Exhibit No.	
Witness:	Michael Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Missouri Industrial Energy Consumers
Case No.	EC-2002-1
Subjects:	Return on Common Equity and Overall Rate of Return

Before the
Missouri Public Service Commission

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

Surrebuttal Testimony of

Michael Gorman

On Behalf of

Missouri Industrial Energy Consumers

Exhibit No. 116
Date 7/10/02 Case No. EC-2002-1
Reporter KEM

June 24, 2002
Project 7651

BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

Before the Public Service Commission
of the State of Missouri

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

STATE OF MISSOURI)
) **SS**
COUNTY OF ST. LOUIS)

Surrebuttal Affidavit of Michael Gorman

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. EC-2002-1.

3. I hereby swear and affirm that the surrebuttal testimony is true and correct and shows the matters and things it purports to show.

Michael Gorman

Michael Gorman

Subscribed and sworn to before this 21st day of June 2002.

CAROL SCHULZ
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: Feb. 26, 2004

Carol S. Schulz

Notary Public

My Commission Expires February 26, 2004.

Before the
Missouri Public Service Commission

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

Surrebuttal Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY FILED REBUTTAL TESTIMONY IN THIS PROCEEDING?

A Yes.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to the rebuttal testimony of AmerenUE Witnesses Dr. Roger Morin, Kathleen C. McShane, Steven Fetter, and Warner L. Baxter.

Q PLEASE SUMMARIZE THE ISSUES YOU TAKE WITH AMERENUE WITNESSES IN YOUR SURREBUTTAL TESTIMONY.

A As set out below, I take the following issues with AmerenUE witnesses:

- A fair return on common equity should be developed in concert with the development of an appropriate and reasonable capital structure. Balancing these two factors is necessary to provide a fair overall rate of return that is just and reasonable.

- AmerenUE witnesses McShane and Morin are recommending returns on common equity without regard or mention of the appropriateness of AmerenUE's common equity balance. Consequently, their return on common equity recommendations are biased and do not provide a reasonable balance between the interests of shareholders and customers.

- Authorized returns on equity by regulatory commissions over the last five years have averaged approximately 11.3%. However, those authorized returns on equity have been made in combination with capital structures that contain common equity ratios of approximately 47%. Other electric utility common equity ratios are significantly lower than AmerenUE's actual common equity ratio of 59% as reflected in Staff's filing. A higher than average common equity ratio, all else equal, implies that AmerenUE has lower than average risk, and should receive a lower than average return on common equity.

- AmerenUE has mischaracterized its financial ratios reflecting Staff's proposed revenue reductions in this proceeding. The Company's near-term financial ratio projections show that Staff's recommended reduction in revenues will provide AmerenUE with financial ratios that are consistent with Standard & Poor's financial benchmarks for a utility with a bond rating of "A," Ameren's current bond rating.

- The Company's rebuttal evidence shows that credit rating agencies are currently expecting the Commission to reduce AmerenUE's rates in this proceeding. The Value Line Investment Survey also is projecting rates to be reduced[1]. Accordingly, the Commission should carefully develop a proper rate of return, capital structure, and earnings entitlement for AmerenUE in this proceeding. The market clearly expects a rate reduction.

- It is reasonable to expect that a utility will have to go to the external market to fund a significant capital improvement program. Projections by Ameren witness William Stouts on the difference between capital expenditures and depreciation receipts show that the Company is expecting to increase its investment in infrastructure plant. A fair and reasonable regulatory construct would not require customers to pay depreciation rates that are higher than reasonable, nor pay for a higher than reasonable rate of return based on an excessive return on equity,

[1] Baxter Rebuttal at 34, and The Value Line Investment Survey, April 5, 2002 at 698.

or a capital structure composed too heavily of common equity. Such a regulatory policy would unnecessarily drive up retail electric rates and abandon the customer protections provided by prudent regulation.

Response to Dr. Morin

Q WHAT ISSUE DO YOU TAKE WITH UE WITNESS DR. MORIN?

A Dr. Morin, at Page 5, refers to Ms. McShane's Schedule 17 in his assertion that other states have allowed electric utilities an authorized return on equity in the range of 10.5% to 12.9% for an average of 11.27%. His testimony is in support of his conclusion that Staff Witness Bible's return on common equity recommendation is too low.

Dr. Morin and Ms. McShane's criticisms of Staff witness Bible's return on common equity ratio are incomplete and misleading. Staff witness Bible made his return on common equity recommendation along with his acceptance of Ameren's capital structure, which includes a common equity ratio of 59%. AmerenUE's common equity ratio is substantially higher than the common equity ratios authorized by regulatory commissions along with the returns on common equity averaging 11.27% over the period cited by Dr. Morin and Ms. McShane.

As I addressed in my direct testimony at Page 9, Table 1, authorized returns on common equity have been approximately 11.3% as referenced by Dr. Morin. However, over the period 1996 through 2000, the average common equity ratios approved by regulatory commissions has been 46.6%.

Clearly, AmerenUE's common equity ratio of 59% is substantially out of line with equity ratios approved by regulatory commissions. Dr. Morin and Ms. McShane's argument that AmerenUE's common equity return should be at least comparable to other utilities' authorized equity returns, while ignoring its excessive

common equity ratio, is biased and will result in an excessive rate of return and overstated AmerenUE Missouri retail rates.

As noted in my rebuttal testimony, all else equal, a higher common equity ratio indicates lower financial risk. An overweighted common equity ratio unnecessarily increases AmerenUE's overall rate of return and retail rates in Missouri. If the Commission does not adjust Ameren's capital structure to reflect a reasonable balance of common equity, then it should award it a return on equity much lower than the average return authorized by other jurisdictions that were made with a lower, more reasonable common equity ratio. An inordinately high common equity ratio represents lower financial risk, and lower financial risk justifies a lower return on common equity.

Response to Ms. McShane

Q PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY TO MS. MCSHANE'S REBUTTAL TESTIMONY.

A The issues I take with Ms. McShane's rebuttal testimony are summarized as follows:

- Ms. McShane erroneously estimates AmerenUE's ROE to fall in the range of 12.0% to 14.0%. Ms. McShane's ROE estimates should be rejected.
- Corrections to Ms. McShane's data and rejection of her proposed unreasonable adjustments to the result of certain models would reduce her ROE estimate to a range of 10% to 11%. However, these estimates would only be reasonable if UE's capital structure is adjusted to reduce its excessive ratio of common equity to total capital. I would note that without Ms. McShane's inappropriate use of data and inappropriate use of adjustments to her model results, the estimated return on common equity for AmerenUE derived from her models and comparable group is nearly identical to that which I estimated in my rebuttal testimony.
- Ms. McShane erroneously adjusted the results of Staff Witness Bible's ROE estimate. Ms. McShane makes purported corrections to Mr. Bible's results and asserts that his analysis would support a return on equity in the range of

11.8% to 12.8% for AmerenUE, rather than Mr. Bible's recommended return on equity of 8.91% to 9.91%.

- Ms. McShane's "corrected" result of Mr. Bible's return on equity estimates suffer from the same flawed use of data and adjustments to models as her own analysis of AmerenUE's return on equity. Ms. McShane's equity return estimates are flawed and biased and should be rejected.

Q HAS MS. MCSHANE OFFERED SOME OBSERVATIONS THAT SHE PURPORTS TO SHOW THAT STAFF'S RETURN ON EQUITY RECOMMENDATION IS UNREASONABLE?

A Yes. Ms. McShane argues that Staff's return on equity would not be adequate to support Ameren Corporation's current dividend. At Pages 10 and 11 of her testimony, she argues that Staff's mid-point return on equity range of 9.41%, multiplied by Ameren Corporation's 2001 book value of $24.05 per share as estimated by Value Line Investment Survey (January 2002), would produce earnings per share of $2.26. She argues that that return on common equity would not produce earnings sufficient to cover Ameren's $2.54 dividend.

Q IS MS. MCSHANE'S OBSERVATION BASED ON REASONABLE CALCULATIONS?

A No. A significant flaw in Ms. McShane's observation, and in her entire response to Mr. Bible, is that she fails to recognize that Mr. Bible's return on common equity is made in concert with his acceptance of AmerenUE's very high common equity ratio of 59%. The Value Line publication she relies on for Ameren Corporation estimates a book value in 2001 of $24.05, as she recognizes. However, that book value is based on a common equity ratio to total capital of 49.5%. In significant contrast, Mr. Bible's return on common equity is made with a common equity ratio of over 59% of total

capital. Hence, there is a significant and meaningful disparity between the book value implicit in Mr. Bible's recommended return on equity for AmerenUE, and the book value Ms. McShane relied on for Ameren Corporation in support of her condition that Staff's return on equity is too low. It is simply erroneous to use Mr. Bible's return on equity, which is based on AmerenUE's 59% common equity ratio, and apply it as she did to Ameren Corporation's book value, which is based on a 49% common equity ratio. Her calculations are flawed.

A simple example will help illustrate this point. Consider a company with $100 of total capital. Assume that the Company's return on common equity is 10%, and it has a common equity ratio of 50%. With this relationship, the company would expect to have earnings of $5.00 ($100 x 50% x 10%). Consider next a company with total capitalization of $100, with a common equity ratio of 40% and a return on common equity of 10%. This company would have expected earnings of $4.00 (100 x 40% x 10%).

If the company is paying a dividend of $4.50, the company that is earning 10% with a capital structure composed of 50% common equity, would produce $5.00 of earnings, which fully covers the $4.50 dividend. In significant contrast, if the Company had a common equity ratio of 40%, it would produce $4.00 of earnings, and the $4.50 dividend would not be covered.

Q PLEASE DESCRIBE MS. MCSHANE'S ANALYSES SUPPORTING HER ESTIMATED RETURN ON EQUITY RANGE FOR AMERENUE.

A Ms. McShane performs three analyses that produced estimates of AmerenUE's return on common equity in the range of 11.0% to 14.0%. The results of her analyses, excluding her proposed adjustments, are shown below in Table 1.

TABLE 1

Summary of McShane's ROE Analyses

Description	Estimate
DCF	11.0% to 11.3%
CAPM	11.4% to 11.8%
Comparable Earnings	14.0%

Source: McShane's Rebuttal at 92, 105 and 112.

Ms. McShane then proposes adjustments to her DCF and CAPM results that raise the DCF and CAPM estimates. Ms. McShane's final estimated return on equity is summarized below in Table 2.

TABLE 2

McShane's Recommended ROE Estimates for AmerenUE

Description	Estimate
DCF	13.2% to 13.5%
CAPM	12.0% to 14.0%
Comparable Earnings	14.0%

Source: Page 112, Table 21, McShane Rebuttal

Q PLEASE SUMMARIZE YOUR ADJUSTMENTS TO THE RESULTS OF MS. MCSHANE'S COMMON EQUITY RETURN ESTIMATES.

A As shown below in Table 3, after reasonable and proper adjustments to data inputs and elimination of inappropriate adjustments to the model results, Ms. McShane's DCF and CAPM estimates would have produced a return on common equity for AmerenUE in the range of 10% to 11%. For reasons discussed below, the comparable earnings analysis is an inappropriate method of estimating a fair return for a utility company in a regulatory proceeding and should be rejected.

TABLE 3

Adjusted McShane
Return on Equity Estimates

Description	Estimate
DCF	10.8% to 11.0%
CAPM	10.0%
Comparable Earnings	Reject

Q PLEASE DESCRIBE THE DISAGREEMENTS YOU HAVE WITH MS. MCSHANE'S DCF ANALYSIS AND RESULTS.

A Ms. McShane's DCF analysis is overstated for several reasons. First, Ms. McShane's estimate is overstated because she relied on a growth rate of 6.2%, which is higher than the consensus analysts' growth rate reflected on her Schedule 8 of 5.9% and 6.0%. By using a growth rate that is higher than the consensus analyst growth rate estimates, she has produced an overstated DCF result. Second, Ms. McShane proposes to add to the results of her DCF an adjustment for financial flexibility, and

an adjustment to reflect the difference between the market value and book value of her proxy utility group.

Q WHAT WOULD MS. MCSHANE'S DCF ESTIMATE HAVE BEEN HAD SHE ONLY USED THE ANALYSTS' CONSENSUS GROWTH RATE ESTIMATES REFLECTED IN HER ANALYSIS?

A Ms. McShane's growth rate would have declined from 6.2% down to approximately 6.0%. This would have reduced the average DCF return for the companies included in her comparable group from 11.0% to 10.8%.

Q WHY SHOULD MS. MCSHANE HAVE RELIED ON THE ANALYSTS' CONSENSUS GROWTH RATES?

A Analysts' consensus growth rate estimates are a better proxy of investor expectations than the method Ms. McShane used to develop her DCF estimate as shown on her Schedule 8. On her Schedule 8, Ms. McShane averaged the IBES, Zack's and cash flow per share forecast from Value Line, to produce the growth rate of 6.2%. The IBES and Zack's growth rates are approximately 6%, whereas the Value Line cash flow per share growth rate is about 6.8%. Analysts' consensus growth rate projections are based on professional analysts' projections of future growth. Security analysts will likely consider projected growth in cash flow, earnings, revenues, plant, and other relevant factors to derive their projected earnings growth.

Ms. McShane's proposal to increase the analysts' consensus earnings growth rates by averaging them with the Value Line cash flow projections is inappropriate and over-weights cash flow considerations of future growth. Further, Ms. McShane's proposal to manipulate the analysts' growth projections is in direct contradiction to her

criticisms of Staff witness Bible's use of historical growth rates. In response to Mr. Bible, Ms. McShane argues that analysts would take historical growth rate results into account in arriving at their forecasts of future growth (McShane Rebuttal at 27).

Ms. McShane cannot have it both ways. Professional security analysts likely do consider historical growth and also projected growth of cash flow in deriving future earnings growth rates. If, according to Ms. McShane, it is inappropriate for Mr. Bible to have averaged historical growth rates with analysts' growth rates, then it is equally as unreasonable for her to average projected growth in cash flow with analysts' growth rates.

Q PLEASE DESCRIBE MS. MCSHANE'S PROPOSED ADJUSTMENTS FOR FINANCIAL FLEXIBILITY.

A Ms. McShane proposes to add to the results of her DCF a 50 basis point premium for financial flexibility. She argues that this is appropriate for two reasons: (1) to allow the Company to recover costs associated with issuing additional stock while preserving a market price that is not less than book value; and (2) position the Company at all times where it can issue additional equity without harming existing shareholders.

Q PLEASE DESCRIBE WHY IT WOULD BE UNREASONABLE TO ADJUST A RETURN ON EQUITY FOR AMERENUE BY MS. MCSHANE'S PROPOSED FINANCIAL FLEXIBILITY ADJUSTMENT.

A Ms. McShane's proposed 50 basis point financial flexibility adjustment should be rejected for several reasons. First, to the extent AmerenUE has incurred costs associated with the issuance of common equity, it should have recorded its flotation

costs to allow an audit and verification of its cost of issuing stock. Ms. McShane's proposed 50 basis point adjustment is not based on AmerenUE's actual issuance cost of common equity. Therefore, AmerenUE's common equity issuance cost is not a known and measurable expense.

Second, her argument to increase the common equity return in order to always maintain the Company's ability to issue common equity is without merit. There is no guarantee that any rate of return the Commission authorizes AmerenUE can guarantee its ability to issue new common equity. Indeed, many factors beyond the Commission's control go into the determination of the market value of Ameren stock. Factors such as management prudence, reasonable investments, fraud, accounting manipulation and other factors affect the market value of stock, and limit a utility's ability to access capital. Customers' obligation to AmerenUE and to its shareholders is to provide a fair return on common equity for investments made in utility plant. Ms. McShane's proposed 50 basis point financial flexibility adjustment would set the return on equity higher than that necessary to provide fair compensation. For this reason, Ms. McShane's financial flexibility adjustment should be rejected.

Q PLEASE DESCRIBE MS. MCSHANE'S PROPOSED ADJUSTMENT TO THE DCF ESTIMATE FOR THE DIFFERENCE IN MARKET VALUE AND BOOK VALUE OF HER PROXY GROUP.

A Ms. McShane argues that a rate of return on equity derived from market value would not produce a reasonable return on book equity if there were a significant difference between market value and book value. She argues that the dollar return expected by investors would not be produced if the market derived rate of return is applied to book

value and the market to book ratio is greater than one. She cites an example of a stock price of $17.50 and a required return of 11%, producing an expected cash flow to equity investors of $1.92. If the 11% rate of return is applied to book value of $10, it would only produce a return of $1.10. She argues then that the return on book value should be adjusted for the ratio of market value to book value, or 175%, to produce a fair return on book equity. She concludes that unless the DCF and CAPM estimates are transformed to a fair return on book value, application of the DCF will significantly understate the return on original cost value that investors require.

Q HAS MS. MCSHANE PROVIDED REASONABLE SUPPORT FOR HER CONTENTION THAT DCF AND CAPM RETURNS SHOULD BE ADJUSTED BY A MARKET TO BOOK RATIO?

A No. To the contrary, if adopted, Ms. McShane's market to book ratio adjustment will unfairly inflate the authorized return on common equity and provide utilities an economic incentive to over-invest or "gold plate" utility plant.

