 78; *see also TrAIL* at P 40 & n.43. This policy has profited IPL handsomely, by allowing it to collect revenues from MISO transmission customers based on a 12.38% ROE, even though Alliant's 8.79% Indicated Cost of Equity ("ICOE") in the record of *Midwest ISO ROE* was the single lowest ICOE found for any of the MISO TOs proxies.[21]

[21] *See Midwest Indep. Transmission Sys. Operator, Inc.*, 99 F.E.R.C. ¶ 63,011, at Appendix A (2002) ("*Midwest ISO ROE Initial Decision*"), *aff'd in relevant part, Midwest Indep. Transmission Sys. Operator, Inc.,* 106 F.E.R.C.

When ITC submitted its May 11, 2007 filing, it recognized and acted upon this policy. As its primary cost of capital study, ITC presented Exh. IT-4, Schedule 3. This exhibit was presented by ITC Witness Dr. Jonathan A. Lesser, and was incorporated into testimony to which Dr. Lesser swore. This exhibit and the associated narrative testimony applied the Commission's standard electric utility DCF methodology, *i.e.,* the constant-growth DCF methodology, to a proxy group of eight publicly-traded parents of Midwest ISO member firms. These eight firms are the same group as the nine-member MISO TO group relied upon in *Midwest ISO ROE,* and as such the basis for the existing MISO-wide unbundled transmission ROE of 12.38%, minus Aquila (*a.k.a.* Utilicorp) which ultimately did not join the Midwest ISO.[22] In its Schedule 3, ITC purported to apply the same basic methodology as provided the exclusive basis for inferring the cost of equity capital in *Midwest ISO ROE*, and in countless cases before and since such as *Southern California Edison Co.*, Opinion No. 445, 92 F.E.R.C. ¶ 61,070 (2000) and *Bangor Hydro-Electric Co.*, Opinion No. 489, 117 F.E.R.C. ¶ 61,129, PP 53-60 (2006). Because that methodology produced (ostensibly) a range of proxy results extending above the requested 13.88%, ITC submitted it to the Commission, announcing that "based on application of the Commission's DCF analysis ... the requested ROE is within the zone of reasonableness."[23]

However, in applying this methodology, ITC committed at least three patent errors. The first was a presumably inadvertent, but highly material, transposition error. Simply correcting the transposition error suffices to establish that even the very top of the range of reasonable returns on equity is well below ITC's requested 13.88%. The second error was the use of false

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¶ 61,302 (2004), *aff'd in relevant part sub nom Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d. 1004 (D.C. Cir. 2005).

[22] Cinergy has been merged into Duke Energy, and the group composition reflects that succession. *Cf. MISO ROE ID,* Appendix A.

[23] Application, at 42.

stock price inputs in deriving one proxy's dividend yield. Correcting for this error too suffices to establish that the range tops out below the currently-applicable 12.38%, and thus miles below the requested 13.88%. The third error is the failure to account for compounding when computing the "*v*" component of $br + sv$ growth. Further correcting for this error shows that the range tops out even further below 12.38% and 13.88% — indeed, below 12%.

The Municipal Coalition's discovery of the first two of these errors led to ITC's June 5, 2007 filing. Therein, ITC stated that it had "come to [its] attention" that Dr. Lesser's testimony "contained errors." ITC tendered an "amended version" of Dr. Lesser's testimony and an associated revised page 42 of the Joint Application. But ITC did not present the same study with corrected inputs and results. Instead, once it saw that the arithmetically correct result was a number too low to provide a rationale for exploiting consumers, ITC sought to simply discard the methodology on which it had previously relied, and rest its case on a different rationale. We will show in Part II.A.2.b)(3) below that that rationale doesn't withstand scrutiny either. But before we step into the batter's box against ITC's relief pitcher, we note that the results of ITC's Schedule 3 study must stay on the scoreboard,[24] and we demonstrate in Parts II.A.2.a)(1)-(3) below that those results preclude approval of ITC's request.

[24] ITC's June 5, 2007 submission is presented not as a withdrawal of its May 11 testimony, but rather as an "amended[ment]" pursuant to no specified Commission Rule of Practice and Procedure. If it were (and to the extent it is) a withdrawal, we would (and conditionally do) move in objection to such withdrawal, pursuant to Rule 216(b), 18 C.F.R. § 385.216(b). The testimony which ITC seeks to disown remains, in conjunction with the arithmetic corrections we have supported, relevant evidence of the actual cost of equity capital invested in transmission facilities operated by the Midwest ISO. Accordingly, it should not be excised from the record. In any case, out of an abundance of caution, we are also filing it as Attachment 4 hereto. Whether as originally filed or as attached here, it stands as (a) a record of what ITC and its witness have asserted, and (b) evidence, when and only when read in conjunction with the necessary arithmetic corrections, of the cost of equity and range of ICOEs.

(1) ITC's ICOEs for MDU and DTE Pick Up The Wrong Inputs from ITC's Workpaper

In its May 11 filing, ITC presented the details of its standard-methodology DCF study at Exhibit IT-4, Schedule 3, titled "FERC-approved One-Stage DCF Model Results (Electric Utilities),"[25] and distilled those purported results in Dr. Lesser's direct testimony, Exhibit IT-4, page 36, Table 6.

Purporting to apply standard methodology to data derived from a six-month study period (September 2006 through February 2007), Dr. Lesser identified 16 implied cost of equity DCF data points, *i.e.,* two data points per proxy, one low and one high (hereafter, "ICOE-low" and "ICOE-high," respectively). **Of these 16 data points, <u>only one</u> exceeded 13.88%, and that one was miscalculated, because what is indisputably a transposition error botched the arithmetic.** Specifically, only the 14.78% ICOE-high presented as that of MDU Resources exceeded 13.88%. <u>All</u> of the others were quite significantly lower, to the point that ITC ascribed to the array a midpoint of 11.17%, a median of 8.74%, and an average (*i.e.,* mean) of 9.24% — and that was <u>after</u> improperly excluding two low-end ICOEs.[26] Thus, the purported 14.78% ICOE-high for MDU Resources is the linchpin of ITC's claim that 13.88% falls within the reasonable range.

But as ITC has now admitted, that linchpin is broken. Reviewing Exhibit IT-4, Schedule 3, line 5 shows that the 14.78% ICOE-high for MDU Resources was based on a dividend yield of

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[25] In the "amended" testimony tendered on June 5, ITC eliminated several exhibits and shifted the numbers of those that remained forward. To avoid confusion, we will refer to the May exhibits by their original (May 11) numeration, and where it is necessary to refer to the June exhibits, will use the citation form "Exh. IT-# (June Rev.).

[26] As discussed below, ITC's summaries of this proxy group at Exh. IT-4 Schedule 3 exclude from the midpoint calculation both an ICOE-low of 4.80% erroneously ascribed to DTE Energy, and an ICOE-low of 7.00%, ascribed to Vectren, that ITC elsewhere (in Exh. IT-4 at 6) correctly retains.

