EXHIBIT

Exhibit No.:	
Issue(s):	Cost of Capital
Witness:	Mark Burdette
Type of Exhibit:	Cross-Surrebuttal
Sponsoring Party:	Public Counsel
Case No.:	EC-2002-1
Date Testimony Prepared:	June 24, 2002

CROSS-SURREBUTTAL TESTIMONY

OF

MARK BURDETTE

Submitted on Behalf of
the Office of the Public Counsel

UNION ELECTRIC

Case No. EC-2002-1

Exhibit No. 96
Date 7/10/02 Case No. EC-2002-1
Reporter KRM

June 24, 2002

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION, Complainant,	)	
vs.	)	Case No. EC-2002-1
UNION ELECTRIC COMPANY, d/b/a AmerenUE, Respondent.	)	

AFFIDAVIT OF MARK BURDETTE

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Mark Burdette, of lawful age and being first duly sworn, deposes and states:

1. My name is Mark Burdette. I am a Financial Analyst for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my affidavit consisting of pages 1 through 20.

3. I hereby swear and affirm that my statements contained in the attached affidavit are true and correct to the best of my knowledge and belief.

Mark Burdette

Mark Burdette

Subscribed and sworn to me this 24th day of June 2002.

KATHLEEN HARRISON
Notary Public - State of Missouri
County of Cole
My Commission Expires Jan. 31, 2006

Kathleen Harrison

Kathleen Harrison
Notary Public

My commission expires January 31, 2006.

CROSS-SURREBUTTAL TESTIMONY

OF

MARK BURDETTE

UNION ELECTRIC COMPANY D/B/A AMERENUE

CASE NO. EC-2002-1

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Mark Burdette, P.O. Box 7800, Jefferson City, Missouri 65102-7800.

Q. ARE YOU THE SAME MARK BURDETTE WHO FILED REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. I will respond to the rebuttal testimony of Ameren witness Kathleen M. McShane and Missouri Industrial Energy Consumers witness Michael Gorman.

Q. WHAT ARE YOUR COMMENTS REGARDING MS. MCSHANE'S REBUTTAL TESTIMONY?

A. I will first present comments regarding specific portions of Ms. McShane's testimony.

Page 5, beginning on line 6: Ms. McShane's adjustments to the Capital Asset Pricing Model inappropriately manipulates each of the inputs for the singular purpose of inflating the results produced by the CAPM. Ms. McShane takes issue with every single input to Staff witness Bible's Capital Asset Pricing Model (CAPM) analysis – specifically the risk-free rate, the market premium, and the company-specific betas. Her unsupported adjustments to these inputs should be disregarded by the MPSC.

· Page 7, beginning on line 8: Ms. McShane begins the first discussion (of several) regarding book value and market value of common stock, in regards to investors' expectations and regulatory returns. Ms. McShane's entire position on this issue relies on the assumption that investors' act irrationally and ignore solid, factual public information. Specifically, she assumes that the market, from the average private investor to an analyst at any major investment company, ignores the fact that regulated utilities earn their returns on book value. This assumption is, quite simply, unsupportable. For Ms. McShane's scenario and assumptions to be valid, she must ignore the basic financial tenant of the efficient market hypothesis. In other words, for Ms. McShane's position to have any merit, we must all assume that the average investor will act in a manner that is NOT in his best interest and that ignores fundamental financial information about the company.

Page 8, beginning on line 5: Ms. McShane's comparable earnings test is flawed and should be ignored by the MPSC. The fundamental concept underlying the comparable earnings test is that companies of comparable risk should have comparable earnings. Ms. McShane, however, selects companies of higher risk than AmerenUE's regulated operations and then attempts to make a subjective adjustment to her results. She has failed to actually perform a comparable earnings analysis, therefore her results are irrelevant.

Page 10, beginning on line 20: Ms. McShane makes the assertion that, if for no other reason, Ameren should receive a return greater than that recommended by Staff because otherwise Ameren will not be able to cover its current dividend. However, it is not the purpose of regulation to ensure the continuation of past management practices or decisions. It is easy to see where such a policy, if adopted by the MPSC, would eventually lead: companies would increase dividends beyond appropriate levels, then file a rate case in order to claim a "need" for increased earnings. The assertion that an appropriate return should fund past management decisions is unsupportable and, simply, bad regulatory philosophy.