Using the parameters of Ms. McShane's analysis will help prove this point. Assume that the DCF return is estimated to be 11%, as Ms. McShane argues. The market to book ratio is assumed to be 150%, the payout ratio is assumed to be 50%. As illustrated in Footnote 76, and using the formulas described at Pages 96 and 97 of Ms. McShane's testimony, her DCF and CAPM results would be adjusted by a factor of 1.2. Thus, the return on book equity would be set at 13.2%.

If regulators accept this adjustment, a utility could then be faced with the prospects of using retained earnings to either make incremental investment in utility plant, or buy back its own stock. These are risk comparable investments. If the utility could earn 13.2% by making incremental investments in utility plant, and could only

earn 11% by buying back its own stock, it would clearly have an economic incentive to make utility plant investments. This occurs because the utility is provided an unjustified higher risk adjusted return on utility plant investments of 13.2%, compared to a comparable risk investment of buying back its own stock and earning 11%.

Making a market to book ratio adjustment to the authorized return on equity for ratemaking purposes will provide utilities with an economic incentive to over-invest or gold plate utility plant investment. This occurs because the adjustment will result in an inordinately and unreasonably high-risk adjusted return on utility plant investment that is distorted by the erroneous market to book ratio adjustment proposed by Ms. McShane.

Q **PLEASE DESCRIBE THE ISSUES YOU HAVE WITH MS. MCSHANE'S CAPM ANALYSIS.**

A Ms. McShane's CAPM analysis is overstated due to her use of an overstated beta estimate and market risk premium.

Q **HOW WOULD THE RESULTS OF MS. MCSHANE'S CAPM ANALYSIS CHANGE IF THE BETA AND THE MARKET RISK PREMIUM ANALYSIS WERE CORRECTED?**

A Using the formula described at Page 104 of her testimony, a Value Line average beta for her proxy group of 0.52%, and a market risk premium of 7.6%, as discussed at Page 100 of her testimony, and a risk free rate of 5.5% to 6% produces a CAPM return estimate in the range of 9.5% to 10%, as shown below.

$$(5.5\% \text{ to } 6.0\%) + 0.52\ (7.6\%) = 9.5\% \text{ to } 10.0\%$$

Using the higher risk free rate of 6% is more in line with projected yields on long-term Treasury securities and will produce a CAPM return of 10% using the group average Value Line beta of 0.52 and a market risk premium of 7.6%. For reasons discussed below, based on my adjustment to Ms. McShane's CAPM analysis, I believe Ms. McShane's analysis reasonably yields a CAPM return estimate for AmerenUE of 10.0%.

Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH THE BETA ESTIMATE USED BY MS. MCSHANE IN HER CAPM ANALYSIS.

A Ms. McShane used a beta estimate of 0.70. Her beta estimate is significantly higher than her proxy group average Value Line beta of 0.52. Ms. McShane argues that it is necessary to use a higher beta estimate because the Value Line beta does not accurately reflect prospective utility risk.

Ms. McShane observes that current electric utility betas of 0.52 are much lower than they have been. For the period 1986-1998 electric utility betas have ranged from approximately 0.65 to 0.73. She believes that the current utility beta of 0.52 does not reflect prospective utility risk.

She bases this conclusion on her observation of other utility risk factors that she believes support her contention that electric utility risk currently is not different than it was over the period 1986 through 2001. As such, she recommends a beta of 0.7.

Q PLEASE RESPOND TO MS. MCSHANE'S PROPOSED ELECTRIC UTILITY BETA ESTIMATE.

A Ms. McShane's proposed use of a beta of 0.7, rather than the observable published utility beta of 0.52, is without merit. Her conclusion that electric utility stock risk has not changed over the last five years is reasonable. However, the flaw in Ms. McShane's argument is that she fails to recognize that while utility risk may be comparable today to what it was five years ago, market risk is not the same but has increased. At Pages 85-86 of her testimony, Ms. McShane observes that market volatility has increased over the last five years. With increased volatility in the overall marketplace, and no additional volatility for electric utility stocks, it is logical that the risk of electric utility stocks in relationship to increasing overall market risk (i.e., beta) would decline.

Q DO YOU HAVE OTHER SUPPORT FOR YOUR CONTENTION THAT MARKET VOLATILITY AND RISK INCREASED OVER THE LAST FIVE YEARS?

A Yes. Standard & Poor's reached a similar conclusion that volatility in the S&P 500 has increased over the last few years relative to the mid-1990s. Based on a study it performed, S&P found that the volatility of the S&P 500 increased in two respects.

First, frequency of large daily price moves and, second, the standard deviation of daily returns. Both of these measures indicate greater volatility in the S&P 500 stock index prices. Greater price volatility indicates that the risk of the S&P 500, a market index, has increased. The increased volatility in the S&P 500 appears also to be reflected in the overall weights of the market index itself. For example, in 1995 technology stocks represented approximately 10.9% of the S&P 500 index. By the end of year 2000, technology stocks weight of the S&P 500 more than doubled to

22.5%. Over the last five years technology stocks have been very volatile investments, the market price often being a significant multiple to current and projected earnings. The increase in technology stocks has also resulted in a significant increase in the price to earnings ratio of the S&P 500 and a reduction to the dividend yield. Both of these factors support the premise that the market itself has become more risky in the last five years (Standard & Poor's U.S. Indices: 2000 Summary and Statistics, Standard & Poor's Index Committee, January 2001).

Again, if the market index risk is increasing, and electric utility stock risk is not increasing, then it is logical for the electrical utility betas to be declining in relationship to the market index. This is precisely what we have seen in electric utility betas over the last five years.

Q PLEASE DESCRIBE MS. MCSHANE'S HISTORICAL MARKET RISK PREMIUM ESTIMATE.

A Ms. McShane makes adjustments to the historical measured market risk premium in relationship to long-term Treasury securities. Ms. McShane adds 40 basis points to her estimate of historical long-term market risk premiums of 7.5% to 7.6%, producing a market risk premium over a shorter ten-year maturity of 7.9% to 8.0%.

Ms. McShane's proposed manipulation of historical data is unreasonable and unnecessary. Market data still is available for long-term Treasury securities as quoted in the Blue Chip Financial Forecasts and from other sources. Hence, Ms. McShane's adjustment to the historical equity risk premium is unnecessary and unreasonable.

Q PLEASE DESCRIBE MS MCSHANE'S PROSPECTIVE MARKET RISK PREMIUM ESTIMATE.

A Ms. McShane does a DCF analysis on the S&P 500 in comparison to a 10-year Treasury bond yield for the period 1992 through 2001.

Q PLEASE COMMENT ON MS. MCSHANE'S MARKET RISK PREMIUM STUDY.

A Ms. McShane's estimate of a market risk premium for use in her CAPM analysis is based on the results of a DCF analysis. Hence, the way she has constructed it, the CAPM analysis does not provide an independent assessment and verification of the reasonableness of the results of her DCF analysis.

To the contrary, her CAPM analysis is predominately driven by the results of a DCF analysis. A CAPM analysis and a risk premium analysis should be independent methodologies to verify the results of other market-based models. Ms. McShane's CAPM analysis is heavily influenced by the results of her DCF analysis and therefore is not an independent methodology to help validate the information produced from a DCF study. Consequently, Ms. McShane's forward-looking market risk premium estimate should be rejected and her CAPM analysis should be constructed based on her estimate of the market risk premium using historical data.

Q DO YOU HAVE ANY OTHER CRITICISMS OF MS. MCSHANE'S CAPM ANALYSIS?

A Yes. Ms. McShane also increases her estimated CAPM results from 11.4% to 11.8% up to 13.75% to 14.0%. She did this by adding 50 basis points for financial flexibility and adjusting by her long-run market to book ratio adjustment of 1.2x (McShane direct at 106).

Q SHOULD MS. MCSHANE'S PROPOSED ADJUSTMENTS TO THE RESULTS OF HER CAPM ANALYSIS BE ADOPTED?

A No. Ms. McShane's proposed financing flexibility and market to book ratio adjustment to her CAPM results are identical to what she proposed for her DCF results. For the same reasons I discussed above in relationship to her DCF analysis, these adjustments to her CAPM results are flawed and should be rejected. No adjustment is necessary.

Q PLEASE DESCRIBE MS. MCSHANE'S COMPARABLE EARNINGS ANALYSIS.

A Ms. McShane estimates the 10-year historical average earned return on book equity of 34 industrial companies over the period 1991 to 2000 to be 18.1%. From this, she concludes that a low-risk industrial consumer-oriented industry may expect to earn a return of no less than 18.0%. She then uses Value Line's data to estimate the median projected return on book equity for the same companies to be 18.3% for the period 2004 through 2007. She then adjusts the median projected return on equity for the difference between the utility beta of 0.53 and the industrial group beta of 0.8, using the formula shown on Page 112, Line 13 of her testimony. This beta adjustment reduces her 18.3% median projected earned return on book equity for the industrial companies down to 14%, which she asserts is appropriate for an electric utility. She concludes that this process produces a risk adjusted return on book equity for AmerenUE.

Q DOES MS. MCSHANE'S COMPARABLE EARNINGS ANALYSIS PRODUCE A REASONABLE RETURN ON EQUITY ESTIMATE FOR AMERENUE?

A No. A comparable earnings analysis does not measure a fair rate of return to use in ratemaking. Rather, a comparable earnings analysis measures an accounting return that may be higher or lower than the return investors require to make an investment.

In contrast, market based models, like the DCF and CAPM analyses, measure the return an investor requires in order to make an investment. Measuring investor required returns, and allowing the utility an opportunity to earn this return, assures that investors are fairly compensated for making incremental investments in utility plant, and customers are not charged excessive prices.

On the other hand, an accounting based return produced from a comparable earnings analysis may be higher or lower than the investor required return. If the comparable earnings return is higher than the investor required return, then investors will receive excessive compensation and utility prices will be higher than a just and reasonable level. Or, if the comparable earnings analysis produces a return that is lower than the investor required return, investors will not be fairly compensated for making incremental improvements to utility plant, and rates would be set too low.

In summary, a comparable earnings analysis does not measure the correct return and is not a reliable model to estimate a return on equity that fairly balances investors and customers' interests. The comparable earnings analysis should be rejected.

Response to Steven Fetter

Q PLEASE SUMMARIZE AMERENUE WITNESS STEVEN M. FETTER'S REBUTTAL TESTIMONY.

A In his testimony, Mr. Fetter provides an overview of two issues. First, Mr. Fetter provides Fitch's view of what comprises fair and economically prudent regulation. Second, he reviews Staff's revenue requirement recommendations and argues, based on numbers included in his Schedules 1 and 2, that Staff's position will result in a downgrade to AmerenUE's bond rating, thus increasing its cost of borrowing and impacting its financial flexibility.

Q PLEASE SUMMARIZE MR. FETTER'S DISCUSSION OF HIS VIEW OF FAIR AND ECONOMICALLY PRUDENT REGULATION.

A Mr. Fetter maintains that in Fitch's evaluation of regulatory climate, the most important consideration is "consistent application of sound economic regulatory principles by a public utilities commission." (Page 4). He maintains that this is necessary in order to encourage major energy investors to commit funds to allow the utilities to fund infrastructure and capital improvements.

Mr. Fetter argues that a broad based incentive or performance based ratemaking program is the best means of providing economic incentives to utility companies and their customers that most closely match economic incentives provided by competitive markets.

Q **PLEASE COMMENT ON MR. FETTER'S DISCUSSION OF ECONOMICALLY PRUDENT REGULATION.**

A I would agree with Mr. Fetter that an important aspect of economically prudent regulation is the consistent application of "sound economic regulatory principles by a pubic utility commission." Both utility investors and customers benefit from sound economic regulatory principles, as they will encourage utility plant investment and allow customers to make reasonable assessments of utility costs in order to make economic investment decisions in utility customer plant and equipment. Hence, the economic regulatory principles should be designed to balance the interests of investors and customers.

Toward that end, I would encourage the Missouri Public Service Commission to closely adhere to the long-standing prudent principle of setting rates by examining revenues, expenses and rate base, within a test year. The test year economic principle matches revenues and expenses, and invested capital within a consistent time period to develop rates that provide fair compensation to investors, maintain the utility's financial integrity, and develop rates that are just and reasonable.

It would not be compatible with sound economic principles to set rates by considering projected costs outside of the test year, without considering all relevant impacts to revenues, sales, customers, operating expenses, and invested capital.

Unfortunately, in his response to Staff, Mr. Fetter does not adhere to prudent regulatory principles. Rather, he considers financial projections well outside the test year, and therefore betrays his own assessment of Fitch's policy to review regulatory risk in terms of regulators' consistent application of sound economic regulatory principles in assessing the financial impact of rate changes.

Q DID MR. FETTER REACH ANY CONCLUSIONS CONCERNING STAFF'S PROPOSED REVENUE ADJUSTMENT FOR AMERENUE IN THIS PROCEEDING?

A Yes. Mr. Fetter opined that in Fitch's opinion, AmerenUE's credit profile would be adversely affected by the adoption of revenue reductions of the magnitude and nature advocated by Staff that would result in a downgrade of the Company's current bond ratings. Mr. Fetter expressed concern about the ongoing revenue reductions that would adversely affect all of AmerenUE's significant financial ratios. He stated particular concern about a decline in the ratio of cash flow to capital expenditures, coincident with a period of rising capital outlays for new energy infrastructure investments to meet customer demands. In addition, he observed that leverage would also go up during the period.

Q HOW DID MR. FETTER REACH HIS CONCLUSIONS CONCERNING THE DEGRADATION TO AMERENUE'S FINANCIAL RATIOS AS A RESULT OF STAFF'S POSITION IN THIS PROCEEDING?

A Attached to his testimony as Schedules 1 and 2 are Mr. Fetter's estimated AmerenUE financial ratios reflecting Staff's range of revenue reductions of $245 million to $285 million.

Based on a forecast put together by AmerenUE, Mr. Fetter calculated these ratios over the period 2000 through 2006. The results of Mr. Fetter's analysis are summarized below in Tables 4 and 5.

Table 4

Fetter's Estimated Ratios
$285 Million Revenue Reduction

	2000	2001	2002	2003	2004	2005	2006
EBIT/interest coverage	5.25	5.87	4.50	3.56	2.92	2.35	2.24
EBITDA/interest coverage	7.34	8.28	6.30	4.96	4.15	3.42	3.29
Cash from operations/interest Coverage	5.87	6.73	5.45	4.43	3.78	3.27	3.14
Net cash from operations/ capital exp.	127.9%	63.3%	53.4%	51.5%	35.5%	23.3%	43.9%
Total debt	39.2%	40.0%	44.9%	47.8%	51.5%	53.2%	55.0%
Debt/EBITDA	1.85	1.95	2.72	3.14	3.73	4.42	4.39

Table 5

Fetter's Estimated Ratios
$245 Million Revenue Reduction

	2000	2001	2002	2003	2004	2005	2006
EBIT/interest coverage	5.25	5.87	4.74	3.81	3.22	2.62	2.54
EBITDA/interest coverage	7.34	8.28	6.54	5.22	4.48	3.72	3.64
Cash from operations/interest coverage	5.87	6.73	5.60	4.59	4.00	3.48	3.40
Net cash from operations/ capital exp.	127.9%	63.3%	57.0%	55.7%	39.7%	26.8%	51.0
Total debt	39.2%	40.0%	44.5%	47.0%	50.3%	51.7%	53.0%
Debt/EBITDA	1.85	1.95	2.61	3.95	3.48	4.08	4.02

Q **WHAT CONCLUSIONS DID MR. FETTER REACH BASED ON THE RATIOS HE CALCULATED?**

A He concludes that the coverage ratios over the period 2002-2006 drop to a level indicative of utility bond ratings in the "BBB" range by the 2005 to 2006 timeframe.

He summarizes his position by stating that AmerenUE's leverage, interest protection and cash flow measures decline steadily throughout the forecast period and by 2005 are reflective of utility companies with ratings in the "BBB" category (Page 12). He attributes this decline in the financial ratios entirely to Staff's proposed revenue reductions for AmerenUE.

Q PLEASE COMMENT ON MR. FETTER'S CALCULATIONS AND CONCLUSIONS BASED ON HIS FINANCIAL RATIO ANALYSIS.

A Mr. Fetter's analysis does not support his conclusion that Staff's recommendation in this proceeding will cause AmerenUE's bond rating to drop to "BBB." First, Mr. Fetter asserts that these ratios were based on a financial forecast made by Ameren (Page 10). Neither Mr. Fetter, nor AmerenUE, provided the assumptions used in developing the forecast.

Consequently, I have not been able to review Ameren's forecasting assumptions with respect to capital expenditures, level of O&M expenses, assumptions about depreciation rates, sales growth, rate changes, and other significant factors that will have a material impact on these ratios over the forecast period. Accordingly, it is impossible to determine whether Mr. Fetter has presented an accurate and/or unbiased assessment of the impact on AmerenUE's financial ratios caused by Staff's proposed revenue reduction or if the ratio degradation was caused by other factors or forecasting assumptions.

For example, Mr. Fetter's financial forecast reflects significant capital improvements, but he does not describe whether sales growth or rate adjustments have been included to support a growing rate base. Thus, the degradation to the Company's

ratios in 2005 and 2006 could be caused simply by the Company not reflecting sales growth or seeking rate relief to support a growing rate base.