4.73%.[27] **But that is more than twice MDU's actual dividend yield!** In response to a data request by the Iowa Office of Consumer Advocate[28] for the workpapers and live spreadsheet underlying Dr. Lesser's FERC testimony, ITC produced the underlying Excel file, which is attached as ~___ hereto. It shows MDU's dividend yield (high,[29] and prior to adjustment for growth between dividends' quarterly payments) as 2.09%, <u>not</u> 4.73%. A glance at any of the myriad standard sources of dividend and stock price information, such as the February 9, 2007 Value Line report for MDU on which ITC Witness Lesser elsewhere relies, shows that the workpaper 2.09% figure for this input is the correct one.[30] Indeed, in Exh. IT-4, Schedule 4, page 2, Dr. Lesser shows a 2.09% "Current Dividend Yield," (which reflects growth between dividends' quarterly payments) based on the $25.11 average daily closing stock price during the same 6-month period.

The source of ITC's spurious 4.73% dividend yield for MDU can be surmised by examining the "Stock Price for FERC-DCF" tab of Dr. Lesser's workpaper spreadsheet. The dividend yield information for DTE Energy there appears immediately above that for MDU Resources, and virtually matches the figures that Exh. IT-4 Schedule 3 mis-reports as the unadjusted dividend yields for MDU.[31] Somehow, ITC reported <u>DTE's</u> dividend yield as that of

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[27] (That purported yield is added to, and scaled up for, br+sv growth of 9.82%, supposedly summing to the 14.78%. That is, Column 6 of Schedule 3 computes an "Adjusted Dividend Yield (High)" of 4.97%, representing 4.73% * (1+(0.5*9.82%), and that 4.97% is added to the 9.82% to generate the linchpin 14.78%.

[28] This request was made in the Iowa Public Utilities Board proceeding concerning the same proposed transmission asset sale that is at issue here (IUB Docket No. SPU-07-11), as Data Request No. OCA-133 (attached as Attachment 5).

[29] In the same data response spreadsheet tab, the MDU dividend yield (low), based on the study period's high stock prices, is 1.94%.

[30] MDU's quarterly dividends per share were $0.127 during most of 2006, increased to $0.135 for the last quarter of 2006 (paid out in January 2007), and have held steady thereafter. Consequently, that Value Line report states MDU's dividend yield as 2.2%.

[31] The spreadsheet tab's dividend yields are as follows:

MDU, and likewise reported the wrong dividend yields for DTE.[32] In Dr. Lesser's workpaper, because it does not commit this patently erroneous transposition, MDU's ICOE-high falls to 12.01% — well below 13.88%, and indeed below the midpoint-based 12.38% that IPL is currently collecting from those transmission customers who do not buy its retail power. Consequently, with just this threshold correction, Dr. Lesser's study stands for the opposite of the proposition for which it was advanced.

A related correction lowers the bottom of the range of ICOEs. In his testimony, unlike his workpaper, Dr. Lesser had mistakenly identified a 2.47% dividend yield for DTE Energy, which (when combined with 2.31% *br* + *sv* growth) produced an apparent 4.90% ICOE-low, which he discarded on the ground that it was below the 6.34% yield for Baa-rated corporate bonds.[33] But when the real dividend-yield-low for DTE Energy is picked up from ITC's workpaper, that necessary correction raises the ICOE-low for that proxy to the point that it exceeds DTE Energy's recent cost of debt and therefore meets the Opinion No. 489 test for retention in the array of ICOEs.[34] Because it uses the right dividend yield input, ITC's

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Company (Ticker)	Dividend Yield-Low	Dividend Yield-High
DTE Energy (DTE)	4.41%	4.63%
MDU Resources (MDU)	1.94%	2.09%

In contrast, the Schedule 3 dividend yields (prior to adjustment for growth) are as follows:

Company (Ticker)	Dividend Yield-Low	Dividend Yield-High
DTE Energy (DTE)	2.47%	2.59%
MDU Resources (MDU)	4.41%	4.73%

We do not know how ITC compounded its error by reporting the transposed 4.63% as 4.73%, but we note that a typographic error could explain the one-digit difference.

[32] *See* note 31 above, and the December 29, 2006 Value Line report for DTE Energy, which confirms that the workpaper version of DTE Energy's dividend yields is the correct one.

[33] *See* Exh. IT-4 at 36-37.

[34] *Bangor Hydro-Elec. Co.,* Opinion No. 489, 117 F.E.R.C. at PP 53-60, *reh'g pending.*

workpaper identifies a 6.77% ICOE-low for DTE Energy, not the 4.80% that Schedule 3 identified and discarded. That is significantly above both Dr. Lesser's 6.34% threshold and the 6.10% bond yield to which this ICOE-low should be compared pursuant to Opinion No. 489.[35] Accordingly, with this correction, the 6.77% ICOE-low for DTE Energy is properly retained in the proxy group results.[36]

With these inarguable and effectively admitted corrections, but no change in methodology and using ITC's former presentation format,[37] ITC's "Midwest ISO Transmission Owners" proxy group presents a significantly different array of results than those on which ITC had relied. With this first revision, it becomes:

[35] DTE bonds are rated BBB. *See* Exh. IT-4, Schedule 5. According to Moody's, at the end of the six-month study period, *i.e.*, in February 2007, the average yield on BBB-rated utility bonds was 6.10%. Since the corrected 6.77% ICOE-low for DTE is not "so near [to] debt costs that no rational investor would invest in equity with such a small differential," it meets the test for retention under Opinion No. 489, PP 53-60.

[36] Even if one improperly excluded this result, the adjusted minimum would be no higher than the 7.00% ICOE-low for Vectren, which ITC properly retains in its Table 1, Exh. IT-4 at 6. Vectren bonds are rated A-. *See* Exh. IT-4, Schedule 5. At the end of the six-month study period, *i.e.* in February, 2007, the average yield on A-rated utility bonds was 5.91%, according to Moody's. Thus, the spread between Vectren's ICOE-low and its bond yield is approximately 100 basis points, more than enough for the ICOE-low to exceed debt costs by a rational amount. Oddly and improperly, ITC discards that 7.00% when presenting its minimum in Exh. IT-4, Schedule 3, thereby inflating that minimum to 7.56%. Even if that were the minimum, the adjusted midpoint would be no higher than 10.32%. But no reason has been given for discarding Vectren's ICOE-low; as ITC's Table 1 reflects, it is not irrationally low and should be retained.

[37] This format was used in Table 6 to Dr. Lesser's May testimony.