Page 16, beginning on line 14: Ms. McShane purports that the investment community, specifically Moody's Investor Services, has expressed an opinion as to the *reasonableness* of Staff's recommended return. However, simply reading the quote from Moody's supplied by Ms. McShane shows this to be untrue. It is true that Moody's comments on possible effects of Staff's return – essentially that if AmerenUE is authorized a lower return, it will have lower earnings. These comments compare AmerenUE's current earnings to possible future earnings. That is decidedly different than making a comment on the reasonableness of the return.

Q. DO YOU HAVE COMMENTS REGARDING MS. MCSHANE'S REJECTION OF ALL HISTORICAL GROWTH RATE ANALYSIS AND HER RELIANCE ON FIVE-YEAR CONSENSUS FORECASTS FOR GROWTH?

A. Yes, I do. Page 33, beginning on line 1: Ms. McShane quotes FERC Order 414-A as support for her assertion that historical growth rates should not be used for DCF analysis. However, Ms. McShane fails to quote that portion of Order 414-A that similarly rejects the methodology **she** utilized in her analysis – specifically, the reliance on short-term, analyst-consensus growth forecasts such as those from I/B/E/S as a proxy for the long-term sustainable growth rate called for by the DCF. FERC Order 414-A states, in part:

> However, no such relative consensus exists with respect to the use or reliability of long-term growth projections. Yet, the Commission still wishes to consider long-term growth projections in its DCF calculation **because it believes that a five-year, short-term projection alone cannot normalize economic anomalies that might occur within such a limited amount of time.** [Pages 23-24] [Emphasis added]
>
> Consistent with Opinion No. 396-B, the Commission, in Opinion No. 414, required the **short-term growth projections to be based on IBES five-year projections** and the long-term growth projections to be based on GDP from the three sources established in Opinion No. 396-B. [Page 24] [Emphasis added]

> Therefore, TMG had ample reason to anticipate that **the Commission would choose IBES data for calculating the short-term growth in this proceeding.** While the Ozark decision did not mandate IBES as the sole source of short-term data, TMG has failed to justify a departure from this established precedent. [Page 24] [Emphasis added]

> The Commission has previously **considered and rejected Transco's argument for the use of IBES data as the sole source for determining growth.** [Page 25] [Emphasis added]

Amazingly, this last quote from Opinion No. 414-A is at the beginning of the *same paragraph* quoted by Ms. McShane as support for her complete rejection of any historical growth rate analysis. Apparently, Ms. McShane believes that the credibility of methodologies supported by FERC is a pick-and-choose situation, even within the same FERC Opinion. She uses the FERC Opinion as support for her analysis regarding the rejection of historical growth rates, yet her analysis disregards FERC's opinion, *provided in the very same document*, that says that five-year consensus growth rates are NOT appropriate proxies for the sustainable growth rate called for in the DCF.

As can be seen on McShane-Rebuttal, Schedule 8, Ms. McShane bases her DCF analysis almost exclusively on five-year consensus growth forecasts from I/B/E/S and Zack's. The inconsistency with which Ms. McShane rallies for and uses FERC-related methodologies is an indication that her analysis is biased and not an objective portrayal of Ameren's cost of capital.

Q. HAS THE MPSC RULED ON THE CONSIDERATION OF HISTORICAL GROWTH RATES WHEN DETERMINING THE SUSTAINABLE GROWTH RATE TO USE FOR THE DCF?

A. Yes. In the Report and Order for Case No. ER-2001-299, The Empire District Electric Company, the Commission stated:

> Dr. Murry's analysis of the growth factor is deficient because it depends entirely upon the growth of earnings per share, ignoring the growth of dividends per share and book value per share, **and because it is heavily**

> **dependent upon projections of future growth, instead of utilizing historical data.** The result is a growth rate that is much higher than Empire has ever achieved in recent years, and it is unreasonable to expect Empire to achieve it. The Commission finds that Public Counsel's calculations are well reasoned and appropriate for this case. [Emphasis added]