This is significant, because Mr. Fetter's primary concern about the impact on the financial ratios appear to be in the last two years of the forecast, 2005 and 2006. Staff's proposed rate reduction in this proceeding will begin in April 2002. Mr. Fetter's estimated financial ratios in 2002 and 2003 fully support AmerenUE's existing bond rating at Staff's proposed revenue adjustments.

In sum, an accurate and fair representation of the adjustments Staff is proposing for AmerenUE's rates is based on a test year cost of service analysis. This is the traditional and most reasonable method of setting appropriate rates in my opinion. In significant contrast, Mr. Fetter's financial projections go out beyond the June 2001 test year, to 2006, and he concludes Staff's position is not reasonable based on AmerenUE's financial ratios in the years 2005 and 2006. Mr. Fetter's analysis fails his own standard of the "consistent application of sound economic regulatory principles."

Q HOW COULD MR. FETTER'S FINANCIAL RATIO CALCULATIONS BE USED BY A SOUND ECONOMIC REGULATORY COMMISSION TO CONSIDER THE IMPACTS OF STAFF'S PROPOSED RATE REDUCTION ON AMERENUE?

A Mr. Fetter's financial ratios should be reviewed within the test year ending June 2001 or, at most, the first full year the lower rates are projected to be in effect. After this time period, it isn't clear whether the ratio degradation would be produced by Staff's proposed rate adjustment in this proceeding, or for some other unknown, unspecified factors or forecasting assumptions.

Q BASED ON REVIEWING MR. FETTER'S SCHEDULES 1 AND 2, IS IT APPARENT WHEN HE ESTIMATED THE STAFF'S REVENUE REDUCTIONS WILL BE PUT INTO EFFECT?

A Review of the operating income shows a significant decrease in calendar year 2002. Hence, it appears that Mr. Fetter assumed that Staff's proposed revenue reduction would be placed into effect in calendar year 2002. I would note that the operating income continues to decline throughout the forecast period. Nevertheless, the largest decrease appears to have been in calendar year 2002, relative to 2001.

Q DO THE FINANCIAL RATIOS CALCULATED BY MR. FETTER FOR CALENDAR YEARS 2002 AND 2003 REFLECT THE DETERIORATION IN THE EARNINGS, AND CASH, COVERAGES OF AMERENUE TO THE LEVEL OF "BBB"?

A No. Below in Tables 6 and 7, I show Mr. Fetter's estimated AmerenUE financial ratios for the two scenarios in calendar years 2002 and 2003, along with Standard & Poor's financial ratio benchmarks for a utility bond rating of "A" with a business position ranking of 4, AmerenUE's current ratings.[2]

As shown in Tables 6 and 7, AmerenUE's financial ratios as calculated by Mr. Fetter will fully support an "A" bond rating in 2002 and 2003. Again, while Mr. Fetter did not provide his list of assumptions used in the forecast (workpapers were not provided until June 20, 2002), based on a review of the change to operating income, it appears that the Company reflected a reduction to its revenues based on Staff's forecast in the year 2002. Accordingly, degradation of financial ratios appears to

[2] In the comparison, Mr. Fetter's Cash Flow from Operations (CFO) is comparable to S&P's Funds from Operations (FFO) measure.

have been caused by factors other than the proposed reduction in revenues made by Staff in this proceeding.

Simply reflecting Staff's proposed revenue reductions, within the test year, shows a strong relationship between the Company's revenues, cost of service, rate base and financial ratios to support its existing bond rating. The degradation in ratios beyond 2003 appears to have been caused by the Company's efforts to increase its investments in electric utility plant, which was primarily financed with debt. This growing plant or rate base would eventually be reflected by the Commission in increased rates if sales growth does not cover the increased investment cost. If AmerenUE's forecast does not reflect sales growth and rate changes, it is not accurate.

Table 6

$285 Million Revenue Reduction

	2002	2003	S&P Benchmark "A" BP of 4
EBIT/interest coverage	4.50	3.56	4.0 –3.3
EBITDA/interest coverage	6.30	4.96	
Cash from operations/interest Coverage	5.45	4.43	4.5 - 3.8
Net cash from operations/ capital exp.	53.4%	51.5%	
Total debt/total capital	44.9%	47.8%	43.0%-49.5%
CFO/Average Debt	28.3%	23.3%	30.5%-24.5%

Table 7

$245 Million Revenue Reduction

	2002	2003	S&P Benchmark "A" BP of 4
EBIT/interest coverage	4.74	3.81	4.0 -3.3
EBITDA/interest coverage	6.54	5.22	
Cash from operations/interest coverage	5.60	4.59	4.5 - 3.8
Net cash from operations/ capital exp.	57.0%	55.7%	
Total debt/total capital	44.5%	47.0%	43.0%-49.5%
CFO/Average Debt	29.4%	24.6%	30.5%-24.5%

Q **ARE THERE OTHER ASPECTS OF MR. FETTER'S FORECAST THAT LEAD YOU TO BELIEVE THAT HIS FINANCIAL RATIOS DO NOT FAIRLY REPRESENT THE IMPACT ON AMERENUE FROM STAFF'S PROPOSED REVENUE ADJUSTMENTS?**

A Yes. Many aspects of Mr. Fetter's projections would call into question the validity of his ratio estimates. These uncertainties are summarized as follows:

- In year 2002, Mr. Fetter's financial projections show a common equity ratio of 52%. This common equity ratio is substantially lower than the 59% common equity ratio reflected in Staff's revenue requirement calculations and the 57.7% common equity ratio, including short-term debt and off-balance sheet obligations, as I estimated in my rebuttal testimony on Schedule 2. However, it is very similar to Ameren Corporation's 2002 common equity ratio of 51.5% reported by Value Line (April 5, 2002 at 697). Accordingly, the capital structures the Company included in its financial forecast appear to be different from those provided, for the $285 million scenario, to Staff in this proceeding.

- The financial forecasts also appear to have included questionable assumptions. Specifically, the operating income continues to decline after the rate decrease is implemented in 2002. The reduction to operating income would be caused by increases in depreciation expense created through additional infrastructure plant investment. However, as stated above, if sales growth did not provide a fair

return on a growing rate base, the Company should have made assumptions for rate relief to provide a fair return. Declining operating income also causes the Company's dividend payout ratio to increase from 77.5% in 2001 to over 100% in the years 2005 and 2006. This questionable assumption results in additional use of debt financing to fund the infrastructure plant improvements. This additional debt financing further erodes the Company's financial ratios in the years 2005 and 2006. Accordingly, it appears the Company made its financial position in years 2005 and 2006 to look especially worse due to modeling assumptions, rather than a direct evaluation of the impact on its operations through Staff's proposed revenue changes.

In summary, it is not clear whether the Company's financial projections reflect AmerenUE, or Ameren Corporation in total, or that the capital structure is accurate. Further, it is not clear whether there is adequate sales growth built into the projections to reflect a growth in the Company's infrastructure, plant investments and costs. Finally, the Company's financial projections appear to assume that rate relief would not be provided, irrespective of the level of prudent infrastructure investment, and the adequacy of rates to provide a fair return on that investment. Such a determination would be conducted in a future rate proceeding, once the Company's actual prudent and reasonable infrastructure investments are made, and the Commission determines an appropriate return to allow the Company to earn on those investments.

Response to Warner L. Baxter

Q DO YOU HAVE ANY COMMENTS ON THE REBUTTAL TESTIMONY OF AMERENUE WITNESS WARNER L. BAXTER?

A Yes. At pages 32-35 of Mr. Baxter's testimony, he cites several credit reports to support his contention that Staff's recommended revenue adjustment in this proceeding will result in a downgrade to AmerenUE's and Ameren Corporation's bond ratings. I acknowledge that many of the bond rating analysts have expressed a concern that Staff's recommendation will reduce AmerenUE's cash flow, which may limit its ability to pay dividends to Ameren Corporation. Concerning the credit rating

implication of Staff's proposed revenue adjustments in this proceeding, I make the following two observations. First, credit rating analysts are not considering the reasonableness of AmerenUE's rates in reaching their conclusions. Rather, credit analysts appear to be clearly focusing on the cash flows produced by AmerenUE, and the dividends AmerenUE can pay to its parent company, Ameren Corporation. Those dividends are needed by the parent company to fund its financial obligations, which include servicing the debt the parent company has taken on to fund non-regulated assets, and to pay common dividends. Credit analysts have not made an evaluation of the justness and reasonableness of Missouri rates, nor have they considered the benefits and consequences of charging inflated rates to its Missouri retail customers and the related economic consequences to the Missouri economy. Accordingly, bond rating analysts are not providing an unbiased view of the appropriateness of Missouri retail rates. They are focused on investor concerns.

Second, there are other concerns expressed by credit analysts that support their decisions to put Ameren Corporation on credit watch. For example, in the July 12, 2001 Moody's publication cited by Mr. Baxter, he neglects to complete the quote on page 33 of his testimony. While Moody's was concerned about the reduced internal cash flow from the reduced revenues proposed by Staff, Moody's also noted a concern toward Ameren Corporation's bond rating as follows:

> "Moody's notes that Ameren Corporation has incurred a significant portion of its financial obligations to finance the construction of Midwest gas-fired peaking plants."

Indeed, Staff's proposal will reduce AmerenUE's cash flows. And, one of Moody's primary concerns appears to be Ameren Corporation's ability to service the debt obligations it has incurred as a result of investing in merchant generating plants.

Also, the Standard & Poor's article cited by Mr. Baxter states concern about Ameren Corporation's non-regulated investment activity and its related risk in its assessment and justification for revising Ameren Corporation's credit outlook to negative. An expanded quote from the same article cited by Mr. Baxter reads as follows:

> "The outlook change reflects the Company's eroding consolidated financial profile that just last year was robust per current ratings. Potentially significant rate reductions at UE, lower forward energy prices, additional financing requirements for installation of a block of combustion turbines, and higher operating expenses will pressure cash flow, earnings protection measures and capital structure balance."
>
> To maintain current ratings, Standard & Poor's considers it necessary that the Company's [Ameren Corporation] overall financial condition strengthens. Although Standard & Poor's credit analysis is prospective, financial improvement may not be as dramatic or as rapid as required to sustain current ratings.
>
> Ameren corporate credit rating is based on the consolidated financial and business risk profiles of the Ameren family of companies. Because there are no regulatory mechanisms or other structural barriers in Missouri that sufficiently restrict access by the parent to the cash flow of AmerenUE, Standard & Poor's views the default risk of UE as being the same as that of Ameren." (Standard & Poor's Corporate Ratings, Ameren Corporation Outlook Revised to Negative, October 5, 2001). (Emphasis added)

As noted in the quote above, Standard & Poor's states concern for the financial health of Ameren Corporation. S&P also notes that Ameren Corporation's and AmerenUE's credit profile are closely tied, and the unregulated aspect of Ameren's business is clearly a significant part of the concern. Retail rates should not be driven by unregulated operations. Clearly, Standard & Poor's review of the credit strength of Ameren Corporation and AmerenUE is not directed at determining whether or not AmerenUE is charging just and reasonable rates. Rather, its concerns are focused on Ameren Corporation's ability to service debt for its non-regulated investments.

AmerenUE's credit rating is certainly a relevant issue. However, credit rating analysts are not charged with the responsibility of establishing just and reasonable rates, regulatory commission are. Therefore, while credit rating analysts' concern should be considered, they should not be the primary driver of the determination of appropriate Missouri retail rates.

Q **DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

A Yes, it does.

MPG:mcl/7651/29839

Exhibit No.	
Witness:	Michael Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Missouri Industrial Energy Consumers
Case No.	EC-2002-1
Subjects:	Return on Common Equity and Overall Rate of Return

Before the
Missouri Public Service Commission

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

Surrebuttal Testimony of

Michael Gorman

On Behalf of

Missouri Industrial Energy Consumers

June 24, 2002
Project 7651

BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

Before the Public Service Commission
of the State of Missouri

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

STATE OF MISSOURI)
) **SS**
COUNTY OF ST. LOUIS)

Surrebuttal Affidavit of Michael Gorman

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my surrrebuttal testimony which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. EC-2002-1.

3. I hereby swear and affirm that the surrebuttal testimony is true and correct and shows the matters and things it purports to show.

Michael Gorman

Michael Gorman

Subscribed and sworn to before this 21st day of June 2002.

CAROL SCHULZ
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: Feb. 26, 2004

Carol Schulz

Notary Public

My Commission Expires February 26, 2004.

Before the
Missouri Public Service Commission

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

<u>Surrebuttal Testimony of Michael Gorman</u>

Q **PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q **ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY FILED REBUTTAL TESTIMONY IN THIS PROCEEDING?**

A Yes.

Q **WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

A I will respond to the rebuttal testimony of AmerenUE Witnesses Dr. Roger Morin, Kathleen C. McShane, Steven Fetter, and Warner L. Baxter.

Q PLEASE SUMMARIZE THE ISSUES YOU TAKE WITH AMERENUE WITNESSES IN YOUR SURREBUTTAL TESTIMONY.

A As set out below, I take the following issues with AmerenUE witnesses:

- A fair return on common equity should be developed in concert with the development of an appropriate and reasonable capital structure. Balancing these two factors is necessary to provide a fair overall rate of return that is just and reasonable.
- AmerenUE witnesses McShane and Morin are recommending returns on common equity without regard or mention of the appropriateness of AmerenUE's common equity balance. Consequently, their return on common equity recommendations are biased and do not provide a reasonable balance between the interests of shareholders and customers.
- Authorized returns on equity by regulatory commissions over the last five years have averaged approximately 11.3%. However, those authorized returns on equity have been made in combination with capital structures that contain common equity ratios of approximately 47%. Other electric utility common equity ratios are significantly lower than AmerenUE's actual common equity ratio of 59% as reflected in Staff's filing. A higher than average common equity ratio, all else equal, implies that AmerenUE has lower than average risk, and should receive a lower than average return on common equity.
- AmerenUE has mischaracterized its financial ratios reflecting Staff's proposed revenue reductions in this proceeding. The Company's near-term financial ratio projections show that Staff's recommended reduction in revenues will provide AmerenUE with financial ratios that are consistent with Standard & Poor's financial benchmarks for a utility with a bond rating of "A," Ameren's current bond rating.
- The Company's rebuttal evidence shows that credit rating agencies are currently expecting the Commission to reduce AmerenUE's rates in this proceeding. The Value Line Investment Survey also is projecting rates to be reduced[1]. Accordingly, the Commission should carefully develop a proper rate of return, capital structure, and earnings entitlement for AmerenUE in this proceeding. The market clearly expects a rate reduction.
- It is reasonable to expect that a utility will have to go to the external market to fund a significant capital improvement program. Projections by Ameren witness William Stouts on the difference between capital expenditures and depreciation receipts show that the Company is expecting to increase its investment in infrastructure plant. A fair and reasonable regulatory construct would not require customers to pay depreciation rates that are higher than reasonable, nor pay for a higher than reasonable rate of return based on an excessive return on equity,

[1] Baxter Rebuttal at 34, and The Value Line Investment Survey, April 5, 2002 at 698.

or a capital structure composed too heavily of common equity. Such a regulatory policy would unnecessarily drive up retail electric rates and abandon the customer protections provided by prudent regulation.

Response to Dr. Morin

Q WHAT ISSUE DO YOU TAKE WITH UE WITNESS DR. MORIN?

A Dr. Morin, at Page 5, refers to Ms. McShane's Schedule 17 in his assertion that other states have allowed electric utilities an authorized return on equity in the range of 10.5% to 12.9% for an average of 11.27%. His testimony is in support of his conclusion that Staff Witness Bible's return on common equity recommendation is too low.

Dr. Morin and Ms. McShane's criticisms of Staff witness Bible's return on common equity ratio are incomplete and misleading. Staff witness Bible made his return on common equity recommendation along with his acceptance of Ameren's capital structure, which includes a common equity ratio of 59%. AmerenUE's common equity ratio is substantially higher than the common equity ratios authorized by regulatory commissions along with the returns on common equity averaging 11.27% over the period cited by Dr. Morin and Ms. McShane.

As I addressed in my direct testimony at Page 9, Table 1, authorized returns on common equity have been approximately 11.3% as referenced by Dr. Morin. However, over the period 1996 through 2000, the average common equity ratios approved by regulatory commissions has been 46.6%.

Clearly, AmerenUE's common equity ratio of 59% is substantially out of line with equity ratios approved by regulatory commissions. Dr. Morin and Ms. McShane's argument that AmerenUE's common equity return should be at least comparable to other utilities' authorized equity returns, while ignoring its excessive

common equity ratio, is biased and will result in an excessive rate of return and overstated AmerenUE Missouri retail rates.

As noted in my rebuttal testimony, all else equal, a higher common equity ratio indicates lower financial risk. An overweighted common equity ratio unnecessarily increases AmerenUE's overall rate of return and retail rates in Missouri. If the Commission does not adjust Ameren's capital structure to reflect a reasonable balance of common equity, then it should award it a return on equity much lower than the average return authorized by other jurisdictions that were made with a lower, more reasonable common equity ratio. An inordinately high common equity ratio represents lower financial risk, and lower financial risk justifies a lower return on common equity.