Midwest ISO Transmission Owners ICOEs
(First Revised)

Company	ICOE-low	ICOE-High
Allete Inc. (ALE)	8.16%	9.96%
Alliant Energy (LNT)	7.90%	9.24%
DTE Energy (DTE)	6.77%	10.43%
Duke Energy (DUK)	9.40%	13.08%
MDU Resources (MDU)	9.16%	12.01%
Otter Tail (OTTR)	7.56%	8.91%
Vectren (VVC)	7.00%	8.58%
Xcel Energy (XEL)	8.06%	10.36%
Average	9.16%	
Minimum	7.56%	
Maximum	13.08%	
Median	9.04%	
Midpoint	10.32%	

As discussed above, any heightened ROEs for transcos must "fall[] within a zone of reasonableness," Order 679 at P 206. In Order 679-A (at, e.g., P 28 & n.45), the Commission affirmed this upper limit, and relied heavily on the "zone of reasonableness" cases that culminated in *Maine Public Utilities Commission. v. FERC,* 454 F.3d 278 (D.C. Cir. 2006) ("*Maine PUC*"). In *Maine PUC,* the D.C. Circuit held that for an above-cost incentive to merit affirmance, it was "necessary" that FERC first "determin[e] the 50 basis point adder to be within the zone of reasonableness." *Id.* at 288. The court relied on the Commission's explanation that "it had ensured that the ROE would result in reasonable rates by making them subject to a cap on the overall ROE … equal to the top of the range of reasonable ROEs for a proxy group consisting of the investor-owned transmission owners participating in the relevant RTO whose shares are publicly traded." *Id.*, quoting 102 F.E.R.C. ¶ 61,032, P 37 (2003). And it made clear that as a "minimum standard for reasonableness," any non-cost "policy considerations" must be "cabin[ed]" by the range of "cost recovering rates." *Id.* at 288-89 (quoting *FPC v. Conway Corp.*, 426 U.S. 271, 278 (1976)).

Here, as demonstrated above, the zone extends no higher than 13.08% according to ITC's own workpapers. Ineluctably, therefore, the supersized 13.88% return request is precluded by Order 679 and by the other authorities (FPA Section 219 and longstanding case law) that underlie the Order 679 rule's limits. Simply picking up the correct figures from ITC's own workpapers suffices to warrant summary disposition rejecting ITC's proposed 13.88% return.

But the patent errors in ITC's "FERC-approved" model results do not end there.

(2) ITC's ICOEs for Duke Are Distorted by a Share Price Error

After the spurious 14.78% MDU ICOE-high discussed above, the next data point down is an ostensible 13.08% ICOE-high for Duke Energy. Reference to ITC's workpapers or to Exhibit IT-4, Schedules 3 and 4, shows that this next-highest ICOE is spurious too. It is based on a purported 6.86% dividend yield (high), which is added to, and scaled up for,[38] February 28, 2007 IBES-projected growth of 6.02%,[39] supposedly summing to the 13.08%. But something is clearly amiss with that purported dividend yield, and we will proceed to show where the error lies. Before delving into the explanation, note the red flag: The December 1, 2006 Value Line report on Duke Energy quotes a 4.2% dividend yield, and the March 2, 2007 release quotes a 4.4% dividend yield. ITC's use of dividend yields in the high-six-percent range demands scrutiny.

Upon scrutiny, ITC's error is readily visible. During the first four months of ITC's study period (September–December 2006), Duke Energy shares actually traded for about $31, give or take a dollar or two. For example, the December 1, 2006 Value Line for Duke Energy quotes (atop the page) a recent price of $31.29. Dividing the then-current annual dividend ($1.25) by

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[38] That is, Column 6 of Schedule 3 computes an "Adjusted Dividend Yield (High)" of 7.06%, representing 6.86% * (1+(0.5*6.02%).

[39] *See* Exh. IT-4, Schedule 2, Note 2.

monthly high and low daily closing prices produces dividend yields in the neighborhood of 4% (give or take about 25 basis points; $1.25/$30=4.166%). But ITC has erroneously divided that annual dividend by mismatched closing prices in the $17–$20 range, as can be seen by tracing the references in ITC's workpaper spreadsheet back to the "6 months stock prices" tab, Column P (which gives purported "DUK Closing Price[s]" for September 2006 through February 2007).

How did ITC come to use the wrong divisor? Because on January 2, 2007, Duke spun off its natural gas operations as "Spectra Energy," giving shareholders a half share of Spectra per share of Duke.[40] The price per share in the reorganized Duke dropped accordingly, opening at $20 on the next trading day.[41] So did Duke's dividend level. Duke Energy announced on January 5, 2007 that starting with the quarterly dividend paid to those owning shares on February 15, 2007 (to be paid out in March 2007), its quarterly dividend would drop to 21 cents per share. Duke noted that "The reduction in Duke Energy's dividend reflects the Jan. 2 spin-off of its natural gas business into a separate stand-alone company, Spectra Energy, which will pay its own dividend."[42] This dividend reduction was anticipated in the December 1, 2006 Value Line — which renders less than credible Witness Lesser's representation that Duke dividends were "Steady or Increasing since 2003."[43]

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[40] The comments section of the December 1, 2006 Value Line for Duke Energy describes this plan.

[41] That next trading day was January 3, 2007. The NYSE was closed on January 2, the national day of mourning for President Gerald Ford.

[42] Financial Press Release, *Duke Energy Declares Quarterly Dividend* (Jan. 5, 2007), http://www.duke-energy.com/news/releases/2007010501.asp.

[43] *Compare* Exh. IT-4, Schedule 5, page 3 (stating "Increasing" in the Duke row for the penultimate column, headed "Dividends Steady or Increasing since 2003?") *with* the comments section of the December 1, 2006 Value Line for Duke Energy. The latter states that Duke management planned "annual dividends of $0.88 a share for Spectra and $0.84 a share for Duke." Since each Duke share spun off half a Spectra share, that effectively divvied up a generally steady combined annual dividend level of approximately $1.25-$1.30, with post-reorganization composite dividends going approximately 2/3 to Duke shareholders and 1/3 to Spectra shareholders.

If an ICOE for Duke Energy can be meaningfully computed based on a six-month period that straddles this reorganization, which is dubious,[44] it can only be done by maintaining consistency between the numerator and divisor of the dividend yield, *i.e.*, between dividends and stock prices. If the numerator is actual historical dividends (thereby including the approximately one-third[45] of dividends that was funded from earnings on the natural gas operations now owned by Spectra), then the divisor must be actual historical stock prices, not adjusted for the spin-off split. If adjusted prices are used in the divisor, then the numerator must be reduced to exclude the dividends associated with the Spectra operations, *e.g.*, by using reduced annual dividend level now associated with the post-reorganization Duke.

Instead, ITC evidently divided the pre-reorganization annual dividend by stock prices that were retrospectively adjusted post-reorganization. ITC's workpaper makes the error obvious, as does the parallel computation partially displayed in Exh. IT-4, Schedule 4, page 2. ITC's version of a Duke Energy stock price for September 2006 through February 2007 is in the \$18.67 ballpark, not the \$31 range that was the historical reality during most of this six-month period. For example, to derive a false 7.24% dividend-yield-high for September 2006, ITC divided a pre-reorganization \$1.25 annual dividend by an adjusted-for-reorganization \$17.26 share price-

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[44] The current (June 1, 2007) Value Line for Duke Energy, which is attached as Attachment 6 and shows a current dividend yield of 4.3%, states that "Duke's previous share price and earnings history is not comparable with the company's current configuration," and that "Data for the 'old' Duke Energy are not shown because they are not comparable." Similarly, the prior (March 2, 2007) Value Line for Duke Energy (which is also attached in composite Attachment 6) noted that "Duke's previous share price and earnings history is not comparable with the company's current configuration." Consequently, in both releases, all of the historical data that would normally appear in the 1997-2006 data columns on the standard-format Value Line page, including the dividend history on which ITC relies, has been withheld to avoid misleading investors, and replaced with either empty cells or "NMF" (No Meaningful Figure) notation. As discussed above, actual dividends paid for holding shares in Duke Energy Corp. have declined significantly from 2006 to 2007. Consequently, for Duke Energy, the answer to the question posed at Exh. IT-4, Sched. 5, page 3 ("Dividends Steady or Increasing since 2003?") is negative.