Q. DO YOU HAVE ADDITIONAL COMMENTS REGARDING MS. MCSHANE'S REBUTTAL TESTIMONY?

A. Yes, I do.

Page 41, beginning on line 6: In discussing risk, Ms. McShane asserts that there are elements of risk that have, to this point, been ignored by the market. Specifically, she states that there are risk "factors that are germane to the future outlook for the company or the industry, but have not necessarily been captured in the rate of return "numbers". [sic]" Again, as with her discussion on book value and market value, Ms. McShane has chosen to selectively ignore the idea of the efficient market. She asserts that "the impacts of industry restructuring on the business risk profile of electric utilities would not necessarily be reflected in historical measures of risk." It is true that a *new* piece of information concerning the business risk of Ameren would not be reflected in *historical* financial information (how could it?). *However (and fortunately), any new, relevant information is reflected in the stock price of the company.* Therefore, Ms. McShane's concern that historical financial information does not reflect new information, while technically accurate, is irrelevant.

Page 43, beginning on line 24: Again discussing a comparable earnings test, Ms. McShane chooses to provide a quote from a text-book that she presents as authoritative. However, Ms. McShane again ignores that she, quite simply, fails to apply this test even as described in the provided quote. Specifically, she quotes Morin as saying "Confidence in the reliability of the estimate of equity cost can be enhanced by estimating the cost of equity capital for a variety of risk-equivalent companies." Ms. McShane fails in her application of the comparable earnings test by failing to choose "risk-equivalent" companies.

Q. CAN YOU GIVE AN EXAMPLE SHOWING THE DIFFERENCES IN RISK BETWEEN AMEREN AND MS. MCSHANE'S SELECTED COMPANIES?

A. Yes. For example, Ameren Corporation's beta, as provided by Value Line Investment Survey, is 0.55. As shown on Schedule 15 of McShane-Rebuttal, the average beta for Ms. McShane's supposedly risk-equivalent group is 0.79, with a median of 0.80. Her group of companies has, on average, a beta that is **43.6% greater** than Ameren's beta. Ms. McShane attempts to rectify this error by, astoundingly, claiming that Ameren's beta is too low. Her solution to this 'problem' is to increase the beta for Ameren and the group of proxy companies used by Staff witness Bible (McShane-Rebuttal, page 57, lines 5-9). Once again, Ms. McShane has chosen to selectively ignore market-based information (beta) because it does not support her inflated recommendation for Ameren.

Q. DO YOU HAVE ADDITIONAL COMMENTS ON MS. MCSHANES' TESTIMONY?

A. Yes.

Page 88, beginning on line 13: Ms. McShane again ignores the concept of the efficient market by making the implicit assumption that investors will act in ways that are, specifically, not in their best interests. It is simply without merit to assume that the average investor will make decisions that ignore relevant market information and that will harm the investor.

Page 88/89: Ms. McShane enters a long discussion on the supposed merits of assuming that investors will act in ways that will harm themselves financially. However, Ms. McShane chooses to ignore fundamental financial principles throughout her discussion of asset values and stock prices. The bottom line is that the current value of a share of common stock is equal to the present value of all expected future cash flows associated with that share of stock, discounted back at a risk-appropriate discount rate. If an investor believes that a regulated utility will earn a return greater than its actual cost of capital, then the market price of the stock will be bid up, above book value. The market knows that the returns of regulated utilities in Missouri are based on book value of rate base, and have factored that information into their estimates of future cash flows. The market price of the stock will reflect that knowledge and information. Investors and the markets do not ignore fundamental information, such as regulatory framework, in order to set the market price of stock to what they 'wish' it were. To take Ms. McShane's assertions as fact is to assume that investors do exactly that.

Page 90 beginning on line 23: Ms. McShane states that she relied on consensus forecasts for "long-term earnings growth" as part of her DCF analysis. She relies exclusively on I/B/E/S International and Zack's for her earnings per share growth rates. However, Ms. McShane's methodology violates a fundamental aspect of the Discounted Cash Flow model – the DCF calls for a *sustainable* growth rate that extends into the indefinite future. Ms. McShane relies on growth rates that are estimates extending out five years only. She fails to consider the differences between what a company may be estimated to earn over the next five years compared to what that company could be reasonably expected to earn over a longer time frame. On page 92, beginning on line 11, Ms. McShane claims that "an alternative approach is to use an estimate of sustainable growth…" Ms. McShane is mistaken that her utilized methodology is an appropriate alternative to the proper application of the DCF. She then provides a cursory explanation of her 'sustainable' growth rate calculation, but fails to provide nor even describe a rigorous analysis or interpretation of her results. Her 'sustainable' growth rate calculation is severely lacking and, as with her misapplication of 5-year growth rates, fails to properly apply the DCF.

