Exhibit No.:	
Issue:	Rate of Return
Witness:	Ronald L. Bible
Sponsoring Party:	MoPSC Staff
Type of Exhibit:	Surrebuttal Testimony
Case No.:	EC-2002-1
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

RONALD L. BIBLE

UNION ELECTRIC COMPANY, d/b/a AMERENUE

CASE NO. EC-2002-1

Jefferson City, Missouri
June 2002

****Denotes Poprietary Information****

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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

AFFIDAVIT OF RONALD L. BIBLE

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Ronald L. Bible, is, of lawful age, and on his oath states: that he has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 49 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Ronald L. Bible
Ronald L. Bible

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

Toni M Charlton
Notary Public

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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d/b/a AMERENUE

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SURREBUTTAL TESTIMONY

OF

RONALD L. BIBLE

UNION ELECTRIC COMPANY

d/b/a AMERENUE

CASE NO. EC-2002-1

Q. Please state your name.

A. My name is Ronald L. Bible.

Q. Have you filed direct testimony in this proceeding as a member of the Staff of the Missouri Public Service Commission (Staff)?

A. Yes.

Q. Did you recommend a fair and reasonable rate of return for the Union Electric Company d/b/a AmerenUE (AmerenUE) in that testimony?

A. Yes, I did.

Q. Why are you filing surrebuttal testimony?

A. I am filing surrebuttal testimony (1) to point out how AmerenUE has grossly erred in the recent past in predicting impacts in the financial markets, (2) to state which issues with regard to rate of return remain between the Staff and AmerenUE, (3) to respond to AmerenUE's criticisms of the Staff's approach to rate of return reflected in the rebuttal testimony of Ms. Kathleen C. McShane, Dr. Roger A. Morin and Mr. Steven M. Fetter, (4) to show the weaknesses and misleading nature of AmerenUE's approach to rate of return, (5) to comment on the rebuttal testimony of Mr. Mark Burdette testifying on behalf of the Office of the Public Counsel (OPC) and Mr. Michael Gorman testifying on behalf of the

Missouri Industrial Energy Consumers (MIEC) Group, (6) to provide a historical perspective of rate of return issues decided by this Commission and finally (7) to provide a summary conclusion for my testimony.

<u>AmerenUE error in predicting impacts in the financial markets</u>

Q. Please explain how AmerenUE grossly erred in the recent past in predicting impacts in the financial markets.

A. On June 25, 2001, one week before the Staff could file its Commission authorized rate reduction complaint case, AmerenUE filed an emergency motion to stay the June 30, 2001 expiration of the Experimental Alternative Rate Plan under which it was operating. On June 27, 2001, AmerenUE amended its motion to stay expiration of the plan. In its motion, AmerenUE stated that mere public filing of such a draconian initiative as the Staff's rate reduction complaint case would have a severe impact on AmerenUE's financial standing and ability to secure the capital needed to meet future generation, transmission and distribution needs. The Company went on to say that public announcement of the effort to cut AmerenUE's earnings would cause stock analysts to predict a drop in the stock price of its parent company, Ameren, by greater than 33 percent.

To illustrate how erroneous this prediction was, I have included a graph from Wallstreetcity.com at Schedule 1. The graph shows the prices of Ameren stock from the time of the first announcement of Staff's rate reduction complaint case in 2001 through the current time period. For comparison, I have included on the graph a line showing stock prices of the Dow Jones Electric Utility Index as compared to Ameren's stock prices. I have also included some news releases and press releases to show how other developments have or have not impacted Ameren's stock prices. This information is included at Schedule 1 of this testimony.

According to Wallstreetcity.com, on June 29, 2001, the last trading day before the Staff filed its original rate reduction complaint case against AmerenUE, Ameren's stock price closed at $42.70. On May 21, 2002, Ameren's stock price closed at $44.15. While Ameren's stock price has declined somewhat since the Staff filed its rate reduction complaint case, as the graph shows, the decline is not even close to the over 33 percent decline that AmerenUE predicted. Instead, Ameren's stock price simply followed the general market as represented by the Dow Jones Electric Utility Index.