[45] *See* note 43 above.

low.[46] But in fact, as Mr. Solomon shows, the actual September 2006 closing price per share for Duke Energy stayed in a narrow range, from a low of $29.65 to a high of $30.66.

Some common sources of historical stock prices (such as Yahoo Finance) adjust actual closing prices for such stock splits. For example, if one visits Yahoo Finance today and downloads historical prices for Duke Energy, the last column for the last trading day of 2006 (December 29) will be an "Adjusted Close" of $18.94, footnoted as "* Close price adjusted for dividends and splits." But the actual, unadjusted closing prices are also available, *e.g.*, from a prior column of Yahoo's downloadable spreadsheet; for that day, the unadjusted closing price was $33.21. Evidently, ITC used closing price data adjusted for splits,[47] and thereby picked up a share price that was multiplied by 3/2 to account for the fact that each two shares of old Duke turned into three, one to hold the Spectra business and two to hold the smaller, new version of Duke.

Consequently, ITC's claimed 13.08% ICOE-high for Duke Energy is grossly inflated by a mismatch: pre-reorganization dividends are erroneously combined with the post-reorganization share price. To avoid the distortion produced by this timing anomaly, Duke Energy should be removed from the proxy group, or if retained, should have its dividend yield re-computed to reverse this mismatch. In the accompanying affidavit (Attachment 2 hereto at ¶ 12-13 and Exhibit JBS-1, page 3), Mr. Solomon supports and performs that re-computation. For the September – December 2006 period, he uses actual closing prices and Dr. Lesser's annualized 2006 dividend level, $1.25. For January and February 2007, he uses actual closing

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[46] *See* ITC workpapers, "Stock Price for FERC-DCF" tab, Cells D56, D58, and D60.

[47] ITC's workpapers cite Thompson Datastream as their source, and use $19.335 as the closing price for December 29, 2006. *See* ITC workpapers, Attachment 5 hereto, "6 months stock prices" tab, Cell P 47. The difference between this $19.335 and Yahoo's $18.94 is presumably due to Yahoo having made a further adjustment for the timing of dividend payments.

prices and the first quarter 2007 indicated annual dividend, $0.84. The results of making these corrections are low and high Duke ICOEs of 6.82% and 10.34%, respectively.

With the Duke dividend yields corrected and the MDU transposition error repaired, the next data point down is the repaired 12.01% ICOE-high for MDU that is discussed in Part II.A.2.a)(1) above. Thus, the results for ITC's "Midwest ISO Transmission Owners" group become:

Midwest ISO Transmission Owners ICOEs
(Second Revised)

Company	ICOE-low	ICOE-High
Allete Inc. (ALE)	8.16%	9.96%
Alliant Energy (LNT)	7.90%	9.24%
DTE Energy (DTE)	6.77%	10.43%
Duke Energy (DUK)	6.82%	10.34%
MDU Resources (MDU)	9.16%	12.01%
Otter Tail (OTTR)	7.56%	8.91%
Vectren (VVC)	7.00%	8.58%
Xcel Energy (XEL)	8.06%	10.36%
Average	8.83%	
Minimum	6.77%	
Maximum	12.01%	
Median	8.74%	
Midpoint	9.39%	

But the patent errors in ITC's "FERC-approved" model results do not end there, either.

(3) ITC's *sv* calculations are inflated by the use of arithmetic rather than geometric growth

Witness Lesser has testified twice (both in May and in June) that his "*br+sv*" calculation methodology tracks that which was applied and approved in *Bangor Hydro-Electric Co.*, Opinion No. 489, 117 F.E.R.C. ¶ 61,129 (2006).[48] Examination of ITC's workpapers[49] shows

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[48] *See* Exh. IT-4 at 27 & n.18; Exh. IT-4 at 29 & n.20 (June Rev.).

[49] See the formula embedded in Column R of the "Earnings Growth (br+sv)" tab, which was omitted from, but affected, ITC's filed exhibits.

that this testimony is not quite true. In fact, Dr. Lesser calculated his share growth rate — the "*s*" in *br+sv* — as one-fourth of the proportionate growth from 2006 to projected 2009-11 share levels. Simply dividing by four in this manner fails to account for year-to-year compounding, unlike the approach on which the Commission relied in Opinion No. 489 and *Midwest ISO ROE*. Compounding should not be ignored. To include compounding, and assuming a four-year comparison[50] and using Excel notation, the formula for computing *s* should be:

$$s = (\text{POWER (Year 4 Shares/Year 0 Shares)}, \tfrac{1}{4})) - 1,$$

not

$$s = ((\text{Year 4 Shares-Year 0 Shares})/\text{Year 0 Shares})/4.$$

Applying this correction for compounding does not have a major effect, but it does reduce MDU's ICOE-high, which sets the top of the ICOEs range, by five basis points. With this correction applied to all eight proxies and the larger corrections explained above, the results for ITC's "Midwest ISO Transmission Owners" proxy group become:

[50] The Opinion No. 489 and *Midwest ISO ROE* methodologies actually applied a five-year comparison, taking the fifth root in computing the shares growth rate and thus yielding smaller *sv* values. In order to be conservatively favorable to ITC and more directly comparable to Dr. Lesser's approach, we apply the Opinion No. 489 approach modified to use four rather than five years.

Midwest ISO Transmission Owners ICOEs
(Third Revised)

Company	ICOE-low	ICOE-High
Allete Inc. (ALE)	8.16%	9.95%
Alliant Energy (LNT)	7.90%	9.24%
DTE Energy (DTE)	6.76%	10.43%
Duke Energy (DUK)	6.82%	10.34%
MDU Resources (MDU)	9.16%	11.96%
Otter Tail (OTTR)	7.55%	8.91%
Vectren (VVC)	7.00%	8.58%
Xcel Energy (XEL)	8.05%	10.36%
Average	**8.82%**	
Minimum[51]	**6.76%**	
Maximum	**11.96%**	
Median	**8.74%**	
Midpoint	**9.36%**	

Bottom line: on the current record, the very top of an updated zone of reasonableness is actually **less than 12% — well below the existing return for Midwest ISO service in the IPL zone, and almost 200 basis points below the return for which ITC has filed.** There is simply no substantial evidentiary basis that would support a conclusion that a standard-methodology DCF analysis, applied to a proxy group of Midwestern utilities as Commission precedent requires, supports a 13.88% equity return. In fact, such analysis indicates that the cost-based return on equity is 8.74% or at most 9.36%,[52] and that the very top of the zone of

[51] Applying this correction to DTE Energy reduces its ICOE-low by one basis point, to 6.76%, which provides the low end of the ICOEs zone. As was the case for the 6.77% ICOE-low before this correction, this result exceeds DTE Energy's cost of long-term debt and is thus due to be retained under the Opinion. No. 489 test for retention. *See* note 35 above.