Additionally, as I have mentioned, FERC has explicitly rejected Ms. McShane's methodology of using five-year consensus growth forecasts as a substitute for the sustainable growth rate called for in the DCF, and FERC did so in the very document cited by Ms. McShane as support for her rejection of all historical growth rate information. FERC supports the use of five-year forecasts for short-term growth only.

Also, as I previously mentioned, the MPSC has explicitly rejected Ms. McShane's methodology of relying on five-year forecasts and rejecting all historical growth rates.

Q. FERC SUPPORTS THE USE OF A TWO-STAGE DCF MODEL. DOES THIS CHANGE THE INAPPROPRIATENESS OF USING FIVE-YEAR GROWTH FORECASTS?

A. No, not at all. A two-stage DCF model divides the future into two parts – a short-term period and a long-term period. However, "long-term" is still long term, whether using the single-stage or double-stage DCF model. Five-year projections are good for only five years regardless of which model you are using.

Q. PLEASE CONTINUE WITH YOUR COMMENTS.

A. Page 93 beginning on line 1: Again, in support of her inflated recommendation, Ms. McShane attempts to convince the MPSC that investors will act irrationally and in a manner that would harm them. Her assertion is that investors will set the market price of common stock based on information OTHER than known facts about the company. She claims that it is illogical for investors to pay a particular market price for stock with the expectation of losing money. However, it is Ms. McShane's assumptions that would provide for illogical behavior. She assumes that investors will ignore known information about a regulated company, such as the fact that it is regulated by the MPSC based on book value rate base, when determining what price to pay for the stock. **The MPSC should be very clear on this issue:** Ms. McShane's position is that regulation should be an *after-the-fact application* – that the MPSC should set the level of authorized earnings based on the current market price of the common stock of the company being regulated and should be set to maintain that stock price. Her position is, in effect, that the MPSC should set authorized earnings to maintain a particular market price of stock. She would have the MPSC **ignore** the basic financial tenant that investors already know and have considered public information that exists in the market about the company, namely regulatory and financial information, and that those investors have factored that information into the price they are willing to pay for the stock. The Commission should not be fooled by this inappropriate application of basic financial theory nor this after-the-fact application of regulation.

Page 94 beginning on line 1: Ms. McShane proposes a highly subjective and inappropriate increase to Ameren's cost of equity of 50 basis points to provide for "financial flexibility", based primarily on flotation costs. The Office of the Public Counsel believes that regulated companies should recoup financing costs on a dollar-for-dollar basis and not via an inappropriate percentage increase to the cost of equity. It is my belief that the Staff also believes that dollar-for-dollar reimbursement is the appropriate manner to deal with financing expenses.

Page 98, beginning on line 4: Remarkably, Ms. McShane yet again chooses to ignore basic market information and apply her own subjective adjustments. In this point, she turns her attention to the inputs to the Capital Asset Pricing Model. She decides that the market-determined rate on the U.S. Government 10-year treasury security is too low and should be increased if it is to serve as the risk free rate for the CAPM. This increase is important because it flows directly to the bottom line of any cost of equity estimates via the CAPM. She then goes on to create an increased "equity risk premium" for use in the CAPM. To complete her total rejection of market-based information, Ms. McShane decides to increase the beta values for the companies she is analyzing (McShane-Rebuttal, page 104, beginning on line 4). The MPSC should, by now, realize that much of Ms.

McShane's analysis is simply irrelevant to an appropriate determination of AmerenUE's cost of capital, and is relevant only to her desire to increase her recommendation.