Response to Ms. McShane

Q PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY TO MS. MCSHANE'S REBUTTAL TESTIMONY.

A The issues I take with Ms. McShane's rebuttal testimony are summarized as follows:

- Ms. McShane erroneously estimates AmerenUE's ROE to fall in the range of 12.0% to 14.0%. Ms. McShane's ROE estimates should be rejected.
- Corrections to Ms. McShane's data and rejection of her proposed unreasonable adjustments to the result of certain models would reduce her ROE estimate to a range of 10% to 11%. However, these estimates would only be reasonable if UE's capital structure is adjusted to reduce its excessive ratio of common equity to total capital. I would note that without Ms. McShane's inappropriate use of data and inappropriate use of adjustments to her model results, the estimated return on common equity for AmerenUE derived from her models and comparable group is nearly identical to that which I estimated in my rebuttal testimony.
- Ms. McShane erroneously adjusted the results of Staff Witness Bible's ROE estimate. Ms. McShane makes purported corrections to Mr. Bible's results and asserts that his analysis would support a return on equity in the range of

11.8% to 12.8% for AmerenUE, rather than Mr. Bible's recommended return on equity of 8.91% to 9.91%.

- Ms. McShane's "corrected" result of Mr. Bible's return on equity estimates suffer from the same flawed use of data and adjustments to models as her own analysis of AmerenUE's return on equity. Ms. McShane's equity return estimates are flawed and biased and should be rejected.

Q HAS MS. MCSHANE OFFERED SOME OBSERVATIONS THAT SHE PURPORTS TO SHOW THAT STAFF'S RETURN ON EQUITY RECOMMENDATION IS UNREASONABLE?

A Yes. Ms. McShane argues that Staff's return on equity would not be adequate to support Ameren Corporation's current dividend. At Pages 10 and 11 of her testimony, she argues that Staff's mid-point return on equity range of 9.41%, multiplied by Ameren Corporation's 2001 book value of $24.05 per share as estimated by Value Line Investment Survey (January 2002), would produce earnings per share of $2.26. She argues that that return on common equity would not produce earnings sufficient to cover Ameren's $2.54 dividend.

Q IS MS. MCSHANE'S OBSERVATION BASED ON REASONABLE CALCULATIONS?

A No. A significant flaw in Ms. McShane's observation, and in her entire response to Mr. Bible, is that she fails to recognize that Mr. Bible's return on common equity is made in concert with his acceptance of AmerenUE's very high common equity ratio of 59%. The Value Line publication she relies on for Ameren Corporation estimates a book value in 2001 of $24.05, as she recognizes. However, that book value is based on a common equity ratio to total capital of 49.5%. In significant contrast, Mr. Bible's return on common equity is made with a common equity ratio of over 59% of total

capital. Hence, there is a significant and meaningful disparity between the book value implicit in Mr. Bible's recommended return on equity for AmerenUE, and the book value Ms. McShane relied on for Ameren Corporation in support of her condition that Staff's return on equity is too low. It is simply erroneous to use Mr. Bible's return on equity, which is based on AmerenUE's 59% common equity ratio, and apply it as she did to Ameren Corporation's book value, which is based on a 49% common equity ratio. Her calculations are flawed.

A simple example will help illustrate this point. Consider a company with $100 of total capital. Assume that the Company's return on common equity is 10%, and it has a common equity ratio of 50%. With this relationship, the company would expect to have earnings of $5.00 ($100 x 50% x 10%). Consider next a company with total capitalization of $100, with a common equity ratio of 40% and a return on common equity of 10%. This company would have expected earnings of $4.00 (100 x 40% x 10%).

If the company is paying a dividend of $4.50, the company that is earning 10% with a capital structure composed of 50% common equity, would produce $5.00 of earnings, which fully covers the $4.50 dividend. In significant contrast, if the Company had a common equity ratio of 40%, it would produce $4.00 of earnings, and the $4.50 dividend would not be covered.

Q PLEASE DESCRIBE MS. MCSHANE'S ANALYSES SUPPORTING HER ESTIMATED RETURN ON EQUITY RANGE FOR AMERENUE.

A Ms. McShane performs three analyses that produced estimates of AmerenUE's return on common equity in the range of 11.0% to 14.0%. The results of her analyses, excluding her proposed adjustments, are shown below in Table 1.

TABLE 1

Summary of McShane's ROE Analyses

Description	Estimate
DCF	11.0% to 11.3%
CAPM	11.4% to 11.8%
Comparable Earnings	14.0%

Source: McShane's Rebuttal at 92, 105 and 112.

Ms. McShane then proposes adjustments to her DCF and CAPM results that raise the DCF and CAPM estimates. Ms. McShane's final estimated return on equity is summarized below in Table 2.

TABLE 2

McShane's Recommended ROE Estimates for AmerenUE

Description	Estimate
DCF	13.2% to 13.5%
CAPM	12.0% to 14.0%
Comparable Earnings	14.0%

Source: Page 112, Table 21, McShane Rebuttal

Q PLEASE SUMMARIZE YOUR ADJUSTMENTS TO THE RESULTS OF MS. MCSHANE'S COMMON EQUITY RETURN ESTIMATES.

A As shown below in Table 3, after reasonable and proper adjustments to data inputs and elimination of inappropriate adjustments to the model results, Ms. McShane's DCF and CAPM estimates would have produced a return on common equity for AmerenUE in the range of 10% to 11%. For reasons discussed below, the comparable earnings analysis is an inappropriate method of estimating a fair return for a utility company in a regulatory proceeding and should be rejected.

TABLE 3

Adjusted McShane
Return on Equity Estimates

Description	Estimate
DCF	10.8% to 11.0%
CAPM	10.0%
Comparable Earnings	Reject

Q PLEASE DESCRIBE THE DISAGREEMENTS YOU HAVE WITH MS. MCSHANE'S DCF ANALYSIS AND RESULTS.

A Ms. McShane's DCF analysis is overstated for several reasons. First, Ms. McShane's estimate is overstated because she relied on a growth rate of 6.2%, which is higher than the consensus analysts' growth rate reflected on her Schedule 8 of 5.9% and 6.0%. By using a growth rate that is higher than the consensus analyst growth rate estimates, she has produced an overstated DCF result. Second, Ms. McShane proposes to add to the results of her DCF an adjustment for financial flexibility, and

an adjustment to reflect the difference between the market value and book value of her proxy utility group.

Q WHAT WOULD MS. MCSHANE'S DCF ESTIMATE HAVE BEEN HAD SHE ONLY USED THE ANALYSTS' CONSENSUS GROWTH RATE ESTIMATES REFLECTED IN HER ANALYSIS?

A Ms. McShane's growth rate would have declined from 6.2% down to approximately 6.0%. This would have reduced the average DCF return for the companies included in her comparable group from 11.0% to 10.8%.

Q WHY SHOULD MS. MCSHANE HAVE RELIED ON THE ANALYSTS' CONSENSUS GROWTH RATES?

A Analysts' consensus growth rate estimates are a better proxy of investor expectations than the method Ms. McShane used to develop her DCF estimate as shown on her Schedule 8. On her Schedule 8, Ms. McShane averaged the IBES, Zack's and cash flow per share forecast from Value Line, to produce the growth rate of 6.2%. The IBES and Zack's growth rates are approximately 6%, whereas the Value Line cash flow per share growth rate is about 6.8%. Analysts' consensus growth rate projections are based on professional analysts' projections of future growth. Security analysts will likely consider projected growth in cash flow, earnings, revenues, plant, and other relevant factors to derive their projected earnings growth.

Ms. McShane's proposal to increase the analysts' consensus earnings growth rates by averaging them with the Value Line cash flow projections is inappropriate and over-weights cash flow considerations of future growth. Further, Ms. McShane's proposal to manipulate the analysts' growth projections is in direct contradiction to her

criticisms of Staff witness Bible's use of historical growth rates. In response to Mr. Bible, Ms. McShane argues that analysts would take historical growth rate results into account in arriving at their forecasts of future growth (McShane Rebuttal at 27).

Ms. McShane cannot have it both ways. Professional security analysts likely do consider historical growth and also projected growth of cash flow in deriving future earnings growth rates. If, according to Ms. McShane, it is inappropriate for Mr. Bible to have averaged historical growth rates with analysts' growth rates, then it is equally as unreasonable for her to average projected growth in cash flow with analysts' growth rates.

Q PLEASE DESCRIBE MS. MCSHANE'S PROPOSED ADJUSTMENTS FOR FINANCIAL FLEXIBILITY.

A Ms. McShane proposes to add to the results of her DCF a 50 basis point premium for financial flexibility. She argues that this is appropriate for two reasons: (1) to allow the Company to recover costs associated with issuing additional stock while preserving a market price that is not less than book value; and (2) position the Company at all times where it can issue additional equity without harming existing shareholders.

Q PLEASE DESCRIBE WHY IT WOULD BE UNREASONABLE TO ADJUST A RETURN ON EQUITY FOR AMERENUE BY MS. MCSHANE'S PROPOSED FINANCIAL FLEXIBILITY ADJUSTMENT.

A Ms. McShane's proposed 50 basis point financial flexibility adjustment should be rejected for several reasons. First, to the extent AmerenUE has incurred costs associated with the issuance of common equity, it should have recorded its flotation

costs to allow an audit and verification of its cost of issuing stock. Ms. McShane's proposed 50 basis point adjustment is not based on AmerenUE's actual issuance cost of common equity. Therefore, AmerenUE's common equity issuance cost is not a known and measurable expense.

Second, her argument to increase the common equity return in order to always maintain the Company's ability to issue common equity is without merit. There is no guarantee that any rate of return the Commission authorizes AmerenUE can guarantee its ability to issue new common equity. Indeed, many factors beyond the Commission's control go into the determination of the market value of Ameren stock. Factors such as management prudence, reasonable investments, fraud, accounting manipulation and other factors affect the market value of stock, and limit a utility's ability to access capital. Customers' obligation to AmerenUE and to its shareholders is to provide a fair return on common equity for investments made in utility plant. Ms. McShane's proposed 50 basis point financial flexibility adjustment would set the return on equity higher than that necessary to provide fair compensation. For this reason, Ms. McShane's financial flexibility adjustment should be rejected.

Q PLEASE DESCRIBE MS. MCSHANE'S PROPOSED ADJUSTMENT TO THE DCF ESTIMATE FOR THE DIFFERENCE IN MARKET VALUE AND BOOK VALUE OF HER PROXY GROUP.

A Ms. McShane argues that a rate of return on equity derived from market value would not produce a reasonable return on book equity if there were a significant difference between market value and book value. She argues that the dollar return expected by investors would not be produced if the market derived rate of return is applied to book

value and the market to book ratio is greater than one. She cites an example of a stock price of $17.50 and a required return of 11%, producing an expected cash flow to equity investors of $1.92. If the 11% rate of return is applied to book value of $10, it would only produce a return of $1.10. She argues then that the return on book value should be adjusted for the ratio of market value to book value, or 175%, to produce a fair return on book equity. She concludes that unless the DCF and CAPM estimates are transformed to a fair return on book value, application of the DCF will significantly understate the return on original cost value that investors require.

Q HAS MS. MCSHANE PROVIDED REASONABLE SUPPORT FOR HER CONTENTION THAT DCF AND CAPM RETURNS SHOULD BE ADJUSTED BY A MARKET TO BOOK RATIO?

A No. To the contrary, if adopted, Ms. McShane's market to book ratio adjustment will unfairly inflate the authorized return on common equity and provide utilities an economic incentive to over-invest or "gold plate" utility plant.

Using the parameters of Ms. McShane's analysis will help prove this point. Assume that the DCF return is estimated to be 11%, as Ms. McShane argues. The market to book ratio is assumed to be 150%, the payout ratio is assumed to be 50%. As illustrated in Footnote 76, and using the formulas described at Pages 96 and 97 of Ms. McShane's testimony, her DCF and CAPM results would be adjusted by a factor of 1.2. Thus, the return on book equity would be set at 13.2%.

If regulators accept this adjustment, a utility could then be faced with the prospects of using retained earnings to either make incremental investment in utility plant, or buy back its own stock. These are risk comparable investments. If the utility could earn 13.2% by making incremental investments in utility plant, and could only

earn 11% by buying back its own stock, it would clearly have an economic incentive to make utility plant investments. This occurs because the utility is provided an unjustified higher risk adjusted return on utility plant investments of 13.2%, compared to a comparable risk investment of buying back its own stock and earning 11%.

Making a market to book ratio adjustment to the authorized return on equity for ratemaking purposes will provide utilities with an economic incentive to over-invest or gold plate utility plant investment. This occurs because the adjustment will result in an inordinately and unreasonably high-risk adjusted return on utility plant investment that is distorted by the erroneous market to book ratio adjustment proposed by Ms. McShane.

Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH MS. MCSHANE'S CAPM ANALYSIS.

A Ms. McShane's CAPM analysis is overstated due to her use of an overstated beta estimate and market risk premium.

Q HOW WOULD THE RESULTS OF MS. MCSHANE'S CAPM ANALYSIS CHANGE IF THE BETA AND THE MARKET RISK PREMIUM ANALYSIS WERE CORRECTED?

A Using the formula described at Page 104 of her testimony, a Value Line average beta for her proxy group of 0.52%, and a market risk premium of 7.6%, as discussed at Page 100 of her testimony, and a risk free rate of 5.5% to 6% produces a CAPM return estimate in the range of 9.5% to 10%, as shown below.

$$(5.5\% \text{ to } 6.0\%) + 0.52\ (7.6\%) = 9.5\% \text{ to } 10.0\%$$

Using the higher risk free rate of 6% is more in line with projected yields on long-term Treasury securities and will produce a CAPM return of 10% using the group average Value Line beta of 0.52 and a market risk premium of 7.6%. For reasons discussed below, based on my adjustment to Ms. McShane's CAPM analysis, I believe Ms. McShane's analysis reasonably yields a CAPM return estimate for AmerenUE of 10.0%.

Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH THE BETA ESTIMATE USED BY MS. MCSHANE IN HER CAPM ANALYSIS.

A Ms. McShane used a beta estimate of 0.70. Her beta estimate is significantly higher than her proxy group average Value Line beta of 0.52. Ms. McShane argues that it is necessary to use a higher beta estimate because the Value Line beta does not accurately reflect prospective utility risk.

Ms. McShane observes that current electric utility betas of 0.52 are much lower than they have been. For the period 1986-1998 electric utility betas have ranged from approximately 0.65 to 0.73. She believes that the current utility beta of 0.52 does not reflect prospective utility risk.

She bases this conclusion on her observation of other utility risk factors that she believes support her contention that electric utility risk currently is not different than it was over the period 1986 through 2001. As such, she recommends a beta of 0.7.

Q PLEASE RESPOND TO MS. MCSHANE'S PROPOSED ELECTRIC UTILITY BETA ESTIMATE.

A Ms. McShane's proposed use of a beta of 0.7, rather than the observable published utility beta of 0.52, is without merit. Her conclusion that electric utility stock risk has not changed over the last five years is reasonable. However, the flaw in Ms. McShane's argument is that she fails to recognize that while utility risk may be comparable today to what it was five years ago, market risk is not the same but has increased. At Pages 85-86 of her testimony, Ms. McShane observes that market volatility has increased over the last five years. With increased volatility in the overall marketplace, and no additional volatility for electric utility stocks, it is logical that the risk of electric utility stocks in relationship to increasing overall market risk (i.e., beta) would decline.

Q DO YOU HAVE OTHER SUPPORT FOR YOUR CONTENTION THAT MARKET VOLATILITY AND RISK INCREASED OVER THE LAST FIVE YEARS?

A Yes. Standard & Poor's reached a similar conclusion that volatility in the S&P 500 has increased over the last few years relative to the mid-1990s. Based on a study it performed, S&P found that the volatility of the S&P 500 increased in two respects.

First, frequency of large daily price moves and, second, the standard deviation of daily returns. Both of these measures indicate greater volatility in the S&P 500 stock index prices. Greater price volatility indicates that the risk of the S&P 500, a market index, has increased. The increased volatility in the S&P 500 appears also to be reflected in the overall weights of the market index itself. For example, in 1995 technology stocks represented approximately 10.9% of the S&P 500 index. By the end of year 2000, technology stocks weight of the S&P 500 more than doubled to

22.5%. Over the last five years technology stocks have been very volatile investments, the market price often being a significant multiple to current and projected earnings. The increase in technology stocks has also resulted in a significant increase in the price to earnings ratio of the S&P 500 and a reduction to the dividend yield. Both of these factors support the premise that the market itself has become more risky in the last five years (Standard & Poor's U.S. Indices: 2000 Summary and Statistics, Standard & Poor's Index Committee, January 2001).

Again, if the market index risk is increasing, and electric utility stock risk is not increasing, then it is logical for the electrical utility betas to be declining in relationship to the market index. This is precisely what we have seen in electric utility betas over the last five years.

Q PLEASE DESCRIBE MS. MCSHANE'S HISTORICAL MARKET RISK PREMIUM ESTIMATE.

A Ms. McShane makes adjustments to the historical measured market risk premium in relationship to long-term Treasury securities. Ms. McShane adds 40 basis points to her estimate of historical long-term market risk premiums of 7.5% to 7.6%, producing a market risk premium over a shorter ten-year maturity of 7.9% to 8.0%.