[52] Because this case involves the rates for a single zone, rather than an RTO-wide rate, and because the median is less likely than the midpoint to be significantly distorted by the kinds of single-proxy anomalies and mistakes that ruined Dr. Lesser's analysis, the Commission should look in this case to the median rather than the midpoint in ascertaining the cost-based component of the equity return. The Commission has found that when selecting an ROE for a single utility, the median is "the most refined measure of central tendency." *Midwest Indep. Transmission Sys. Operator, Inc.*, 106 F.E.R.C. ¶ 61,302, P 10 (2004), *aff'd sub nom Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d. 1004 (D.C. Cir. 2005). *See also Golden Spread Elec. Coop., Inc. v. Southwestern Pub. Serv. Co.*, 115 F.E.R.C. ¶ 63,043, P 106 (2006) (Judge Cowan) (adopting median for use in setting wholesale requirements power rates of a single utility), *corrected,* 115 F.E.R.C. ¶ 63,054 (2004), *exceptions pending*. This policy is consistent with the Commission's prior ruling upon having been directed to clarify its policy on central tendency measures. On remand

reasonableness — and thus the absolute ceiling[53] for above-cost incentives pursuant to Order 679 — is 11.96%. That level is below the 12.38% that currently applies to unbundled transmission customers in MISO's IPL zone.

b) ITC's Alternative, Unconventional Studies Likewise Fail to Support a 13.88% ROE

(1) "Quarterly" DCF

The second ROE study that ITC presented in the testimony to which Dr. Lesser swore in May is a "quarterly" DCF analysis. Its results were summarized in the first numerical column of Table 7 of that testimony. It purports to be based on February 2007 stock prices and March 2007 through February 2008 expected dividends. With one fatally flawed exception, this study points toward a lower ROE than the existing 12.38%:

from *Canadian Ass'n of Petrol. Producers v. FERC*, 254 F.3d 289, 297-99 (D.C. Cir. 2001), the Commission explained that "Since the midpoint is the average of the highest and lowest numbers in the group, it is clearly subject to distortion by extremely high or low values," and that therefore, "the laws of statistics support the Commission's use of the median in setting ROE for a company facing average risk because it has important advantages over the mean and midpoint approaches in determining central tendency." *Northwest Pipeline Corp.*, 99 F.E.R.C. ¶ 61,305 at 62,276 (2002). In Order 679-A regarding transmission incentives, the Commission stated that basing an electric transmission ROE on the median is "an acceptable method." Order 679-A at P 63 & n.105 (2006).

[53] The Municipal Coalition does not concede that the ROE for ITC Midwest should be placed at the top of the zone of ICOEs, or even in its upper portion. Especially given the other unconventional and favorable rate treatments sought by Applicants, the just and reasonable ROE for ITC Midwest may well be closer to, or even below, the middle of the zone. However, given that even the very top of the range falls below the existing 12.38%, and in light of the "last clean rate" doctrine, it is not necessary to reach that issue in these Section 203 and 205 proceedings.

Company	ICOE
Allete Inc. (ALE)	9.02%
Alliant Energy (LNT)	8.37%
DTE Energy (DTE)	9.60%
Duke Energy (DUK)	14.57%
MDU Resources (MDU)	10.00%
Otter Tail (OTTR)	8.37%
Vectren (VVC)	8.60%
Xcel Energy (XEL)	9.86%
Average	**9.80%**
Minimum	**8.37%**
Maximum	**14.57%**
Median	**9.31%**
Midpoint	**11.47%**

The only ICOE in this study's results that exceeds 10.00% is that of Duke Energy, at a purported 14.57%, but that ICOE is fatally flawed, due to the mismatch discussed in Part II.A.2.a)(2) above. Relying on data that was already outdated during his February 2007 stock price study period, Dr. Lesser erroneously applied current Duke Energy quarterly dividends of 31 to 32 cents per share to "measure the value of the expected dividend … one year from the stock price measurement date." Exh. IT-4 at 39. But Duke Energy had by then already cut its dividend (announced on January 5, 2007, applicable to shareholders as of February 15, 2007, and already anticipated by the time of the December 1, 2006 Value Line, whose comment section anticipates annual dividends per share of $0.88). Consequently, the numerator of the Duke dividend yield in Exh. IT-4, Schedule 2, page 1 does not jibe with that purported yield's $19.61/share divisor.

As recognized in the March 2, 2007 Value Line — dated just two days after Dr. Lesser's study periods ended — Duke Energy's four quarterly dividends for 2007 are expected to total only 86 cents per share, not the $1.25 erroneously assumed by Dr. Lesser. Divided by the same

February 2007 monthly-average stock price on which Dr. Lesser relied, that corrected dividend level implies a dividend yield of 4.39%, not 6.37%.

With that correction alone, ITC's second study yields the following modified results:

Company	**ICOE**
Allete Inc. (ALE)	9.02%
Alliant Energy (LNT)	8.37%
DTE Energy (DTE)	9.60%
Duke Energy (DUK)	12.08%
MDU Resources (MDU)	10.00%
Otter Tail (OTTR)	8.37%
Vectren (VVC)	8.60%
Xcel Energy (XEL)	9.86%
Average	**9.49%**
Minimum	**8.37%**
Maximum	**12.08%**
Median	**9.31%**
Midpoint	**10.23%**

Of course, even with this error repaired, this study deviates from the Commission's standard DCF methodology. In particular, it relies on one month of stock price data, including February 27, 2007, when the Dow Jones Industrial Average dropped a wrenching 415 points. As such, it is subject to the same criticism that ITC successfully leveled in the MISO-wide ROE case at the testimony of Minnesota Municipal Power Agency witness Glahn. Glahn submitted a DCF analysis based on one week of stock price data. However, the Commission rejected that study, on the ITC-urged ground that by relying on less than six months of stock prices, it embodied a "spot" stock price contrary to Commission precedent.[54]

In short, ITC's second study likewise fails to provide any substantial evidentiary basis for ITC's assertion that a 13.88% equity return is within the zone of reasonableness.

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[54] *Midwest ISO ROE Decision* at P 29 & n.25 (2002) (citing *Consumers Advocates Div. of the W. V. Pub. Serv. Comm'n,* 40 F.E.R.C. ¶ 61,117, 61,319 (1987).

(2) "Quarterly" DCF with Six Months' Stock Prices

The third ROE study that ITC presented in the testimony to which Dr. Lesser swore in May is a "quarterly" DCF analysis. Its results were summarized in the second numerical column of Table 7 of that testimony. This third study is identical to the one just discussed, except that for its stock price input, it looks beyond February 2007 prices to the average closing prices over a six-month period (September 2006 through February 2007). In principle, this is a sound approach, and if applied using temporally consistent dividend yields, it can have the virtue of avoiding a temporal mismatch in which past dividend yields are paired with expected future growth that is associated with a reduced dividend. Its use of a single ICOE per company is appropriate, and is expressly allowed under Order 679-A.[55] However, just as with ITC's second study, this methodology was mis-applied by applying an erroneous dividend yield for Duke Energy.