Page 106, beginning on line 3: Ms. McShane, yet again, applies subjective and unsupported upward adjustments in her analysis and ignores basic market information. I have already addressed her assertions regarding floatation costs and 'financial flexibility.' However, Ms. McShane takes her rejection of market-based information a step further here by suggesting that the cost of equity should be increased to "provide a cushion against unanticipated market conditions." Ms. McShane should realize that 'unanticipated market conditions' has a different name - risk - and that investors and the market as a whole understand that **all companies** face unanticipated market conditions and take that into account when determining stock price. The MPSC should look at this section of Ms. McShane's testimony as perhaps the most transparent example of, quite simply, smoke and mirrors. The entire process of determining a company's cost of capital has to do with an assessment of risk for the company and the market's determination of what return is appropriate for that risk. Risk is, by definition, unknown future variability. For a financial analyst to complete an analysis and then have to make adjustments for "unanticipated market conditions" shows that the analysis performed was either lacking in the very basics in the first place or that the recommended adjustments are nothing more than a blatant attempt to increase earnings beyond that which is appropriate. Either way, the MPSC should see through such smoke and ignore such adjustments.

Page 107, beginning on line 21: Ms. McShane outlines her opinions on the proper application of the comparable earnings test. She states again that any results must be adjusted to account for differences in risk between the company under analysis and the group selected. The "adjustment" necessary depends entirely on the appropriateness of the companies selected for comparison. As I've already stated, Ms. McShane's group has an average beta value that is over 43% higher than Ameren's beta. Ms. McShane violates the most fundamental aspect of a comparable earnings test when she fails to select companies with comparable risk. But, she does open the door to make subjective upward adjustments to her results.

Q. WHAT DO YOU BELIELVE IS THE PRIMARY PROBLEM WITH MS. MCSHANE'S COST OF CAPITAL ANALYSIS?

A. The greatest problem with Ms. McShane's analysis is that she selectively ignores solid, market-based financial information when that information does not support her consistent attempts to increase her recommendation for Ameren, and instead substitutes her own opinion for market data. These substitutions force her to abandon basic financial principles such as the efficient market hypothesis and the idea of the rational investor in order to justify her recommendation.

An obvious example of this substitution is how she changes all inputs to the Capital Asset Pricing Model. Ms. McShane does not use primary market information for the risk-free rate, the market premium, nor even for beta.

Q. IN MAKING HER 'CORRECTIONS' TO MARKET DATA, DOES MS. MCSHANE EVER FIND REASON TO ADJUST A NUMBER IN A WAY THAT WOULD TEND TO DECREASE HER RECOMMENDATION FOR AMERENUE'S ROE?

A. No. While she asserts that each of these market-based values must be altered in some way, amazingly, **none** of her recommended changes work to decrease her ROE recommendation. In fact, throughout her testimony as she 'repairs' market data, **none** of her recommended adjustments decrease her recommendation.

Not only is the MPSC to believe that the United States' financial markets are not capable of providing trusted information, but that **every single piece of information** that is provided *understates* the cost of capital for Ameren. Yet, somehow, she is able to glean from these same markets the information she needs to 'correct' the numerical values. That is an stunning position for Ms. McShane to stake out as a financial analyst.

This puts the MPSC in the position of making a decision – are we to trust the financial markets of the United States, including all market participants from the average single investor to the largest institutional investor, from analysts at local investment firms to the opinions put out by agencies such as Moody's, or are we to trust that Ms. McShane alone possesses the knowledge of not only the errors in market information, but also how to correct those errors?

Q. HAS THE MPSC PREVIOUSLY RULED ON THE INAPPROPRIATENESS OF SUBSTITUTING AN ANALYST'S OPINION IN THE PLACE OF ACTUAL MARKET DATA?

A. Yes. In the Report and Order for Case No. ER-93-37, Missouri Public Service, the Commission addresses not only the substitution of opinion for market data, but also the addition of numerous upward adjustments to ROE recommendations:

> The Commission finds that MoPub's proposed return on common equity is not warranted. **MoPub makes several upward adjustments in order to arrive at its proposed figure of 13.50 percent, without adequately justifying the basis for the adjustments. The Commission agrees with Public Counsel that MoPub wishes to substitute the judgment of its witnesses for that of the capital markets.** Since no one can predict when interest rates will return to normal, use of data showing the expectations of current investors is appropriate. The Commission also determines that the link between interest rates and utility stocks is included in the market's pricing of the stocks. **In addition, an upwards adjustment for flotation costs is not warranted since MoPub does not issue common stock. Likewise, an upwards adjustment to reflect current market circumstances is also unnecessary since the DCF method is a forward-looking model.** [Report and Order, Case No. ER-93-37] [Emphasis added]

This paragraph is as applicable to Ms. McShane's analysis in this case as it was to MoPub's analysis in ER-93-37.