Ms. McShane's proposed manipulation of historical data is unreasonable and unnecessary. Market data still is available for long-term Treasury securities as quoted in the Blue Chip Financial Forecasts and from other sources. Hence, Ms. McShane's adjustment to the historical equity risk premium is unnecessary and unreasonable.

Q PLEASE DESCRIBE MS MCSHANE'S PROSPECTIVE MARKET RISK PREMIUM ESTIMATE.

A Ms. McShane does a DCF analysis on the S&P 500 in comparison to a 10-year Treasury bond yield for the period 1992 through 2001.

Q PLEASE COMMENT ON MS. MCSHANE'S MARKET RISK PREMIUM STUDY.

A Ms. McShane's estimate of a market risk premium for use in her CAPM analysis is based on the results of a DCF analysis. Hence, the way she has constructed it, the CAPM analysis does not provide an independent assessment and verification of the reasonableness of the results of her DCF analysis.

To the contrary, her CAPM analysis is predominately driven by the results of a DCF analysis. A CAPM analysis and a risk premium analysis should be independent methodologies to verify the results of other market-based models. Ms. McShane's CAPM analysis is heavily influenced by the results of her DCF analysis and therefore is not an independent methodology to help validate the information produced from a DCF study. Consequently, Ms. McShane's forward-looking market risk premium estimate should be rejected and her CAPM analysis should be constructed based on her estimate of the market risk premium using historical data.

Q DO YOU HAVE ANY OTHER CRITICISMS OF MS. MCSHANE'S CAPM ANALYSIS?

A Yes. Ms. McShane also increases her estimated CAPM results from 11.4% to 11.8% up to 13.75% to 14.0%. She did this by adding 50 basis points for financial flexibility and adjusting by her long-run market to book ratio adjustment of 1.2x (McShane direct at 106).

Q SHOULD MS. MCSHANE'S PROPOSED ADJUSTMENTS TO THE RESULTS OF HER CAPM ANALYSIS BE ADOPTED?

A No. Ms. McShane's proposed financing flexibility and market to book ratio adjustment to her CAPM results are identical to what she proposed for her DCF results. For the same reasons I discussed above in relationship to her DCF analysis, these adjustments to her CAPM results are flawed and should be rejected. No adjustment is necessary.

Q PLEASE DESCRIBE MS. MCSHANE'S COMPARABLE EARNINGS ANALYSIS.

A Ms. McShane estimates the 10-year historical average earned return on book equity of 34 industrial companies over the period 1991 to 2000 to be 18.1%. From this, she concludes that a low-risk industrial consumer-oriented industry may expect to earn a return of no less than 18.0%. She then uses Value Line's data to estimate the median projected return on book equity for the same companies to be 18.3% for the period 2004 through 2007. She then adjusts the median projected return on equity for the difference between the utility beta of 0.53 and the industrial group beta of 0.8, using the formula shown on Page 112, Line 13 of her testimony. This beta adjustment reduces her 18.3% median projected earned return on book equity for the industrial companies down to 14%, which she asserts is appropriate for an electric utility. She concludes that this process produces a risk adjusted return on book equity for AmerenUE.

Q DOES MS. MCSHANE'S COMPARABLE EARNINGS ANALYSIS PRODUCE A REASONABLE RETURN ON EQUITY ESTIMATE FOR AMERENUE?

A No. A comparable earnings analysis does not measure a fair rate of return to use in ratemaking. Rather, a comparable earnings analysis measures an accounting return that may be higher or lower than the return investors require to make an investment.

In contrast, market based models, like the DCF and CAPM analyses, measure the return an investor requires in order to make an investment. Measuring investor required returns, and allowing the utility an opportunity to earn this return, assures that investors are fairly compensated for making incremental investments in utility plant, and customers are not charged excessive prices.

On the other hand, an accounting based return produced from a comparable earnings analysis may be higher or lower than the investor required return. If the comparable earnings return is higher than the investor required return, then investors will receive excessive compensation and utility prices will be higher than a just and reasonable level. Or, if the comparable earnings analysis produces a return that is lower than the investor required return, investors will not be fairly compensated for making incremental improvements to utility plant, and rates would be set too low.

In summary, a comparable earnings analysis does not measure the correct return and is not a reliable model to estimate a return on equity that fairly balances investors and customers' interests. The comparable earnings analysis should be rejected.

Response to Steven Fetter

Q PLEASE SUMMARIZE AMERENUE WITNESS STEVEN M. FETTER'S REBUTTAL TESTIMONY.

A In his testimony, Mr. Fetter provides an overview of two issues. First, Mr. Fetter provides Fitch's view of what comprises fair and economically prudent regulation. Second, he reviews Staff's revenue requirement recommendations and argues, based on numbers included in his Schedules 1 and 2, that Staff's position will result in a downgrade to AmerenUE's bond rating, thus increasing its cost of borrowing and impacting its financial flexibility.

Q PLEASE SUMMARIZE MR. FETTER'S DISCUSSION OF HIS VIEW OF FAIR AND ECONOMICALLY PRUDENT REGULATION.

A Mr. Fetter maintains that in Fitch's evaluation of regulatory climate, the most important consideration is "consistent application of sound economic regulatory principles by a public utilities commission." (Page 4). He maintains that this is necessary in order to encourage major energy investors to commit funds to allow the utilities to fund infrastructure and capital improvements.

Mr. Fetter argues that a broad based incentive or performance based ratemaking program is the best means of providing economic incentives to utility companies and their customers that most closely match economic incentives provided by competitive markets.

Q PLEASE COMMENT ON MR. FETTER'S DISCUSSION OF ECONOMICALLY PRUDENT REGULATION.

A I would agree with Mr. Fetter that an important aspect of economically prudent regulation is the consistent application of "sound economic regulatory principles by a pubic utility commission." Both utility investors and customers benefit from sound economic regulatory principles, as they will encourage utility plant investment and allow customers to make reasonable assessments of utility costs in order to make economic investment decisions in utility customer plant and equipment. Hence, the economic regulatory principles should be designed to balance the interests of investors and customers.

Toward that end, I would encourage the Missouri Public Service Commission to closely adhere to the long-standing prudent principle of setting rates by examining revenues, expenses and rate base, within a test year. The test year economic principle matches revenues and expenses, and invested capital within a consistent time period to develop rates that provide fair compensation to investors, maintain the utility's financial integrity, and develop rates that are just and reasonable.

It would not be compatible with sound economic principles to set rates by considering projected costs outside of the test year, without considering all relevant impacts to revenues, sales, customers, operating expenses, and invested capital.

Unfortunately, in his response to Staff, Mr. Fetter does not adhere to prudent regulatory principles. Rather, he considers financial projections well outside the test year, and therefore betrays his own assessment of Fitch's policy to review regulatory risk in terms of regulators' consistent application of sound economic regulatory principles in assessing the financial impact of rate changes.

Q DID MR. FETTER REACH ANY CONCLUSIONS CONCERNING STAFF'S PROPOSED REVENUE ADJUSTMENT FOR AMERENUE IN THIS PROCEEDING?

A Yes. Mr. Fetter opined that in Fitch's opinion, AmerenUE's credit profile would be adversely affected by the adoption of revenue reductions of the magnitude and nature advocated by Staff that would result in a downgrade of the Company's current bond ratings. Mr. Fetter expressed concern about the ongoing revenue reductions that would adversely affect all of AmerenUE's significant financial ratios. He stated particular concern about a decline in the ratio of cash flow to capital expenditures, coincident with a period of rising capital outlays for new energy infrastructure investments to meet customer demands. In addition, he observed that leverage would also go up during the period.

Q HOW DID MR. FETTER REACH HIS CONCLUSIONS CONCERNING THE DEGRADATION TO AMERENUE'S FINANCIAL RATIOS AS A RESULT OF STAFF'S POSITION IN THIS PROCEEDING?

A Attached to his testimony as Schedules 1 and 2 are Mr. Fetter's estimated AmerenUE financial ratios reflecting Staff's range of revenue reductions of $245 million to $285 million.

Based on a forecast put together by AmerenUE, Mr. Fetter calculated these ratios over the period 2000 through 2006. The results of Mr. Fetter's analysis are summarized below in Tables 4 and 5.

Table 4

Fetter's Estimated Ratios
<u>$285 Million Revenue Reduction</u>

	2000	2001	2002	2003	2004	2005	2006
EBIT/interest coverage	5.25	5.87	4.50	3.56	2.92	2.35	2.24
EBITDA/interest coverage	7.34	8.28	6.30	4.96	4.15	3.42	3.29
Cash from operations/interest Coverage	5.87	6.73	5.45	4.43	3.78	3.27	3.14
Net cash from operations/ capital exp.	127.9%	63.3%	53.4%	51.5%	35.5%	23.3%	43.9%
Total debt	39.2%	40.0%	44.9%	47.8%	51.5%	53.2%	55.0%
Debt/EBITDA	1.85	1.95	2.72	3.14	3.73	4.42	4.39

Table 5

Fetter's Estimated Ratios
<u>$245 Million Revenue Reduction</u>

	2000	2001	2002	2003	2004	2005	2006
EBIT/interest coverage	5.25	5.87	4.74	3.81	3.22	2.62	2.54
EBITDA/interest coverage	7.34	8.28	6.54	5.22	4.48	3.72	3.64
Cash from operations/interest coverage	5.87	6.73	5.60	4.59	4.00	3.48	3.40
Net cash from operations/ capital exp.	127.9%	63.3%	57.0%	55.7%	39.7%	26.8%	51.0
Total debt	39.2%	40.0%	44.5%	47.0%	50.3%	51.7%	53.0%
Debt/EBITDA	1.85	1.95	2.61	3.95	3.48	4.08	4.02

Q WHAT CONCLUSIONS DID MR. FETTER REACH BASED ON THE RATIOS HE CALCULATED?

A He concludes that the coverage ratios over the period 2002-2006 drop to a level indicative of utility bond ratings in the "BBB" range by the 2005 to 2006 timeframe.

He summarizes his position by stating that AmerenUE's leverage, interest protection and cash flow measures decline steadily throughout the forecast period and by 2005 are reflective of utility companies with ratings in the "BBB" category (Page 12). He attributes this decline in the financial ratios entirely to Staff's proposed revenue reductions for AmerenUE.

Q PLEASE COMMENT ON MR. FETTER'S CALCULATIONS AND CONCLUSIONS BASED ON HIS FINANCIAL RATIO ANALYSIS.

A Mr. Fetter's analysis does not support his conclusion that Staff's recommendation in this proceeding will cause AmerenUE's bond rating to drop to "BBB." First, Mr. Fetter asserts that these ratios were based on a financial forecast made by Ameren (Page 10). Neither Mr. Fetter, nor AmerenUE, provided the assumptions used in developing the forecast.

Consequently, I have not been able to review Ameren's forecasting assumptions with respect to capital expenditures, level of O&M expenses, assumptions about depreciation rates, sales growth, rate changes, and other significant factors that will have a material impact on these ratios over the forecast period. Accordingly, it is impossible to determine whether Mr. Fetter has presented an accurate and/or unbiased assessment of the impact on AmerenUE's financial ratios caused by Staff's proposed revenue reduction or if the ratio degradation was caused by other factors or forecasting assumptions.

For example, Mr. Fetter's financial forecast reflects significant capital improvements, but he does not describe whether sales growth or rate adjustments have been included to support a growing rate base. Thus, the degradation to the Company's

ratios in 2005 and 2006 could be caused simply by the Company not reflecting sales growth or seeking rate relief to support a growing rate base.

This is significant, because Mr. Fetter's primary concern about the impact on the financial ratios appear to be in the last two years of the forecast, 2005 and 2006. Staff's proposed rate reduction in this proceeding will begin in April 2002. Mr. Fetter's estimated financial ratios in 2002 and 2003 fully support AmerenUE's existing bond rating at Staff's proposed revenue adjustments.

In sum, an accurate and fair representation of the adjustments Staff is proposing for AmerenUE's rates is based on a test year cost of service analysis. This is the traditional and most reasonable method of setting appropriate rates in my opinion. In significant contrast, Mr. Fetter's financial projections go out beyond the June 2001 test year, to 2006, and he concludes Staff's position is not reasonable based on AmerenUE's financial ratios in the years 2005 and 2006. Mr. Fetter's analysis fails his own standard of the "consistent application of sound economic regulatory principles."

Q **HOW COULD MR. FETTER'S FINANCIAL RATIO CALCULATIONS BE USED BY A SOUND ECONOMIC REGULATORY COMMISSION TO CONSIDER THE IMPACTS OF STAFF'S PROPOSED RATE REDUCTION ON AMERENUE?**

A Mr. Fetter's financial ratios should be reviewed within the test year ending June 2001 or, at most, the first full year the lower rates are projected to be in effect. After this time period, it isn't clear whether the ratio degradation would be produced by Staff's proposed rate adjustment in this proceeding, or for some other unknown, unspecified factors or forecasting assumptions.

Q BASED ON REVIEWING MR. FETTER'S SCHEDULES 1 AND 2, IS IT APPARENT WHEN HE ESTIMATED THE STAFF'S REVENUE REDUCTIONS WILL BE PUT INTO EFFECT?

A Review of the operating income shows a significant decrease in calendar year 2002. Hence, it appears that Mr. Fetter assumed that Staff's proposed revenue reduction would be placed into effect in calendar year 2002. I would note that the operating income continues to decline throughout the forecast period. Nevertheless, the largest decrease appears to have been in calendar year 2002, relative to 2001.

Q DO THE FINANCIAL RATIOS CALCULATED BY MR. FETTER FOR CALENDAR YEARS 2002 AND 2003 REFLECT THE DETERIORATION IN THE EARNINGS, AND CASH, COVERAGES OF AMERENUE TO THE LEVEL OF "BBB"?

A No. Below in Tables 6 and 7, I show Mr. Fetter's estimated AmerenUE financial ratios for the two scenarios in calendar years 2002 and 2003, along with Standard & Poor's financial ratio benchmarks for a utility bond rating of "A" with a business position ranking of 4, AmerenUE's current ratings.[2]

As shown in Tables 6 and 7, AmerenUE's financial ratios as calculated by Mr. Fetter will fully support an "A" bond rating in 2002 and 2003. Again, while Mr. Fetter did not provide his list of assumptions used in the forecast (workpapers were not provided until June 20, 2002), based on a review of the change to operating income, it appears that the Company reflected a reduction to its revenues based on Staff's forecast in the year 2002. Accordingly, degradation of financial ratios appears to

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[2] In the comparison, Mr. Fetter's Cash Flow from Operations (CFO) is comparable to S&P's Funds from Operations (FFO) measure.

have been caused by factors other than the proposed reduction in revenues made by Staff in this proceeding.

Simply reflecting Staff's proposed revenue reductions, within the test year, shows a strong relationship between the Company's revenues, cost of service, rate base and financial ratios to support its existing bond rating. The degradation in ratios beyond 2003 appears to have been caused by the Company's efforts to increase its investments in electric utility plant, which was primarily financed with debt. This growing plant or rate base would eventually be reflected by the Commission in increased rates if sales growth does not cover the increased investment cost. If AmerenUE's forecast does not reflect sales growth and rate changes, it is not accurate.

Table 6

$285 Million Revenue Reduction

	2002	2003	S&P Benchmark "A" BP of 4
EBIT/interest coverage	4.50	3.56	4.0 –3.3
EBITDA/interest coverage	6.30	4.96	
Cash from operations/interest Coverage	5.45	4.43	4.5 - 3.8
Net cash from operations/ capital exp.	53.4%	51.5%	
Total debt/total capital	44.9%	47.8%	43.0%-49.5%
CFO/Average Debt	28.3%	23.3%	30.5%-24.5%

Table 7

$245 Million Revenue Reduction

	2002	2003	S&P Benchmark "A" BP of 4
EBIT/interest coverage	4.74	3.81	4.0 -3.3
EBITDA/interest coverage	6.54	5.22	
Cash from operations/interest coverage	5.60	4.59	4.5 - 3.8
Net cash from operations/ capital exp.	57.0%	55.7%	
Total debt/total capital	44.5%	47.0%	43.0%-49.5%
CFO/Average Debt	29.4%	24.6%	30.5%-24.5%

Q ARE THERE OTHER ASPECTS OF MR. FETTER'S FORECAST THAT LEAD YOU TO BELIEVE THAT HIS FINANCIAL RATIOS DO NOT FAIRLY REPRESENT THE IMPACT ON AMERENUE FROM STAFF'S PROPOSED REVENUE ADJUSTMENTS?

A Yes. Many aspects of Mr. Fetter's projections would call into question the validity of his ratio estimates. These uncertainties are summarized as follows:

- In year 2002, Mr. Fetter's financial projections show a common equity ratio of 52%. This common equity ratio is substantially lower than the 59% common equity ratio reflected in Staff's revenue requirement calculations and the 57.7% common equity ratio, including short-term debt and off-balance sheet obligations, as I estimated in my rebuttal testimony on Schedule 2. However, it is very similar to Ameren Corporation's 2002 common equity ratio of 51.5% reported by Value Line (April 5, 2002 at 697). Accordingly, the capital structures the Company included in its financial forecast appear to be different from those provided, for the $285 million scenario, to Staff in this proceeding.