Applying as the dividend yield numerator the updated and reduced dividend expectation of 86 cents per Duke Energy share, and dividing it by the same six-month average stock price on which Dr. Lesser relied, implies a dividend yield of 4.61%, not 6.70%. With that correction alone, ITC's third study yields the following modified results:

[55] Order 679-A at P 64 & n.105 (2006) ("averaging each company's low and high DCF return … [into] a single average DCF result for each electric company, making it like the single DCF return for gas and oil pipelines, from which a median return on equity for the group can be calculated" is an acceptable method.)

Company	ICOE
Allete Inc. (ALE)	9.18%
Alliant Energy (LNT)	8.45%
DTE Energy (DTE)	9.75%
Duke Energy (DUK)	12.34%
MDU Resources (MDU)	10.08%
Otter Tail (OTTR)	8.58%
Vectren (VVC)	8.64%
Xcel Energy (XEL)	10.11%
Average	**9.64%**
Minimum	**8.45%**
Maximum	**12.34%**
Median	**9.47%**
Midpoint	**10.40%**

(3) Self-Referential Analyses of ITC Holdings

As demonstrated above, once clearly necessary corrections are made, not one of the proxy group ICOEs rises anywhere near the 13.88% that ITC seeks. Once ITC learned what its sponsored methodology actually showed, ITC sought to disown its May 11 filed testimony, and to get over this essential threshold test for incentives eligibility by pulling on its own bootstraps. But ITC's June amendment leaves it with no study of the Midwestern proxy group, which clearly does not pass muster under the Commission precedent discussed above.[56] In any event, the May 11 testimony remains in the record,[57] and ITC's attempt to use ITC Holdings as the sole proxy for ITC Midwest is even less credible than the as-filed, error-ridden proxy group studies.

ITC's witness asserts that because ITC is "unique," its requested ROE should be measured against a DCF analysis of the returns that investors expect to receive from ITC itself. Accordingly, in his June testimony, he repeated the three analyses previously performed and discussed as to the Midwest ISO Transmission Owner proxy group, but did so substituting ITC

[56] *See* Part II.A.2.a above, discussing *Midwest ISO ROE, ComEd,* and *TrAIL.*

[57] *See* note 24 above.

Holdings (the publicly-traded parent of ITC Midwest, ITC*Transmission*, METC, and other subsidiaries) as the sole proxy. Now that ITC has sought (upon seeing their true results) to disown its analyses of the Midwest ISO Transmission Owner proxy group, these are the only DCF results that ITC wishes to be considered. But this approach is fatally flawed in at least five respects: It is circular, distorted by acquisition-related and other short-term financial perturbations, reflective of unsustainable growth from an outdated baseline, further distorted by the parent's much more leveraged capital structure, and based on remarkably few shareholders.

(a) Circularity

Any study that uses ITC Holdings as a proxy for ITC Midwest is utterly circular, because all ITC Holdings revenues come through FERC-regulated rates for monopoly service. See Exh. IT-4, Schedule 5, page 1 (listing ITC Holdings "Regulated Total Company Revenues" as 100% of "Total Company Revenues," *i.e.,* the same $224 million, and citing ITC's SEC Form 10-K as its source). A DCF analysis limited to ITC Holdings can therefore measure nothing more informative than the predictions of investors and investment analysts as to what level of profit the Commission will continue to allow ITC's operating subsidiaries to collect.

Order 679-A explicitly recognized this circularity problem, and to resolve it required that the DCF methodology be applied such that the input cash flows would "not be significantly affected by an incentive return." Order 679-A at P 62. In his sworn May 11 testimony, ITC's witness Lesser likewise recognizes that there is a serious "logical inconsistency" problem if the inputs to a regulatory DCF analysis include "a regulated firm's earnings [which in turn] are largely determined by the regulator itself." Exh. IT-4 at 38. ITC's witness has sworn that such an approach "is completely circular," *id.,* and has cited to Dr. Roger A. Morin's textbook, *Regulatory Finance*, for a "fuller discussion." Dr. Morin does explain the issue in greater depth, stating:

> **Circularity problem.** Stock price, hence cost of equity capital, depends on investors' growth expectations, which in turn depend partially on investors' perception of the regulatory process. The net result is that the cost of equity depends in part on anticipated regulatory action, since both components of equity return — yield and growth — are influenced by the regulatory process. Carried to its extreme, this implies that regulation would in effect deliver whatever equity return investors expect.

Roger A. Morin, *Regulatory Finance: Utilities' Cost of Capital* at 202 (P.U.R. 1994).

ITC's witness cited this discussion in a misguided attempt to downplay the $br + sv$ component of his eight-proxy DCF analysis, but the circularity problem there is not serious. As Dr. Morin's textbook proceeds to explain, "The circularity problem, to the extent that it exists, can be mitigated by referencing data ... on other utilities." *Id.*; *cf.* Order 679-A at P 62. ITC itself is not among ITC's eight Midwest utilities proxies, and those proxies' regulated revenues are determined principally at retail under state-regulated rates.[58] For electric utilities whose principal revenues are at retail under state-regulated rates, of course, it is not unusual for this Commission to include the subject utility as one member of a multi-member proxy group. In such cases, only a minor share of the proxy firms' revenues will be affected by this Commission's ruling. Any circular feedback from the case being decided to the facts on which it will be decided is therefore small and rapidly damped. And that is the case for ITC's eight-company proxy group.

The circularity problem does get serious, however, when the "proxy group" consists of one firm that is the parent of the operating company whose rates are at issue. Recognizing as

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[58] In addition, as discussed in Part II.A.3 below, only about one-quarter of the revenues for MDU and Otter Tail come from regulated rates.

much, the Commission in *Southern California Edison Co.,* Opinion No. 445, 92 F.E.R.C. ¶ 61,070 (2000) decided to rely on the DCF results from a proxy group of four other utilities rather than the DCF study results for SCE's parent Edison Mission, which were also before it.[59] And when substantially all of that parent firm's revenues are FERC-regulated, the problem is beyond serious. At that point, we have been carried to the extreme about which Dr. Morin warns. Indeed, the end result of ITC's recommendation would be to "in effect, set the allowed rate of return on common equity at the rate of return investors expect [the regulated utility] ... to earn on common equity (r), rather than the market cost of common equity (k)," contrary to *Orange & Rockland Utils., Inc.,*44 F.E.R.C. ¶ 61,253, 61,952 (1988) (emphasis added), *reh'g in part*, 45 F.E.R.C. ¶ 61,252 (1998), *and reh'g denied*, 46 F.E.R.C. ¶ 31,036 (1989). Recognizing as much, Order No. 679 held that any "incentive return for Transcos" would be evaluated by "assessing representative proxy companies" in individual section 205 proceedings. Order 679 at P 229. A DCF analysis of ITC Holdings plainly does not satisfy that requirement.

(b) Distortion

The second fatal flaw in ITC's navel-gazing studies is that they are distorted by several major short-term financial perturbations. Consequently, in addition to being fatally circular, any DCF analysis based on ITC's current financials will be distorted to the point of being meaningless. In particular, the 14.6% IBES and 16.0% Zack's earnings per share growth rates on which ITC now relies[60] are clearly distorted by short-term perturbations, and therefore do not represent sustainable constant growth.