Q. COULD YOU SUMMARIZE THE PROBLEMS WITH MS. MCSHANE'S ANALYSIS?

A. Yes.

1. Ms. McShane's rejects any consideration of historical growth rate data to help determine the sustainable growth rate to use for the DCF.

The MPSC ruled in Case No. ER-2001-299 that the failure to consider historical growth rates is not a proper application of the DCF.

2. Ms. McShane's rejects the consideration of historical growth rate data to help determine the sustainable growth rate to use for the DCF.

Ms. McShane relies on five-year analyst-consensus growth rates projections for her DCF analysis, citing FERC Opinion 414-A as support for her position. However, a complete reading of FERC Opinion 414-A makes it clear that **FERC rejects the methodology utilized by Ms. McShane** of substituting five-year consensus growth forecasts for the sustainable growth rate in the DCF. Also, regardless of what opinions have been issued by FERC, five-year growth rate projections are not an appropriate substitute for the sustainable growth rate called for in the DCF.

3. Ms. McShane consistently rejects actual market-based information and instead substitutes her own opinion and adjusted values.

The MPSC ruled in Case No. ER-93-37 that the substitution of an analyst's opinion in place of actual market data is inappropriate and produces unreliable results.

4. Ms. McShane's application of the Comparable Earnings test utilizes companies that are of higher risk than AmerenUE.

Ms. McShane's comparable earnings test should be ignored by the MPSC because she fails to appropriately apply the test – specifically, she fails to select companies of comparable risk in order to calculate the level of 'comparable' earnings. Her results are, therefore, irrelevant to this proceeding.

5. Ms. McShane's assertions rely on the average investor acting in ways that are irrational and ignore the concept of the efficient market.

Ms. McShane's analysis assumes that investors ignore basic public information such as regulatory policy, and that investors make financial decisions based on the way they think things 'should be' rather than reality. Ms. McShane, therefore, essentially asserts that regulation should be applied after-the-fact in order to meet investors' expectations. For example, regulation should ensure that a company can maintain its current dividend.

6. Ms. McShane ignores the concept of the efficient market.

Ms. McShane asserts that AmerenUE faces risks that have not been recognized by the market and therefore are not incorporated into investors' expectations nor market information. She similarly asserts that the financial markets are unaware of the regulatory policy under which AmerenUE operates.

7. Ms. McShane makes a series of unwarranted and unsupported upward adjustments to her calculated numbers before reaching her recommended ROE.

Ms. McShane goes so far with these upward adjustments that she increases her recommended ROE to "provide a cushion against unanticipated market conditions." Ms. McShane fails to mention that ALL companies face 'unanticipated market conditions' – those unanticipated conditions are called **risk.** Her analysis, from the outset, *should have* considered the fundamental business risk faced by AmerenUE. If Ms. McShane believes that she failed to properly consider risk so that she must adjust her calculations, then that is further indication that the MPSC cannot and should not consider nor rely on her recommendations.

Q. WHAT ARE YOUR COMMENTS REGARDING THE REBUTTAL TESTIMONY OF MISSOURI INDUSTRIAL ENERGY CONSUMERS' WITNESS MICHAEL GORMAN?

A. Mr. Gorman chose to calculate a hypothetical capital structure for AmerenUE for this proceeding based on his conclusion that the Company's actual capital structure contained too much common equity. He then upwardly adjusted his recommended cost of common equity to account for this lower level of equity (and potential increased level of financial risk), and he correspondingly had to adjust the remainder of the Company's capital structure to reflect the increased level of debt.

Q. WHY DOES MR. GORMAN RECOMMEND THE USE OF A HYPOTHETICAL CAPITAL STRUCTURE RATHER THAN AMERENUE'S ACTUAL CAPITAL STRUCTURE?