- The financial forecasts also appear to have included questionable assumptions. Specifically, the operating income continues to decline after the rate decrease is implemented in 2002. The reduction to operating income would be caused by increases in depreciation expense created through additional infrastructure plant investment. However, as stated above, if sales growth did not provide a fair

return on a growing rate base, the Company should have made assumptions for rate relief to provide a fair return. Declining operating income also causes the Company's dividend payout ratio to increase from 77.5% in 2001 to over 100% in the years 2005 and 2006. This questionable assumption results in additional use of debt financing to fund the infrastructure plant improvements. This additional debt financing further erodes the Company's financial ratios in the years 2005 and 2006. Accordingly, it appears the Company made its financial position in years 2005 and 2006 to look especially worse due to modeling assumptions, rather than a direct evaluation of the impact on its operations through Staff's proposed revenue changes.

In summary, it is not clear whether the Company's financial projections reflect AmerenUE, or Ameren Corporation in total, or that the capital structure is accurate. Further, it is not clear whether there is adequate sales growth built into the projections to reflect a growth in the Company's infrastructure, plant investments and costs. Finally, the Company's financial projections appear to assume that rate relief would not be provided, irrespective of the level of prudent infrastructure investment, and the adequacy of rates to provide a fair return on that investment. Such a determination would be conducted in a future rate proceeding, once the Company's actual prudent and reasonable infrastructure investments are made, and the Commission determines an appropriate return to allow the Company to earn on those investments.

Response to Warner L. Baxter

Q DO YOU HAVE ANY COMMENTS ON THE REBUTTAL TESTIMONY OF AMERENUE WITNESS WARNER L. BAXTER?

A Yes. At pages 32-35 of Mr. Baxter's testimony, he cites several credit reports to support his contention that Staff's recommended revenue adjustment in this proceeding will result in a downgrade to AmerenUE's and Ameren Corporation's bond ratings. I acknowledge that many of the bond rating analysts have expressed a concern that Staff's recommendation will reduce AmerenUE's cash flow, which may limit its ability to pay dividends to Ameren Corporation. Concerning the credit rating

implication of Staff's proposed revenue adjustments in this proceeding, I make the following two observations. First, credit rating analysts are not considering the reasonableness of AmerenUE's rates in reaching their conclusions. Rather, credit analysts appear to be clearly focusing on the cash flows produced by AmerenUE, and the dividends AmerenUE can pay to its parent company, Ameren Corporation. Those dividends are needed by the parent company to fund its financial obligations, which include servicing the debt the parent company has taken on to fund non-regulated assets, and to pay common dividends. Credit analysts have not made an evaluation of the justness and reasonableness of Missouri rates, nor have they considered the benefits and consequences of charging inflated rates to its Missouri retail customers and the related economic consequences to the Missouri economy. Accordingly, bond rating analysts are not providing an unbiased view of the appropriateness of Missouri retail rates. They are focused on investor concerns.

Second, there are other concerns expressed by credit analysts that support their decisions to put Ameren Corporation on credit watch. For example, in the July 12, 2001 Moody's publication cited by Mr. Baxter, he neglects to complete the quote on page 33 of his testimony. While Moody's was concerned about the reduced internal cash flow from the reduced revenues proposed by Staff, Moody's also noted a concern toward Ameren Corporation's bond rating as follows:

> "Moody's notes that Ameren Corporation has incurred a significant portion of its financial obligations to finance the construction of Midwest gas-fired peaking plants."

Indeed, Staff's proposal will reduce AmerenUE's cash flows. And, one of Moody's primary concerns appears to be Ameren Corporation's ability to service the debt obligations it has incurred as a result of investing in merchant generating plants.

Also, the Standard & Poor's article cited by Mr. Baxter states concern about Ameren Corporation's non-regulated investment activity and its related risk in its assessment and justification for revising Ameren Corporation's credit outlook to negative. An expanded quote from the same article cited by Mr. Baxter reads as follows:

> "The outlook change reflects the Company's eroding consolidated financial profile that just last year was robust per current ratings. Potentially significant rate reductions at UE, lower forward energy prices, additional financing requirements for installation of a block of combustion turbines, and higher operating expenses will pressure cash flow, earnings protection measures and capital structure balance."
>
> To maintain current ratings, Standard & Poor's considers it necessary that the Company's [Ameren Corporation] overall financial condition strengthens. Although Standard & Poor's credit analysis is prospective, financial improvement may not be as dramatic or as rapid as required to sustain current ratings.
>
> <u>Ameren corporate credit rating is based on the consolidated financial and business risk profiles of the Ameren family of companies. Because there are no regulatory mechanisms or other structural barriers in Missouri that sufficiently restrict access by the parent to the cash flow of AmerenUE, Standard & Poor's views the default risk of UE as being the same as that of Ameren</u>." (Standard & Poor's Corporate Ratings, Ameren Corporation Outlook Revised to Negative, October 5, 2001). (Emphasis added)

As noted in the quote above, Standard & Poor's states concern for the financial health of Ameren Corporation. S&P also notes that Ameren Corporation's and AmerenUE's credit profile are closely tied, and the unregulated aspect of Ameren's business is clearly a significant part of the concern. Retail rates should not be driven by unregulated operations. Clearly, Standard & Poor's review of the credit strength of Ameren Corporation and AmerenUE is not directed at determining whether or not AmerenUE is charging just and reasonable rates. Rather, its concerns are focused on Ameren Corporation's ability to service debt for its non-regulated investments.

AmerenUE's credit rating is certainly a relevant issue. However, credit rating analysts are not charged with the responsibility of establishing just and reasonable rates, regulatory commission are. Therefore, while credit rating analysts' concern should be considered, they should not be the primary driver of the determination of appropriate Missouri retail rates.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

MPG:mcl/7651/29839

Exhibit No.	
Witness:	Michael Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Missouri Industrial Energy Consumers
Case No.	EC-2002-1
Subjects:	Return on Common Equity and Overall Rate of Return

Before the
Missouri Public Service Commission

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

Surrebuttal Testimony of

Michael Gorman

On Behalf of

Missouri Industrial Energy Consumers

June 24, 2002
Project 7651

BAI
BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

Before the Public Service Commission
of the State of Missouri

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

STATE OF MISSOURI)
) **SS**
COUNTY OF ST. LOUIS)

Surrebuttal Affidavit of Michael Gorman

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my surrrebuttal testimony which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. EC-2002-1.

3. I hereby swear and affirm that the surrebuttal testimony is true and correct and shows the matters and things it purports to show.

Michael Gorman
Michael Gorman

Subscribed and sworn to before this 21st day of June 2002.

CAROL SCHULZ
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: Feb. 26, 2004

Carol Schulz
Notary Public

My Commission Expires February 26, 2004.

Before the
Missouri Public Service Commission

Staff of the Missouri Public Service Commission	)	
Complainant	)	
v.	)	**Case No. EC-2002-1**
Union Electric Company, d/b/a AmerenUE	)	
Respondent.	)	

Surrebuttal Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY FILED REBUTTAL TESTIMONY IN THIS PROCEEDING?

A Yes.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to the rebuttal testimony of AmerenUE Witnesses Dr. Roger Morin, Kathleen C. McShane, Steven Fetter, and Warner L. Baxter.

Q PLEASE SUMMARIZE THE ISSUES YOU TAKE WITH AMERENUE WITNESSES IN YOUR SURREBUTTAL TESTIMONY.

A As set out below, I take the following issues with AmerenUE witnesses:

- A fair return on common equity should be developed in concert with the development of an appropriate and reasonable capital structure. Balancing these two factors is necessary to provide a fair overall rate of return that is just and reasonable.

- AmerenUE witnesses McShane and Morin are recommending returns on common equity without regard or mention of the appropriateness of AmerenUE's common equity balance. Consequently, their return on common equity recommendations are biased and do not provide a reasonable balance between the interests of shareholders and customers.

- Authorized returns on equity by regulatory commissions over the last five years have averaged approximately 11.3%. However, those authorized returns on equity have been made in combination with capital structures that contain common equity ratios of approximately 47%. Other electric utility common equity ratios are significantly lower than AmerenUE's actual common equity ratio of 59% as reflected in Staff's filing. A higher than average common equity ratio, all else equal, implies that AmerenUE has lower than average risk, and should receive a lower than average return on common equity.

- AmerenUE has mischaracterized its financial ratios reflecting Staff's proposed revenue reductions in this proceeding. The Company's near-term financial ratio projections show that Staff's recommended reduction in revenues will provide AmerenUE with financial ratios that are consistent with Standard & Poor's financial benchmarks for a utility with a bond rating of "A," Ameren's current bond rating.

- The Company's rebuttal evidence shows that credit rating agencies are currently expecting the Commission to reduce AmerenUE's rates in this proceeding. The Value Line Investment Survey also is projecting rates to be reduced[1]. Accordingly, the Commission should carefully develop a proper rate of return, capital structure, and earnings entitlement for AmerenUE in this proceeding. The market clearly expects a rate reduction.

- It is reasonable to expect that a utility will have to go to the external market to fund a significant capital improvement program. Projections by Ameren witness William Stouts on the difference between capital expenditures and depreciation receipts show that the Company is expecting to increase its investment in infrastructure plant. A fair and reasonable regulatory construct would not require customers to pay depreciation rates that are higher than reasonable, nor pay for a higher than reasonable rate of return based on an excessive return on equity,

[1] Baxter Rebuttal at 34, and The Value Line Investment Survey, April 5, 2002 at 698.

or a capital structure composed too heavily of common equity. Such a regulatory policy would unnecessarily drive up retail electric rates and abandon the customer protections provided by prudent regulation.

Response to Dr. Morin

Q WHAT ISSUE DO YOU TAKE WITH UE WITNESS DR. MORIN?

A Dr. Morin, at Page 5, refers to Ms. McShane's Schedule 17 in his assertion that other states have allowed electric utilities an authorized return on equity in the range of 10.5% to 12.9% for an average of 11.27%. His testimony is in support of his conclusion that Staff Witness Bible's return on common equity recommendation is too low.

Dr. Morin and Ms. McShane's criticisms of Staff witness Bible's return on common equity ratio are incomplete and misleading. Staff witness Bible made his return on common equity recommendation along with his acceptance of Ameren's capital structure, which includes a common equity ratio of 59%. AmerenUE's common equity ratio is substantially higher than the common equity ratios authorized by regulatory commissions along with the returns on common equity averaging 11.27% over the period cited by Dr. Morin and Ms. McShane.

As I addressed in my direct testimony at Page 9, Table 1, authorized returns on common equity have been approximately 11.3% as referenced by Dr. Morin. However, over the period 1996 through 2000, the average common equity ratios approved by regulatory commissions has been 46.6%.

Clearly, AmerenUE's common equity ratio of 59% is substantially out of line with equity ratios approved by regulatory commissions. Dr. Morin and Ms. McShane's argument that AmerenUE's common equity return should be at least comparable to other utilities' authorized equity returns, while ignoring its excessive

common equity ratio, is biased and will result in an excessive rate of return and overstated AmerenUE Missouri retail rates.

As noted in my rebuttal testimony, all else equal, a higher common equity ratio indicates lower financial risk. An overweighted common equity ratio unnecessarily increases AmerenUE's overall rate of return and retail rates in Missouri. If the Commission does not adjust Ameren's capital structure to reflect a reasonable balance of common equity, then it should award it a return on equity much lower than the average return authorized by other jurisdictions that were made with a lower, more reasonable common equity ratio. An inordinately high common equity ratio represents lower financial risk, and lower financial risk justifies a lower return on common equity.

Response to Ms. McShane

Q PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY TO MS. MCSHANE'S REBUTTAL TESTIMONY.

A The issues I take with Ms. McShane's rebuttal testimony are summarized as follows:

- Ms. McShane erroneously estimates AmerenUE's ROE to fall in the range of 12.0% to 14.0%. Ms. McShane's ROE estimates should be rejected.
- Corrections to Ms. McShane's data and rejection of her proposed unreasonable adjustments to the result of certain models would reduce her ROE estimate to a range of 10% to 11%. However, these estimates would only be reasonable if UE's capital structure is adjusted to reduce its excessive ratio of common equity to total capital. I would note that without Ms. McShane's inappropriate use of data and inappropriate use of adjustments to her model results, the estimated return on common equity for AmerenUE derived from her models and comparable group is nearly identical to that which I estimated in my rebuttal testimony.
- Ms. McShane erroneously adjusted the results of Staff Witness Bible's ROE estimate. Ms. McShane makes purported corrections to Mr. Bible's results and asserts that his analysis would support a return on equity in the range of

11.8% to 12.8% for AmerenUE, rather than Mr. Bible's recommended return on equity of 8.91% to 9.91%.

- Ms. McShane's "corrected" result of Mr. Bible's return on equity estimates suffer from the same flawed use of data and adjustments to models as her own analysis of AmerenUE's return on equity. Ms. McShane's equity return estimates are flawed and biased and should be rejected.

Q HAS MS. MCSHANE OFFERED SOME OBSERVATIONS THAT SHE PURPORTS TO SHOW THAT STAFF'S RETURN ON EQUITY RECOMMENDATION IS UNREASONABLE?

A Yes. Ms. McShane argues that Staff's return on equity would not be adequate to support Ameren Corporation's current dividend. At Pages 10 and 11 of her testimony, she argues that Staff's mid-point return on equity range of 9.41%, multiplied by Ameren Corporation's 2001 book value of $24.05 per share as estimated by Value Line Investment Survey (January 2002), would produce earnings per share of $2.26. She argues that that return on common equity would not produce earnings sufficient to cover Ameren's $2.54 dividend.

Q IS MS. MCSHANE'S OBSERVATION BASED ON REASONABLE CALCULATIONS?

A No. A significant flaw in Ms. McShane's observation, and in her entire response to Mr. Bible, is that she fails to recognize that Mr. Bible's return on common equity is made in concert with his acceptance of AmerenUE's very high common equity ratio of 59%. The Value Line publication she relies on for Ameren Corporation estimates a book value in 2001 of $24.05, as she recognizes. However, that book value is based on a common equity ratio to total capital of 49.5%. In significant contrast, Mr. Bible's return on common equity is made with a common equity ratio of over 59% of total

capital. Hence, there is a significant and meaningful disparity between the book value implicit in Mr. Bible's recommended return on equity for AmerenUE, and the book value Ms. McShane relied on for Ameren Corporation in support of her condition that Staff's return on equity is too low. It is simply erroneous to use Mr. Bible's return on equity, which is based on AmerenUE's 59% common equity ratio, and apply it as she did to Ameren Corporation's book value, which is based on a 49% common equity ratio. Her calculations are flawed.

A simple example will help illustrate this point. Consider a company with $100 of total capital. Assume that the Company's return on common equity is 10%, and it has a common equity ratio of 50%. With this relationship, the company would expect to have earnings of $5.00 ($100 x 50% x 10%). Consider next a company with total capitalization of $100, with a common equity ratio of 40% and a return on common equity of 10%. This company would have expected earnings of $4.00 (100 x 40% x 10%).

If the company is paying a dividend of $4.50, the company that is earning 10% with a capital structure composed of 50% common equity, would produce $5.00 of earnings, which fully covers the $4.50 dividend. In significant contrast, if the Company had a common equity ratio of 40%, it would produce $4.00 of earnings, and the $4.50 dividend would not be covered.

Q PLEASE DESCRIBE MS. MCSHANE'S ANALYSES SUPPORTING HER ESTIMATED RETURN ON EQUITY RANGE FOR AMERENUE.

A Ms. McShane performs three analyses that produced estimates of AmerenUE's return on common equity in the range of 11.0% to 14.0%. The results of her analyses, excluding her proposed adjustments, are shown below in Table 1.

TABLE 1

Summary of McShane's ROE Analyses

Description	Estimate
DCF	11.0% to 11.3%
CAPM	11.4% to 11.8%
Comparable Earnings	14.0%

Source: McShane's Rebuttal at 92, 105 and 112.

Ms. McShane then proposes adjustments to her DCF and CAPM results that raise the DCF and CAPM estimates. Ms. McShane's final estimated return on equity is summarized below in Table 2.

TABLE 2

McShane's Recommended ROE Estimates for AmerenUE

Description	Estimate
DCF	13.2% to 13.5%
CAPM	12.0% to 14.0%
Comparable Earnings	14.0%

Source: Page 112, Table 21, McShane Rebuttal

Q PLEASE SUMMARIZE YOUR ADJUSTMENTS TO THE RESULTS OF MS. MCSHANE'S COMMON EQUITY RETURN ESTIMATES.

A As shown below in Table 3, after reasonable and proper adjustments to data inputs and elimination of inappropriate adjustments to the model results, Ms. McShane's DCF and CAPM estimates would have produced a return on common equity for AmerenUE in the range of 10% to 11%. For reasons discussed below, the comparable earnings analysis is an inappropriate method of estimating a fair return for a utility company in a regulatory proceeding and should be rejected.

TABLE 3

Adjusted McShane
Return on Equity Estimates

Description	Estimate
DCF	10.8% to 11.0%
CAPM	10.0%
Comparable Earnings	Reject

Q PLEASE DESCRIBE THE DISAGREEMENTS YOU HAVE WITH MS. MCSHANE'S DCF ANALYSIS AND RESULTS.