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[59] *Compare id.* at 61,263 (finding DCF-based ICOE of 10.51% for SCE's parent) *with id.* at 61,266-67 (relying instead on the DCF-based ICOEs for four unaffiliated proxies).

[60] *See* Exh. IT-4 at 40, line 6 (June Rev.).

Acquisition-related perturbations. Throughout the six-month study period, ITC Holdings was involved in a series of major acquisitions, including the one at issue here.

The single largest driver, by far, of analysts' expectations for increased ITC Holdings earnings per share is the already-experienced major jump from 2006 to 2007 due to ITC's acquisition of the Michigan Electric Transmission Company ("METC"). That acquisition closed during Witness Lesser's 6-month study period, in October 2006. During the study period, ITC Holdings' earnings per share were depressed by the issuance of debt and new equity to finance the acquisition. According to the April 13, 2007 Value Line report on ITC Holdings, its earnings per share declined by 21.5% from 2005 to 2006. But that was before the increased annual earnings level associated with the acquisition had arrived. In its recent "Stock Report" on ITC Holdings, Standard & Poors explains that after a leap upwards due to the realization in 2007 of the growth spurt associated with this acquisition, ITC's EPS growth will moderate considerably, to "about 8.1%."

> Assuming an effective tax rate of 35.6% and share increases related to the METC acquisition, we forecast 2007 operating EPS of $1.60, an increase of about 62% from 2006's $0.99. Our 2008 forecast is $1.73, an additional gain of about 8.1% from 2007.

S & P Stock Report, ITC Holdings Corp. (June 9, 2007), at 1, attached as Attachment 7.

The Prospectus that ITC Holdings filed with the SEC on October 4, 2006[61] (in connection with the public offering through which ITC partially funded its METC acquisition) explains that the $0.99 estimate is for the pre-acquisition ITC, and thus not comparable to the post-acquisition $1.60 EPS. It states:

> ***Earnings and Other Guidance***
> On August 10, 2006, we announced that we expect that ITC

[61] Form 424B4 Prospectus (Oct. 4, 2006), http://itc.client./shareholder.com/secfiling.cfm?filingID=104749-06-12401 ("ITC Prospectus").

> Holdings and Subsidiaries will have total net income of between \$31.0 million and \$34.0 million for the year ending December 31, 2006 and diluted earnings per share of between \$0.97 and \$0.99 for the same period, <u>which does not include any impact from MTH and METC</u>. In addition, we announced that we expect ITC Holdings and Subsidiaries on a pro forma basis, including MTH and METC, will have diluted earnings per share of between \$1.50 and \$1.60 … for the year ending December 31, 2007…

ITC Prospectus at 7 (emphasis added).

The estimates of rapid EPS growth that drive ITC's self-studies above a 13.88% ICOE appear to represent comparisons of the post-acquisition ITC to the pre-acquisition \$0.99 baseline. For example, in the April 13, 2007 Value Line report on ITC Holdings (which does not hazard a 5-year growth forecast, perhaps because the ITC Holdings history is too short and acquisition-distorted to allow a reliable long-term forecast), the "2007/2008" earnings per share is projected as \$1.60, presumably reflecting Value Line's usual focus on earnings on continuing operations and a blend of 2007 and 2008 projections. That is up substantially from the \$0.94 that Value Line gives for the corresponding figure in 2006, but represents no increase at all when compared to the \$1.60 presented in ITC's prospectus (block-quoted above) as *pro forma* with-acquisition earnings for 2007. Thus, this Value Line report indicates that 2008 is not expected to yield significantly more in ITC earnings per share than ITC itself expects for 2007. This projection of modest further growth (beyond the growth spurt associated with the METC acquisition) corroborates Standard & Poors estimate of a modest post-2007 EPS growth rate of 8.1%.

Assuming *arguendo* that any self-referential study of ITC Holdings was appropriate, it should look to the Standard & Poors 8.1% growth projection rather than the unsustainable, acquisition-confounded 14.6% and 16.0% growth projections on which ITC relies.[62] Combining that growth projection with the dividend yields calculated by ITC produces, in every case, an Indicated Cost of Equity <u>below</u> the currently-applicable 12.38%. ITC has excised those dividend yields from its June testimony, but they remain in the record from ITC's May testimony and are visible in the attached ITC workpapers. They are:

Study	Source[63]	Dividend Yield
FERC-approved model (lower of two yields)	Sched. 3, col. 1	2.74%
FERC-approved model (higher of two yields)	Sched. 3, col. 2	3.01%
Quarterly DCF model	Sched. 4, p.1, col.4	2.48%
Quarterly DCF model, 6-mo. stock prices	Sched. 4, p.2, col.4	2.85%

Combining those dividend yields with the 8.1% growth rate discussed above produces the modified results shown below. In the second row, we have combined the 3.01% for the dividend-yield-high with the 8.49% *br+sv* developed by ITC.[64] That is the standard-methodology approach: because that growth rate exceeds the 8.1% analyst-projected growth rate, it is combined with the high dividend yield while the 8.1% growth rate is combined with the low dividend yield.

Study	Dividend Yield	Growth	Adjusted Dividend Yield	ICOE
FERC-approved model (lower of two yields)	2.74%	8.1%	2.85%	10.95%
FERC-approved model (higher of two yields)	3.01%	8.49%	3.14%	11.63%
Quarterly DCF model	2.48%	8.1%	2.58%	10.68%
Quarterly DCF model, using 6-months of stock	2.85%	8.1%	2.97%	11.07%

[62] *See* Exh. IT-4 at 40, line 6 (June Rev.).

[63] Citations are to ITC's May testimony.

[64] *See* Exh. IT-4, Schedule 3, col. 3.

prices

Note that as in ITC's first three DCF studies (discussed in Part II.A.2.a) above), none of these ICOEs exceeds 12%, much less the 13.88% that ITC must show to be within the range of reasonableness, before its proposal may even be considered under Order 679.

Also significant, the proposed disposition at issue here was announced on January 19, 2007.[65] That day, ITC's stock rose 9%, as can be seen on the "6 months stock prices" tab of ITC's workpapers, Cells R34-R35. The Zacks' and IBES growth projections on which ITC relies for these studies are dated February 19 and 28, 2007, respectively, and therefore reflect earnings growth associated with expanding to encompass the IPL zone. But the dividend yields with which they are matched are based almost entirely on share prices that pre-date the January 19 announcement and stock price rise. This distortion reinforces the conclusion that the cost of equity capital to ITC Midwest cannot be reliably inferred from the stock price data for ITC Holdings.