A. Mr. Gorman states that he did not use AmerenUE's actual capital structure because he believes "it is too heavily weighted with common equity, and therefore not reasonable to use for ratemaking purposes." [Gorman-Rebuttal, page 4, lines 6-7]

Q. WHY CAN A CAPITAL STRUCTURE TOO HEAVILY WEIGHTED WITH COMMON BE UNREASONABLE FOR RATEMAKING PURPOSES?

A. Common equity is the most expensive form of financing. Therefore, too much common equity will unnecessarily increase the cost of service. In that situation, AmerenUE could decrease the amount of common equity, increase the level of debt, and produce a lower overall cost of capital.

Q. WHAT IS AMEREUE'S MANAGEMENT'S RESPONSIBILITY REGARDING CAPITAL STRUCTURE?

A. AmerenUE's management has the responsibility to manage capital structure in such a way that will attempt to minimize the cost of capital and maintain financing flexibility.

Q. PLEASE EXPLAIN MR. GORMAN'S CHANGES.

A. Mr. Gorman's recommended hypothetical capital structure and component costs are shown below:

Component	Weight	Cost	Wtd. Cost	Pre-tax Wtd. Cost
Common equity	51.20%	10.40%	5.33%	8.66%
Preferred stock	3.50%	5.72%	0.20%	0.33%
Long-term debt	37.40%	6.82%	2.55%	2.55%
Additional LTD	7.80%	7.50%	0.59%	0.59%
			8.67%	12.12%

Mr. Gorman made the following changes to AmerenUE's capital structure and component costs of capital, as compared to the capital structure and component costs filed by Staff witness Bible and as compared to my recommendation:

1. He reduced the level of common equity in AmerenUE's capital structure to 51.2% from the actual level of 59.08%.

2. He based his upwardly-adjusted 10.4% ROE recommendation on an 'increased' level of financial risk that would potentially exist for a company with 51.2% common equity as compared to the same company with 59.08% common equity (and the corresponding increased level of debt that necessarily has to occur as the level of equity decreases).

3. He added an additional 7.80% of long-term debt to the capital structure to fill in the space created when he reduced common equity.

4. He estimated a cost rate of 7.5% for this 'new' portion of debt.

Q. IS THERE A PROBLEM WITH THIS RECOMMENDATION?

A. Yes. The problem that Mr. Gorman's method creates is that through his changes in capital structure, and the resulting cost rates that he utilizes, he actually produces a higher overall cost of capital under certain circumstances than if he'd utilized the Company's actual capital structure and actual capital costs. In effect, his recommendation would potentially increase the Company's cost of service (as reflected by the cost of capital) with no increase in the level of used and useful assets nor any increase in AmerenUE's ability to provide service.

Q. WHAT ARE THE CIRCUMSTANCES UNDER WHICH MR. GORMAN'S RECOMMENDATION WOULD PRODUCE A HIGHER OVERALL PRE-TAX WEIGHTED COST OF CAPITAL?

A. If AmerenUE's actual, current cost of equity in the market is 9.63% or below, then adopting Mr. Gorman's recommendation would produce a *higher* overall pre-tax weighted cost of capital as applied to rate base.

If AmerenUE's actual, current cost of equity in the market is greater than 9.63%, then Mr. Gorman's recommendation would produce a *lower* overall pre-tax weighted cost of capital.

Q. PLEASE EXPLAIN.

A. The appropriate factors to consider pertaining to Mr. Gorman's methodology are the pre-tax weighted costs of each type of capital as applied to rate base. For example, my recommended capital structure, component costs (assuming 9.83% cost of common equity), weighted costs and pre-tax weighted costs (assuming a tax factor of 1.6248) are as follows:

Component	Weight	Cost	Wtd. Cost	Pre-tax Wtd. Cost
Common equity	59.08%	9.83%	5.81%	9.44%
Preferred stock	3.52%	5.72%	0.20%	0.33%
Long-term debt	37.40%	6.82%	2.55%	2.55%
			8.56%	12.31%

This table assumes that 59.08% of AmerenUE's rate base is financed with common equity, at a cost of 9.83%. That means when calculating revenue requirement including income taxes, *all* of rate base is multiplied by the **weighted cost of equity** of 9.44% to determine actual revenue pertaining to equity. Similarly, because 37.40% of rate base is financed with long-term debt at a cost of 6.82%, all of rate base is multiplied by the weighted cost of long-term debt (2.55%) to determine the amount of revenue pertaining to long-term debt. The pre-tax weighted cost of long-term debt is the same as the weighted cost because the interest payments are tax deductible. All of rate base is multiplied by 0.33% (the pre-tax weighted cost of preferred stock) to determine the amount of revenue pertaining to preferred stock. Overall, my weighted costs sum to 12.31%. When I multiply this 12.31% pre-tax weighted cost times rate base, I calculate the level of revenue pertaining to all three components of capital structure, capturing all capital costs.