A Ms. McShane's DCF analysis is overstated for several reasons. First, Ms. McShane's estimate is overstated because she relied on a growth rate of 6.2%, which is higher than the consensus analysts' growth rate reflected on her Schedule 8 of 5.9% and 6.0%. By using a growth rate that is higher than the consensus analyst growth rate estimates, she has produced an overstated DCF result. Second, Ms. McShane proposes to add to the results of her DCF an adjustment for financial flexibility, and

an adjustment to reflect the difference between the market value and book value of her proxy utility group.

Q WHAT WOULD MS. MCSHANE'S DCF ESTIMATE HAVE BEEN HAD SHE ONLY USED THE ANALYSTS' CONSENSUS GROWTH RATE ESTIMATES REFLECTED IN HER ANALYSIS?

A Ms. McShane's growth rate would have declined from 6.2% down to approximately 6.0%. This would have reduced the average DCF return for the companies included in her comparable group from 11.0% to 10.8%.

Q WHY SHOULD MS. MCSHANE HAVE RELIED ON THE ANALYSTS' CONSENSUS GROWTH RATES?

A Analysts' consensus growth rate estimates are a better proxy of investor expectations than the method Ms. McShane used to develop her DCF estimate as shown on her Schedule 8. On her Schedule 8, Ms. McShane averaged the IBES, Zack's and cash flow per share forecast from Value Line, to produce the growth rate of 6.2%. The IBES and Zack's growth rates are approximately 6%, whereas the Value Line cash flow per share growth rate is about 6.8%. Analysts' consensus growth rate projections are based on professional analysts' projections of future growth. Security analysts will likely consider projected growth in cash flow, earnings, revenues, plant, and other relevant factors to derive their projected earnings growth.

Ms. McShane's proposal to increase the analysts' consensus earnings growth rates by averaging them with the Value Line cash flow projections is inappropriate and over-weights cash flow considerations of future growth. Further, Ms. McShane's proposal to manipulate the analysts' growth projections is in direct contradiction to her

criticisms of Staff witness Bible's use of historical growth rates. In response to Mr. Bible, Ms. McShane argues that analysts would take historical growth rate results into account in arriving at their forecasts of future growth (McShane Rebuttal at 27).

Ms. McShane cannot have it both ways. Professional security analysts likely do consider historical growth and also projected growth of cash flow in deriving future earnings growth rates. If, according to Ms. McShane, it is inappropriate for Mr. Bible to have averaged historical growth rates with analysts' growth rates, then it is equally as unreasonable for her to average projected growth in cash flow with analysts' growth rates.

Q PLEASE DESCRIBE MS. MCSHANE'S PROPOSED ADJUSTMENTS FOR FINANCIAL FLEXIBILITY.

A Ms. McShane proposes to add to the results of her DCF a 50 basis point premium for financial flexibility. She argues that this is appropriate for two reasons: (1) to allow the Company to recover costs associated with issuing additional stock while preserving a market price that is not less than book value; and (2) position the Company at all times where it can issue additional equity without harming existing shareholders.

Q PLEASE DESCRIBE WHY IT WOULD BE UNREASONABLE TO ADJUST A RETURN ON EQUITY FOR AMERENUE BY MS. MCSHANE'S PROPOSED FINANCIAL FLEXIBILITY ADJUSTMENT.

A Ms. McShane's proposed 50 basis point financial flexibility adjustment should be rejected for several reasons. First, to the extent AmerenUE has incurred costs associated with the issuance of common equity, it should have recorded its flotation

costs to allow an audit and verification of its cost of issuing stock. Ms. McShane's proposed 50 basis point adjustment is not based on AmerenUE's actual issuance cost of common equity. Therefore, AmerenUE's common equity issuance cost is not a known and measurable expense.

Second, her argument to increase the common equity return in order to always maintain the Company's ability to issue common equity is without merit. There is no guarantee that any rate of return the Commission authorizes AmerenUE can guarantee its ability to issue new common equity. Indeed, many factors beyond the Commission's control go into the determination of the market value of Ameren stock. Factors such as management prudence, reasonable investments, fraud, accounting manipulation and other factors affect the market value of stock, and limit a utility's ability to access capital. Customers' obligation to AmerenUE and to its shareholders is to provide a fair return on common equity for investments made in utility plant. Ms. McShane's proposed 50 basis point financial flexibility adjustment would set the return on equity higher than that necessary to provide fair compensation. For this reason, Ms. McShane's financial flexibility adjustment should be rejected.

Q PLEASE DESCRIBE MS. MCSHANE'S PROPOSED ADJUSTMENT TO THE DCF ESTIMATE FOR THE DIFFERENCE IN MARKET VALUE AND BOOK VALUE OF HER PROXY GROUP.

A Ms. McShane argues that a rate of return on equity derived from market value would not produce a reasonable return on book equity if there were a significant difference between market value and book value. She argues that the dollar return expected by investors would not be produced if the market derived rate of return is applied to book

value and the market to book ratio is greater than one. She cites an example of a stock price of $17.50 and a required return of 11%, producing an expected cash flow to equity investors of $1.92. If the 11% rate of return is applied to book value of $10, it would only produce a return of $1.10. She argues then that the return on book value should be adjusted for the ratio of market value to book value, or 175%, to produce a fair return on book equity. She concludes that unless the DCF and CAPM estimates are transformed to a fair return on book value, application of the DCF will significantly understate the return on original cost value that investors require.

Q HAS MS. MCSHANE PROVIDED REASONABLE SUPPORT FOR HER CONTENTION THAT DCF AND CAPM RETURNS SHOULD BE ADJUSTED BY A MARKET TO BOOK RATIO?

A No. To the contrary, if adopted, Ms. McShane's market to book ratio adjustment will unfairly inflate the authorized return on common equity and provide utilities an economic incentive to over-invest or "gold plate" utility plant.

Using the parameters of Ms. McShane's analysis will help prove this point. Assume that the DCF return is estimated to be 11%, as Ms. McShane argues. The market to book ratio is assumed to be 150%, the payout ratio is assumed to be 50%. As illustrated in Footnote 76, and using the formulas described at Pages 96 and 97 of Ms. McShane's testimony, her DCF and CAPM results would be adjusted by a factor of 1.2. Thus, the return on book equity would be set at 13.2%.

If regulators accept this adjustment, a utility could then be faced with the prospects of using retained earnings to either make incremental investment in utility plant, or buy back its own stock. These are risk comparable investments. If the utility could earn 13.2% by making incremental investments in utility plant, and could only

earn 11% by buying back its own stock, it would clearly have an economic incentive to make utility plant investments. This occurs because the utility is provided an unjustified higher risk adjusted return on utility plant investments of 13.2%, compared to a comparable risk investment of buying back its own stock and earning 11%.

Making a market to book ratio adjustment to the authorized return on equity for ratemaking purposes will provide utilities with an economic incentive to over-invest or gold plate utility plant investment. This occurs because the adjustment will result in an inordinately and unreasonably high-risk adjusted return on utility plant investment that is distorted by the erroneous market to book ratio adjustment proposed by Ms. McShane.

Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH MS. MCSHANE'S CAPM ANALYSIS.

A Ms. McShane's CAPM analysis is overstated due to her use of an overstated beta estimate and market risk premium.

Q HOW WOULD THE RESULTS OF MS. MCSHANE'S CAPM ANALYSIS CHANGE IF THE BETA AND THE MARKET RISK PREMIUM ANALYSIS WERE CORRECTED?

A Using the formula described at Page 104 of her testimony, a Value Line average beta for her proxy group of 0.52%, and a market risk premium of 7.6%, as discussed at Page 100 of her testimony, and a risk free rate of 5.5% to 6% produces a CAPM return estimate in the range of 9.5% to 10%, as shown below.

$$(5.5\% \text{ to } 6.0\%) + 0.52\ (7.6\%) = 9.5\% \text{ to } 10.0\%$$

Using the higher risk free rate of 6% is more in line with projected yields on long-term Treasury securities and will produce a CAPM return of 10% using the group average Value Line beta of 0.52 and a market risk premium of 7.6%. For reasons discussed below, based on my adjustment to Ms. McShane's CAPM analysis, I believe Ms. McShane's analysis reasonably yields a CAPM return estimate for AmerenUE of 10.0%.

Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH THE BETA ESTIMATE USED BY MS. MCSHANE IN HER CAPM ANALYSIS.

A Ms. McShane used a beta estimate of 0.70. Her beta estimate is significantly higher than her proxy group average Value Line beta of 0.52. Ms. McShane argues that it is necessary to use a higher beta estimate because the Value Line beta does not accurately reflect prospective utility risk.

Ms. McShane observes that current electric utility betas of 0.52 are much lower than they have been. For the period 1986-1998 electric utility betas have ranged from approximately 0.65 to 0.73. She believes that the current utility beta of 0.52 does not reflect prospective utility risk.

She bases this conclusion on her observation of other utility risk factors that she believes support her contention that electric utility risk currently is not different than it was over the period 1986 through 2001. As such, she recommends a beta of 0.7.

Q PLEASE RESPOND TO MS. MCSHANE'S PROPOSED ELECTRIC UTILITY BETA ESTIMATE.

A Ms. McShane's proposed use of a beta of 0.7, rather than the observable published utility beta of 0.52, is without merit. Her conclusion that electric utility stock risk has not changed over the last five years is reasonable. However, the flaw in Ms. McShane's argument is that she fails to recognize that while utility risk may be comparable today to what it was five years ago, market risk is not the same but has increased. At Pages 85-86 of her testimony, Ms. McShane observes that market volatility has increased over the last five years. With increased volatility in the overall marketplace, and no additional volatility for electric utility stocks, it is logical that the risk of electric utility stocks in relationship to increasing overall market risk (i.e., beta) would decline.

Q DO YOU HAVE OTHER SUPPORT FOR YOUR CONTENTION THAT MARKET VOLATILITY AND RISK INCREASED OVER THE LAST FIVE YEARS?

A Yes. Standard & Poor's reached a similar conclusion that volatility in the S&P 500 has increased over the last few years relative to the mid-1990s. Based on a study it performed, S&P found that the volatility of the S&P 500 increased in two respects.

First, frequency of large daily price moves and, second, the standard deviation of daily returns. Both of these measures indicate greater volatility in the S&P 500 stock index prices. Greater price volatility indicates that the risk of the S&P 500, a market index, has increased. The increased volatility in the S&P 500 appears also to be reflected in the overall weights of the market index itself. For example, in 1995 technology stocks represented approximately 10.9% of the S&P 500 index. By the end of year 2000, technology stocks weight of the S&P 500 more than doubled to

22.5%. Over the last five years technology stocks have been very volatile investments, the market price often being a significant multiple to current and projected earnings. The increase in technology stocks has also resulted in a significant increase in the price to earnings ratio of the S&P 500 and a reduction to the dividend yield. Both of these factors support the premise that the market itself has become more risky in the last five years (Standard & Poor's U.S. Indices: 2000 Summary and Statistics, Standard & Poor's Index Committee, January 2001).

Again, if the market index risk is increasing, and electric utility stock risk is not increasing, then it is logical for the electrical utility betas to be declining in relationship to the market index. This is precisely what we have seen in electric utility betas over the last five years.

Q PLEASE DESCRIBE MS. MCSHANE'S HISTORICAL MARKET RISK PREMIUM ESTIMATE.

A Ms. McShane makes adjustments to the historical measured market risk premium in relationship to long-term Treasury securities. Ms. McShane adds 40 basis points to her estimate of historical long-term market risk premiums of 7.5% to 7.6%, producing a market risk premium over a shorter ten-year maturity of 7.9% to 8.0%.

Ms. McShane's proposed manipulation of historical data is unreasonable and unnecessary. Market data still is available for long-term Treasury securities as quoted in the Blue Chip Financial Forecasts and from other sources. Hence, Ms. McShane's adjustment to the historical equity risk premium is unnecessary and unreasonable.

Q PLEASE DESCRIBE MS MCSHANE'S PROSPECTIVE MARKET RISK PREMIUM ESTIMATE.

A Ms. McShane does a DCF analysis on the S&P 500 in comparison to a 10-year Treasury bond yield for the period 1992 through 2001.

Q PLEASE COMMENT ON MS. MCSHANE'S MARKET RISK PREMIUM STUDY.

A Ms. McShane's estimate of a market risk premium for use in her CAPM analysis is based on the results of a DCF analysis. Hence, the way she has constructed it, the CAPM analysis does not provide an independent assessment and verification of the reasonableness of the results of her DCF analysis.

To the contrary, her CAPM analysis is predominately driven by the results of a DCF analysis. A CAPM analysis and a risk premium analysis should be independent methodologies to verify the results of other market-based models. Ms. McShane's CAPM analysis is heavily influenced by the results of her DCF analysis and therefore is not an independent methodology to help validate the information produced from a DCF study. Consequently, Ms. McShane's forward-looking market risk premium estimate should be rejected and her CAPM analysis should be constructed based on her estimate of the market risk premium using historical data.

Q DO YOU HAVE ANY OTHER CRITICISMS OF MS. MCSHANE'S CAPM ANALYSIS?

A Yes. Ms. McShane also increases her estimated CAPM results from 11.4% to 11.8% up to 13.75% to 14.0%. She did this by adding 50 basis points for financial flexibility and adjusting by her long-run market to book ratio adjustment of 1.2x (McShane direct at 106).

Q SHOULD MS. MCSHANE'S PROPOSED ADJUSTMENTS TO THE RESULTS OF HER CAPM ANALYSIS BE ADOPTED?

A No. Ms. McShane's proposed financing flexibility and market to book ratio adjustment to her CAPM results are identical to what she proposed for her DCF results. For the same reasons I discussed above in relationship to her DCF analysis, these adjustments to her CAPM results are flawed and should be rejected. No adjustment is necessary.

Q PLEASE DESCRIBE MS. MCSHANE'S COMPARABLE EARNINGS ANALYSIS.

A Ms. McShane estimates the 10-year historical average earned return on book equity of 34 industrial companies over the period 1991 to 2000 to be 18.1%. From this, she concludes that a low-risk industrial consumer-oriented industry may expect to earn a return of no less than 18.0%. She then uses Value Line's data to estimate the median projected return on book equity for the same companies to be 18.3% for the period 2004 through 2007. She then adjusts the median projected return on equity for the difference between the utility beta of 0.53 and the industrial group beta of 0.8, using the formula shown on Page 112, Line 13 of her testimony. This beta adjustment reduces her 18.3% median projected earned return on book equity for the industrial companies down to 14%, which she asserts is appropriate for an electric utility. She concludes that this process produces a risk adjusted return on book equity for AmerenUE.

Q **DOES MS. MCSHANE'S COMPARABLE EARNINGS ANALYSIS PRODUCE A REASONABLE RETURN ON EQUITY ESTIMATE FOR AMERENUE?**

A No. A comparable earnings analysis does not measure a fair rate of return to use in ratemaking. Rather, a comparable earnings analysis measures an accounting return that may be higher or lower than the return investors require to make an investment.

In contrast, market based models, like the DCF and CAPM analyses, measure the return an investor requires in order to make an investment. Measuring investor required returns, and allowing the utility an opportunity to earn this return, assures that investors are fairly compensated for making incremental investments in utility plant, and customers are not charged excessive prices.

On the other hand, an accounting based return produced from a comparable earnings analysis may be higher or lower than the investor required return. If the comparable earnings return is higher than the investor required return, then investors will receive excessive compensation and utility prices will be higher than a just and reasonable level. Or, if the comparable earnings analysis produces a return that is lower than the investor required return, investors will not be fairly compensated for making incremental improvements to utility plant, and rates would be set too low.

In summary, a comparable earnings analysis does not measure the correct return and is not a reliable model to estimate a return on equity that fairly balances investors and customers' interests. The comparable earnings analysis should be rejected.

Response to Steven Fetter

Q PLEASE SUMMARIZE AMERENUE WITNESS STEVEN M. FETTER'S REBUTTAL TESTIMONY.

A In his testimony, Mr. Fetter provides an overview of two issues. First, Mr. Fetter provides Fitch's view of what comprises fair and economically prudent regulation. Second, he reviews Staff's revenue requirement recommendations and argues, based on numbers included in his Schedules 1 and 2, that Staff's position will result in a downgrade to AmerenUE's bond rating, thus increasing its cost of borrowing and impacting its financial flexibility.

Q PLEASE SUMMARIZE MR. FETTER'S DISCUSSION OF HIS VIEW OF FAIR AND ECONOMICALLY PRUDENT REGULATION.

A Mr. Fetter maintains that in Fitch's evaluation of regulatory climate, the most important consideration is "consistent application of sound economic regulatory principles by a public utilities commission." (Page 4). He maintains that this is necessary in order to encourage major energy investors to commit funds to allow the utilities to fund infrastructure and capital improvements.

Mr. Fetter argues that a broad based incentive or performance based ratemaking program is the best means of providing economic incentives to utility companies and their customers that most closely match economic incentives provided by competitive markets.

Q PLEASE COMMENT ON MR. FETTER'S DISCUSSION OF ECONOMICALLY PRUDENT REGULATION.