As the graph shows, Ameren's stock price followed the general trend of the Dow Jones Electric Utility Index until mid October 2001. From that point Ameren's stock price continued to trend ***up*** while the stock price for the electric utility index trended ***down***. In addition, among the other events that occurred subsequent to the Staff's filing of its rate reduction complaint case against AmerenUE, was Ameren's announcement on February 27, 2002 that it had raised $498 million from stock and convertible offerings and its announcement on April 2, 2002, of its intention to purchase Central Illinois Light Co. (CILCO) for $1.4 billion.

The mere public filing or public announcement of the Staff's "draconian" rate reduction complaint case against AmerenUE did not have the effect on Ameren's stock price or its ability to raise capital as it represented to this Commission.

Q. Does AmerenUE's current version of impacts in the financial markets support the exaggerated claims they made previously?

A. No. AmerenUE witness Baxter presented information in his rebuttal testimony that shows that the impact on Ameren's stock price was not anywhere near the 33 percent the company originally claimed. In his testimony, Mr. Baxter claims the impact of both the

Staff's excess earnings complaint in the Staff's February 1, 2001 Experimental Alternative Rate Plan (EARP) filing and the July 2, 2001 filing of the Staff's rate reduction complaint case, taken together, amounted to ** P ** in stock price.

In addition, AmerenUE witness Randolph presents capital cost information at Schedule 4 in his rebuttal testimony. The capital cost information shows that AmerenUE had higher capital expenditures in 2001, the year the Staff first filed its rate reduction complaint case, than in any year under the EARP. In fact, capital expenditures for 2001 were higher than the sum total of all capital expenditures in all the years AmerenUE was subject to the EARP from 1997 through 2000. The same holds true for 2002, the year the Staff filed its second set of direct testimony in the rate reduction complaint case for AmerenUE. Capital expenditures for 2002 are projected to be higher than for any year, 1997 through 2000, that AmerenUE was subject to the EARP. Furthermore, for every year from 2003 through 2006, capital expenditures are projected to be higher than in any year, 1997 through 2000. Therefore, AmerenUE's own analysis indicates that the Staff's complaint did not prevent AmrenUE from raising capital to support its construction expenditures.

Q. Do you believe Mr. Baxter, in his rebuttal testimony, accurately quantifies the impact, if any the Staff's excess earnings and rate reduction complaints had on Ameren's stock price?

A. No. The data provided by Mr. Baxter do not support his claim that the Staff's excess earnings and rate reduction complaints caused Ameren's stock price to ** P ** in market value. Using his starting point of February 1, 2001, when the Staff filed its EARP excess earnings complaint, Ameren's stock price closed at 40.64. This is shown at Schedule 3-1 of Mr. Baxter's rebuttal testimony. On July 2, 2001, the day the Staff filed its rate reduction complaint, Ameren's stock price closed at 43.45. This is shown at Schedule 3-2 of Mr. Baxter's rebuttal testimony.

Using Mr. Baxter's logic, the Staff could claim that the filing of its excess earnings complaint caused Ameren's stock price to go up 7 percent. The data on Ameren's stock prices for the entire period Mr. Baxter uses in his analysis, from February 1, 2001 through July 19, 2001, shows that Ameren's stock closed from 40.64 to 40.44, a decline of one half of one percent.

In addition, in response to the Staff's data request number 160, Ameren provided the minutes to its Annual Meeting of Stockholders held on Tuesday, April 23, 2002. In those minutes Mr. Charles W. Mueller, Chairman of the Board for Ameren was quoted as saying:

> The combined events of September 11 and the economic downturn result in short declines in stock performance across the board. Compared to a 13 percent drop for the S&P 500, the utility industry saw an 8.8 percent decline. During that same time period, Ameren experienced only a three percent drop in share price in 2001….

Therefore, not even the Chairman of the Board for Ameren agrees with Mr. Baxter's comments, and attributes the decline in Ameren's stock price to other causes, not the Staff's rate reduction complaint case.