Using the low end of my ROE recommendation of 9.40% produces component weighted costs and an overall pre-tax weighted cost of 11.90% as shown below:

Component	Weight	Cost	Wtd. Cost	Pre-tax Wtd. Cost
Common equity	59.08%	9.40%	5.55%	9.02%
Preferred stock	3.52%	5.72%	0.20%	0.33%
Long-term debt	37.40%	6.82%	2.55%	2.55%
			8.31%	11.90%

The only change between the two weighted cost calculations is the cost of common equity. The lower 9.40% cost, plus taxes, applied to 59.08% of rate base, produces a 9.02% pre-tax weighted cost of equity rather than the 9.44% pre-tax weighted cost of equity using a 9.83% ROE.

Q. WHAT IS THE PROBLEM YOU BELIEVE EXISTS WITH MR. GORMAN'S METHODOLOGY?

A. Mr. Gorman recommends the use of his hypothetical capital structure because he states that AmerenUE's actual capital structure leads to a cost of capital that is too high. Therefore, he changes the relative levels of capital in the capital structure and adjusts component costs. However, Mr. Gorman's recommended pre-tax weighted cost of capital of 12.12% is lower than my recommendation ONLY if AmerenUE's actual, current cost of equity is greater than 9.63%. In other words, if AmerenUE's actual, current cost of equity is 9.63% or lower, then in fact it would NOT be beneficial for AmerenUE to alter its capital structure as Mr. Gorman suggests. Therefore, the MPSC should consider Mr. Gorman's recommendation ONLY if the Commission determines that AmerenUE's actual, current cost of equity is greater than 9.63% using the actual level of common equity of 59.08%.

For example, assume the MPSC determines that AmerenUE's current cost of equity in the market is 9.60%. At that cost of equity, AmerenUE's pre-tax weighted cost of capital using the Company's actual capital structure is 12.09%, which is a lower cost than Mr. Gorman's recommended pre-tax cost of 12.12%. In that scenario, it does not make sense for AmerenUE's management to alter the capital structure as Mr. Gorman recommends, because the result is a higher overall cost of capital.

However, assume the MPSC determines that AmerenUE's current return on equity is 9.83%. At that cost of equity and assuming the actual capital structure, AmerenUE's pre-tax cost of capital is 12.31%, which is *higher* than Mr. Gorman's recommendation of 12.12%. In that case, the Commission will be in a position to determine if indeed AmerenUE should have a lower level of common equity as Mr. Gorman suggests, which would produce a lower cost of capital than using the actual capital structure, which would lead to lower rates for Missouri's consumers.

If the MPSC made those two determinations, 1) that AmerenUE's current cost of equity in the market is greater than 9.63%, and 2) that AmerenUE should have a lower level of common equity in its capital structure, then the Commission could appropriately authorize Mr. Gorman's recommended pre-tax cost of capital of 12.12%.

Q. ISN'T THE RECOMMENDATION TO THE COMMISSION TO CONSIDER MR. GORMAN'S ANALYSIS ONLY UNDER CERTAIN CIRCUMSTANCES INCONSISTENT?

A. No. It is incumbent on AmerenUE's management to operate with a capital structure that minimizes the overall cost of capital. The 'best' capital structure under certain conditions may not be the best capital structure under other conditions. Therefore, the question arises as to which capital structure is 'best' *now*. If AmerenUE's current cost of equity in the market is indeed 9.63% or below, then the actual capital structure is 'best' compared to Mr. Gorman's hypothetical capital structure because the current cost of equity and actual capital structure produce the lower overall cost of capital. However, if AmerenUE's current cost of equity in the market is greater than 9.63% given their actual capital structure, then (accepting Mr. Gorman's assumptions) his analysis shows that AmerenUE's management should alter their capital structure in order to secure a lower overall cost of capital.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.