A I would agree with Mr. Fetter that an important aspect of economically prudent regulation is the consistent application of "sound economic regulatory principles by a pubic utility commission." Both utility investors and customers benefit from sound economic regulatory principles, as they will encourage utility plant investment and allow customers to make reasonable assessments of utility costs in order to make economic investment decisions in utility customer plant and equipment. Hence, the economic regulatory principles should be designed to balance the interests of investors and customers.

Toward that end, I would encourage the Missouri Public Service Commission to closely adhere to the long-standing prudent principle of setting rates by examining revenues, expenses and rate base, within a test year. The test year economic principle matches revenues and expenses, and invested capital within a consistent time period to develop rates that provide fair compensation to investors, maintain the utility's financial integrity, and develop rates that are just and reasonable.

It would not be compatible with sound economic principles to set rates by considering projected costs outside of the test year, without considering all relevant impacts to revenues, sales, customers, operating expenses, and invested capital.

Unfortunately, in his response to Staff, Mr. Fetter does not adhere to prudent regulatory principles. Rather, he considers financial projections well outside the test year, and therefore betrays his own assessment of Fitch's policy to review regulatory risk in terms of regulators' consistent application of sound economic regulatory principles in assessing the financial impact of rate changes.

Q DID MR. FETTER REACH ANY CONCLUSIONS CONCERNING STAFF'S PROPOSED REVENUE ADJUSTMENT FOR AMERENUE IN THIS PROCEEDING?

A Yes. Mr. Fetter opined that in Fitch's opinion, AmerenUE's credit profile would be adversely affected by the adoption of revenue reductions of the magnitude and nature advocated by Staff that would result in a downgrade of the Company's current bond ratings. Mr. Fetter expressed concern about the ongoing revenue reductions that would adversely affect all of AmerenUE's significant financial ratios. He stated particular concern about a decline in the ratio of cash flow to capital expenditures, coincident with a period of rising capital outlays for new energy infrastructure investments to meet customer demands. In addition, he observed that leverage would also go up during the period.

Q HOW DID MR. FETTER REACH HIS CONCLUSIONS CONCERNING THE DEGRADATION TO AMERENUE'S FINANCIAL RATIOS AS A RESULT OF STAFF'S POSITION IN THIS PROCEEDING?

A Attached to his testimony as Schedules 1 and 2 are Mr. Fetter's estimated AmerenUE financial ratios reflecting Staff's range of revenue reductions of $245 million to $285 million.

Based on a forecast put together by AmerenUE, Mr. Fetter calculated these ratios over the period 2000 through 2006. The results of Mr. Fetter's analysis are summarized below in Tables 4 and 5.

Table 4

Fetter's Estimated Ratios
$285 Million Revenue Reduction

	2000	2001	2002	2003	2004	2005	2006
EBIT/interest coverage	5.25	5.87	4.50	3.56	2.92	2.35	2.24
EBITDA/interest coverage	7.34	8.28	6.30	4.96	4.15	3.42	3.29
Cash from operations/interest Coverage	5.87	6.73	5.45	4.43	3.78	3.27	3.14
Net cash from operations/ capital exp.	127.9%	63.3%	53.4%	51.5%	35.5%	23.3%	43.9%
Total debt	39.2%	40.0%	44.9%	47.8%	51.5%	53.2%	55.0%
Debt/EBITDA	1.85	1.95	2.72	3.14	3.73	4.42	4.39

Table 5

Fetter's Estimated Ratios
$245 Million Revenue Reduction

	2000	2001	2002	2003	2004	2005	2006
EBIT/interest coverage	5.25	5.87	4.74	3.81	3.22	2.62	2.54
EBITDA/interest coverage	7.34	8.28	6.54	5.22	4.48	3.72	3.64
Cash from operations/interest coverage	5.87	6.73	5.60	4.59	4.00	3.48	3.40
Net cash from operations/ capital exp.	127.9%	63.3%	57.0%	55.7%	39.7%	26.8%	51.0
Total debt	39.2%	40.0%	44.5%	47.0%	50.3%	51.7%	53.0%
Debt/EBITDA	1.85	1.95	2.61	3.95	3.48	4.08	4.02

Q WHAT CONCLUSIONS DID MR. FETTER REACH BASED ON THE RATIOS HE CALCULATED?

A He concludes that the coverage ratios over the period 2002-2006 drop to a level indicative of utility bond ratings in the "BBB" range by the 2005 to 2006 timeframe.

He summarizes his position by stating that AmerenUE's leverage, interest protection and cash flow measures decline steadily throughout the forecast period and by 2005 are reflective of utility companies with ratings in the "BBB" category (Page 12). He attributes this decline in the financial ratios entirely to Staff's proposed revenue reductions for AmerenUE.

Q PLEASE COMMENT ON MR. FETTER'S CALCULATIONS AND CONCLUSIONS BASED ON HIS FINANCIAL RATIO ANALYSIS.

A Mr. Fetter's analysis does not support his conclusion that Staff's recommendation in this proceeding will cause AmerenUE's bond rating to drop to "BBB." First, Mr. Fetter asserts that these ratios were based on a financial forecast made by Ameren (Page 10). Neither Mr. Fetter, nor AmerenUE, provided the assumptions used in developing the forecast.

Consequently, I have not been able to review Ameren's forecasting assumptions with respect to capital expenditures, level of O&M expenses, assumptions about depreciation rates, sales growth, rate changes, and other significant factors that will have a material impact on these ratios over the forecast period. Accordingly, it is impossible to determine whether Mr. Fetter has presented an accurate and/or unbiased assessment of the impact on AmerenUE's financial ratios caused by Staff's proposed revenue reduction or if the ratio degradation was caused by other factors or forecasting assumptions.

For example, Mr. Fetter's financial forecast reflects significant capital improvements, but he does not describe whether sales growth or rate adjustments have been included to support a growing rate base. Thus, the degradation to the Company's

ratios in 2005 and 2006 could be caused simply by the Company not reflecting sales growth or seeking rate relief to support a growing rate base.

This is significant, because Mr. Fetter's primary concern about the impact on the financial ratios appear to be in the last two years of the forecast, 2005 and 2006. Staff's proposed rate reduction in this proceeding will begin in April 2002. Mr. Fetter's estimated financial ratios in 2002 and 2003 fully support AmerenUE's existing bond rating at Staff's proposed revenue adjustments.

In sum, an accurate and fair representation of the adjustments Staff is proposing for AmerenUE's rates is based on a test year cost of service analysis. This is the traditional and most reasonable method of setting appropriate rates in my opinion. In significant contrast, Mr. Fetter's financial projections go out beyond the June 2001 test year, to 2006, and he concludes Staff's position is not reasonable based on AmerenUE's financial ratios in the years 2005 and 2006. Mr. Fetter's analysis fails his own standard of the "consistent application of sound economic regulatory principles."

Q HOW COULD MR. FETTER'S FINANCIAL RATIO CALCULATIONS BE USED BY A SOUND ECONOMIC REGULATORY COMMISSION TO CONSIDER THE IMPACTS OF STAFF'S PROPOSED RATE REDUCTION ON AMERENUE?

A Mr. Fetter's financial ratios should be reviewed within the test year ending June 2001 or, at most, the first full year the lower rates are projected to be in effect. After this time period, it isn't clear whether the ratio degradation would be produced by Staff's proposed rate adjustment in this proceeding, or for some other unknown, unspecified factors or forecasting assumptions.

Q BASED ON REVIEWING MR. FETTER'S SCHEDULES 1 AND 2, IS IT APPARENT WHEN HE ESTIMATED THE STAFF'S REVENUE REDUCTIONS WILL BE PUT INTO EFFECT?

A Review of the operating income shows a significant decrease in calendar year 2002. Hence, it appears that Mr. Fetter assumed that Staff's proposed revenue reduction would be placed into effect in calendar year 2002. I would note that the operating income continues to decline throughout the forecast period. Nevertheless, the largest decrease appears to have been in calendar year 2002, relative to 2001.

Q DO THE FINANCIAL RATIOS CALCULATED BY MR. FETTER FOR CALENDAR YEARS 2002 AND 2003 REFLECT THE DETERIORATION IN THE EARNINGS, AND CASH, COVERAGES OF AMERENUE TO THE LEVEL OF "BBB"?

A No. Below in Tables 6 and 7, I show Mr. Fetter's estimated AmerenUE financial ratios for the two scenarios in calendar years 2002 and 2003, along with Standard & Poor's financial ratio benchmarks for a utility bond rating of "A" with a business position ranking of 4, AmerenUE's current ratings.[2]

As shown in Tables 6 and 7, AmerenUE's financial ratios as calculated by Mr. Fetter will fully support an "A" bond rating in 2002 and 2003. Again, while Mr. Fetter did not provide his list of assumptions used in the forecast (workpapers were not provided until June 20, 2002), based on a review of the change to operating income, it appears that the Company reflected a reduction to its revenues based on Staff's forecast in the year 2002. Accordingly, degradation of financial ratios appears to

[2] In the comparison, Mr. Fetter's Cash Flow from Operations (CFO) is comparable to S&P's Funds from Operations (FFO) measure.

have been caused by factors other than the proposed reduction in revenues made by Staff in this proceeding.

Simply reflecting Staff's proposed revenue reductions, within the test year, shows a strong relationship between the Company's revenues, cost of service, rate base and financial ratios to support its existing bond rating. The degradation in ratios beyond 2003 appears to have been caused by the Company's efforts to increase its investments in electric utility plant, which was primarily financed with debt. This growing plant or rate base would eventually be reflected by the Commission in increased rates if sales growth does not cover the increased investment cost. If AmerenUE's forecast does not reflect sales growth and rate changes, it is not accurate.

Table 6

$285 Million Revenue Reduction

	2002	2003	S&P Benchmark "A" BP of 4
EBIT/interest coverage	4.50	3.56	4.0 –3.3
EBITDA/interest coverage	6.30	4.96	
Cash from operations/interest Coverage	5.45	4.43	4.5 - 3.8
Net cash from operations/ capital exp.	53.4%	51.5%	
Total debt/total capital	44.9%	47.8%	43.0%-49.5%
CFO/Average Debt	28.3%	23.3%	30.5%-24.5%

Table 7

$245 Million Revenue Reduction

	2002	2003	S&P Benchmark "A" BP of 4
EBIT/interest coverage	4.74	3.81	4.0 -3.3
EBITDA/interest coverage	6.54	5.22	
Cash from operations/interest coverage	5.60	4.59	4.5 - 3.8
Net cash from operations/ capital exp.	57.0%	55.7%	
Total debt/total capital	44.5%	47.0%	43.0%-49.5%
CFO/Average Debt	29.4%	24.6%	30.5%-24.5%

Q **ARE THERE OTHER ASPECTS OF MR. FETTER'S FORECAST THAT LEAD YOU TO BELIEVE THAT HIS FINANCIAL RATIOS DO NOT FAIRLY REPRESENT THE IMPACT ON AMERENUE FROM STAFF'S PROPOSED REVENUE ADJUSTMENTS?**

A Yes. Many aspects of Mr. Fetter's projections would call into question the validity of his ratio estimates. These uncertainties are summarized as follows:

- In year 2002, Mr. Fetter's financial projections show a common equity ratio of 52%. This common equity ratio is substantially lower than the 59% common equity ratio reflected in Staff's revenue requirement calculations and the 57.7% common equity ratio, including short-term debt and off-balance sheet obligations, as I estimated in my rebuttal testimony on Schedule 2. However, it is very similar to Ameren Corporation's 2002 common equity ratio of 51.5% reported by Value Line (April 5, 2002 at 697). Accordingly, the capital structures the Company included in its financial forecast appear to be different from those provided, for the $285 million scenario, to Staff in this proceeding.

- The financial forecasts also appear to have included questionable assumptions. Specifically, the operating income continues to decline after the rate decrease is implemented in 2002. The reduction to operating income would be caused by increases in depreciation expense created through additional infrastructure plant investment. However, as stated above, if sales growth did not provide a fair

return on a growing rate base, the Company should have made assumptions for rate relief to provide a fair return. Declining operating income also causes the Company's dividend payout ratio to increase from 77.5% in 2001 to over 100% in the years 2005 and 2006. This questionable assumption results in additional use of debt financing to fund the infrastructure plant improvements. This additional debt financing further erodes the Company's financial ratios in the years 2005 and 2006. Accordingly, it appears the Company made its financial position in years 2005 and 2006 to look especially worse due to modeling assumptions, rather than a direct evaluation of the impact on its operations through Staff's proposed revenue changes.

In summary, it is not clear whether the Company's financial projections reflect AmerenUE, or Ameren Corporation in total, or that the capital structure is accurate. Further, it is not clear whether there is adequate sales growth built into the projections to reflect a growth in the Company's infrastructure, plant investments and costs. Finally, the Company's financial projections appear to assume that rate relief would not be provided, irrespective of the level of prudent infrastructure investment, and the adequacy of rates to provide a fair return on that investment. Such a determination would be conducted in a future rate proceeding, once the Company's actual prudent and reasonable infrastructure investments are made, and the Commission determines an appropriate return to allow the Company to earn on those investments.

Response to Warner L. Baxter

Q DO YOU HAVE ANY COMMENTS ON THE REBUTTAL TESTIMONY OF AMERENUE WITNESS WARNER L. BAXTER?

A Yes. At pages 32-35 of Mr. Baxter's testimony, he cites several credit reports to support his contention that Staff's recommended revenue adjustment in this proceeding will result in a downgrade to AmerenUE's and Ameren Corporation's bond ratings. I acknowledge that many of the bond rating analysts have expressed a concern that Staff's recommendation will reduce AmerenUE's cash flow, which may limit its ability to pay dividends to Ameren Corporation. Concerning the credit rating

implication of Staff's proposed revenue adjustments in this proceeding, I make the following two observations. First, credit rating analysts are not considering the reasonableness of AmerenUE's rates in reaching their conclusions. Rather, credit analysts appear to be clearly focusing on the cash flows produced by AmerenUE, and the dividends AmerenUE can pay to its parent company, Ameren Corporation. Those dividends are needed by the parent company to fund its financial obligations, which include servicing the debt the parent company has taken on to fund non-regulated assets, and to pay common dividends. Credit analysts have not made an evaluation of the justness and reasonableness of Missouri rates, nor have they considered the benefits and consequences of charging inflated rates to its Missouri retail customers and the related economic consequences to the Missouri economy. Accordingly, bond rating analysts are not providing an unbiased view of the appropriateness of Missouri retail rates. They are focused on investor concerns.

Second, there are other concerns expressed by credit analysts that support their decisions to put Ameren Corporation on credit watch. For example, in the July 12, 2001 Moody's publication cited by Mr. Baxter, he neglects to complete the quote on page 33 of his testimony. While Moody's was concerned about the reduced internal cash flow from the reduced revenues proposed by Staff, Moody's also noted a concern toward Ameren Corporation's bond rating as follows:

> "Moody's notes that Ameren Corporation has incurred a significant portion of its financial obligations to finance the construction of Midwest gas-fired peaking plants."

Indeed, Staff's proposal will reduce AmerenUE's cash flows. And, one of Moody's primary concerns appears to be Ameren Corporation's ability to service the debt obligations it has incurred as a result of investing in merchant generating plants.

Also, the Standard & Poor's article cited by Mr. Baxter states concern about Ameren Corporation's non-regulated investment activity and its related risk in its assessment and justification for revising Ameren Corporation's credit outlook to negative. An expanded quote from the same article cited by Mr. Baxter reads as follows:

> "The outlook change reflects the Company's eroding consolidated financial profile that just last year was robust per current ratings. Potentially significant rate reductions at UE, lower forward energy prices, additional financing requirements for installation of a block of combustion turbines, and higher operating expenses will pressure cash flow, earnings protection measures and capital structure balance."
>
> To maintain current ratings, Standard & Poor's considers it necessary that the Company's [Ameren Corporation] overall financial condition strengthens. Although Standard & Poor's credit analysis is prospective, financial improvement may not be as dramatic or as rapid as required to sustain current ratings.
>
> Ameren corporate credit rating is based on the consolidated financial and business risk profiles of the Ameren family of companies. Because there are no regulatory mechanisms or other structural barriers in Missouri that sufficiently restrict access by the parent to the cash flow of AmerenUE, Standard & Poor's views the default risk of UE as being the same as that of Ameren." (Standard & Poor's Corporate Ratings, Ameren Corporation Outlook Revised to Negative, October 5, 2001). (Emphasis added)

As noted in the quote above, Standard & Poor's states concern for the financial health of Ameren Corporation. S&P also notes that Ameren Corporation's and AmerenUE's credit profile are closely tied, and the unregulated aspect of Ameren's business is clearly a significant part of the concern. Retail rates should not be driven by unregulated operations. Clearly, Standard & Poor's review of the credit strength of Ameren Corporation and AmerenUE is not directed at determining whether or not AmerenUE is charging just and reasonable rates. Rather, its concerns are focused on Ameren Corporation's ability to service debt for its non-regulated investments.

AmerenUE's credit rating is certainly a relevant issue. However, credit rating analysts are not charged with the responsibility of establishing just and reasonable rates, regulatory commission are. Therefore, while credit rating analysts' concern should be considered, they should not be the primary driver of the determination of appropriate Missouri retail rates.

Q **DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

A Yes, it does.

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