Revenue timing perturbations. Pending the acquisition proposed here, substantially all of ITC's revenues are from network service customers in the ITC*Transmission* and METC zones in the lower peninsula of Michigan, principally the former bundled retail customers of Consumers and Detroit Edison. With ITC's acquisition of METC, the recent phase-out of rate caps under Michigan's Act 141, the related end of deferral periods under which rate increases had been accrued as regulatory assets in lieu of current collection, the network service rates received by the ITC companies for those MISO zones have skyrocketed. In a short time, they have risen from what had been about $0.98/kW-month and $1.075/kW-month, to (respectively

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[65] *See* ITC's January 19, 2007 Press Release, "*ITC Holdings Signs Agreement to Acquire Transmission Assets of Alliant Energy*" (available at http://www.itctransco.com/app.php?sec=3&id=37&nid=73).

and approximately) $1.70/kW-month and $2.12/kW-month. Contemporaneously, ITC has changed rates in these zones from the lagging basis that is prevalent in MISO to a current recovery formula, and it now books the resulting earnings based on the revenue requirements year. See the ITC Holdings Form 10-Q, Filed May 7, 2007 at 8 ("beginning January 1, 2007, ITC*Transmission* and METC recover expenses and earn a return on and recover investments in property, plant and equipment on a current rather than a lagging basis. In periods of capital expansion and increasing rate base, ITC*Transmission* and METC will recover the costs of these capital investments on a more timely basis than under the previous Attachment O method that used historical information.").

With these transitions (from one zone to two, from accruing regulatory assets to recovering current cash, and from lagging to current revenue requirements in its rate formulas), ITC's earnings have, of course, soared. But as Standard & Poors recognizes, that is no basis to infer that its earnings will continue to increase at that rate for the long term. Indeed, Dr. Lesser admits that revenues during most of 2006 are not "representative of ITC's current business profile."[66] By the same token, as discussed below, a short-term projection of ITC's earnings growth that uses 2006 earnings as the baseline cannot reasonably be relied upon in a constant-growth DCF analysis.

(c) Unsustainability

The third fatal flaw in ITC's self-referential studies is closely related to the second flaw, discussed immediately above. Even if a 14.6% or 16.0% growth rate did represent the expected five-year growth from the current, post-acquisition baseline, that growth rate would be unsustainable, and the resulting ICOE would, therefore, have to be disregarded. As the

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[66] *See* Exh. IT-4 at 58; *id.* at 50 (June Rev.).

Commission held in the New England ROE case (on which ITC's witness elsewhere relies[67]), "a 13.3 percent growth rate is not a sustainable growth rate over time and therefore does not meet threshold tests of economic logic." *ISO New England, Inc.*, 109 F.E.R.C. ¶ 61,147, P 205 (2004); *see also ISO New England, Inc.*, 110 F.E.R.C. ¶ 61,111, P 23 (2005), *reh'g denied*, 111 F.E.R.C. ¶ 61,344 (2005). Accordingly, the Commission ruled that a DCF-based ICOE that assumed constant growth at a rate of 13.3 % or higher was not reliable, and should be disregarded. The same conclusion applies here, especially given that as shown above, Standard & Poors does not expect ITC Holdings to sustain earnings growth above 8.1% even for the short term.

(d) Leverage

As ITC's witness explains, "Capital structure affects financial risk. All else equal, a higher percentage of debt (lower percentage of equity) increases the financial risks for both owners of a firm's debt and equity."[68] As discussed in Part II.A.3 below, ITC Holdings is much more leveraged than ITC Midwest — the debt share of the capital structure is approximately 70% for ITC Holdings (the parent) and only about 40% for ITC Midwest (the subsidiary). If one treats those capital structures as having financial reality (as opposed to being manipulated in order to maximize the effect of an equity return heightener), then it follows that the risk faced by <u>ITC Midwest</u> equity is significantly smaller than the risk faced by <u>ITC Holdings</u> equity. Consequently, even if ITC's DCF studies of ITC Holdings provided an accurate picture of the cost of equity for ITC Holdings, they would say little about the cost of the much less risky equity invested in ITC Midwest.

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[67] *See* note 48 above.

[68] Exh. IT-4 at 64; Exh. IT-4 at 56 (June Rev.).

Furthermore, the IBES and Zacks' growth estimates on which ITC relies are estimates of earnings growth at the ITC Holdings level. See Exh. IT-4, Schedule 2. But given the dramatically different capital structures of ITC Holdings and ITC Midwest, at the operating company (ITC Midwest) level, each revenue dollar must be spread across a proportionately greater equity investment. Consequently, there will not be a one-for-one correspondence between increases in earnings per dollar invested in ITC Holdings common equity and increases in earnings per dollar invested as common equity in ITC Midwest. Rather, a 10% increase in parent-level earnings per common equity dollar will represent a significantly smaller increase in subsidiary-level earnings per common equity dollar.

(e) Few Shareholders

ITC Witness Lesser testifies that "If a stock is not actively traded, none of the standard financial models, whether DCF, CAPM, or Fama-French, will be accurate."[69] The same can be said if a stock is narrowly held; for example, if a large percentage of the stock's shareholders are corporate insiders, sales by those corporate insiders can materially affect the market price. In the case of ITC Holdings, the number of shareholders is remarkably small for a utility, numbering only in the low hundreds,[70] and almost half of ITC Holdings' shares is held by corporate insiders.[71] This is a further reason not to infer the cost of equity capital to ITC Midwest from the stock price data for ITC Holdings.

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[69] Exh. IT-4 at 59; Exh. IT-4 at 51 (June Rev.).

[70] See Solomon Affidavit (Attachment 2 hereto) at ¶ 21.

[71] According to Yahoo Finance, which includes as one of its "Key Statistics" for ITC Holdings the "% Held by Insiders" as reported by Computershare, 43.05% of ITC Holdings' shares were held by insiders as of June 19, 2007. *See* http://finance.yahoo.com/q/ks?s=ITC. The parallel figure for Alliant Energy is 0.37%.

(4) "Fama-French" Version of Risk Premium Analysis

ITC's last stab at a fact-based rationale for its requested 13.88% ROE is a "Fama-French" analysis, which ITC portrays as "essentially expand[ing] on the CAPM [Capital Asset Pricing Model]…."[72] But the entire analysis is misdirected. It is based on "two independent sorts of all stocks listed on the NYSE, AMEX and NASDAQ exchanges," and on the "average return on the [entire stock] market."[73] That is, it measures how much more has historically been earned on all stocks (economy-wide) than on one-month Treasury bills, while differentiating that economy-wide risk premium for variations in firm size (market equity capitalization) and in the ratio of book equity to market equity. For all its superficial sophistication, ITC's Fama-French analysis answers an irrelevant question. It merely identifies how much more than the short-term treasury rate one could earn by investing in a portfolio of many companies, similar to ITC in their size and market-to-book ratio, but diversified across all of the economy's many sectors, and not restricted to utilities or otherwise restricted to companies that resemble ITC in their riskiness. That may be an academically interesting question, but it plainly is not the question that *Hope* and *Bluefield*[74] asked. As ITC elsewhere concedes (Exh. IT-4 at 20-21), these foundational cases instructed the Commission to allow returns "commensurate with returns on other enterprises having corresponding risks." But ITC's application of the Fama-French model does not even attempt to identify the risk premium associated with those small, high M/B ratio companies whose assets are natural monopolies and which do not face meaningful competition. It therefore deserves no consideration in this proceeding.

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[72] Exh. IT-4 at 48.

[73] Exh. IT-4 at 54 (emphasis added), *id.* at 57. The same passages appear in the June version, at pages 47 and 49 respectively.

[74] *Federal Power Comm'n, v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923).