The type of analysis Mr. Baxter has done is very sensitive to the time frames used. That's why it is better to use the Staff's approach, and view the longer term change in Ameren's stock price as presented elsewhere in the Staff's surrebuttal testimony and illustrated in the graph at Schedule 1 of the Staff's surrebuttal testimony.

Rate of Return Issues Remaining between the Staff and AmerenUE

Q. What rate-of-return issues remain between the Staff and AmerenUE in this case?

A. There are two broad rate-of-return issues that remain unresolved between the Staff and AmerenUE in this case. The first is the components of rate of return. The second is how rate of return should be calculated. AmerenUE witness McShane presented her recommendation for rate of return for AmerenUE in Table 22 found on page 114 of her rebuttal testimony. I presented my recommendation for rate of return at Schedule 26 of my direct testimony. For comparison, both of these recommendations are presented in Table 1 below:

Table 1

McShane Rebuttal Testimony

Component	Proportion	Cost Rate	Weighted Cost
Debt	37.40%	6.82%	2.55%
Preferred Shares	3.52%	5.72%	0.20%
Common Equity	59.08%	12.50%	7.38%
	Return on Rate Base		10.13%

Bible Direct Testimony

Capital Component	Percentage of Capital	Embedded Cost	Weighted Cost
Common Stock Equity	59.08%	9.41%	5.56%
Preferred Stock	3.52%	5.72%	0.20%
Long-Term Debt	37.40%	6.82%	2.55%
Short-Term Debt	0.00%	0.00%	0.00%
	Weighted Cost of Capital		8.31%

Each recommendation is presented in Table 1 in exactly the same format as it appears in the pre-filed testimony. The shaded areas represent the components of rate of return upon which the Staff and AmerenUE agree. The double-bordered areas represent the components of rate-of-return upon which the Staff and AmerenUE do not agree. The components of rate of return upon which the Staff and AmerenUE agree, as indicated by Ms. McShane's response to the Staff's data request number 3830, are:

Common equity as a percentage of total capital

Debt as a percentage of total capital

Preferred as a percentage of total capital

Embedded cost of debt

Embedded cost of preferred

Weighted cost of debt

Weighted cost of preferred

The components of rate-of-return upon which the Staff and AmerenUE disagree are:

Cost of common equity (return on equity)

Weighted cost of common equity

Rate of return (cost of capital or rate of return on rate base)

It is important to note that return on equity is not the only component of rate of return that the Staff and AmerenUE dispute, as AmerenUE would have the Commission believe. Nor is it the most important component. The most important component of rate of return in this case is the weighted cost of equity, and how it fits into the overall rate of return and before tax rate of return. I will demonstrate the importance of weighted cost of equity through the rest of this testimony.

The second issue is how rate of return should be calculated. AmerenUE witnesses McShane and Morin, went to great lengths in their respective rebuttal testimony to attempt to discredit my methodology for computing rate of return. In *Federal Power Commission et al. v. Hope Gas Company*, 320 U.S. 591 (1944). The Supreme Court decided that:

> The Constitution does not bind ratemaking bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments, which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at end.

In its May 13, 2002 decision for *Verizon Communications Inc. et al. v. Federal Communications Commission et al.,* The Supreme Court stated:

> Indeed, the general rule is that any question about the constitutionality of ratesetting is raised by rates, not methods.

What is apparent from the Supreme Court decisions is that the methodology is not what is important. What is important is that after reviewing all the facts presented, the Commission order produces no arbitrary result.

Each witness filing rate-of-return testimony in this case used a different methodology. AmerenUE witnesses McShane and Morin would have the Commission believe that <u>only</u> Ms. McShane's methodology is correct. But, again, it's not the methodology that is subject to judicial review, but whether the Commission's decision is supported by the record and is not an arbitrary result. Not only will I demonstrate throughout the remainder of this testimony that the Staff's rate-of-return recommendation produces no arbitrary result, I will also illustrate how consistent my results are when appropriately compared to decisions by other commissions. Furthermore, I will illustrate how Ms. McShane's recommended rate-of-return result is arbitrary when correctly compared to decisions made by other commissions.

Response to AmerenUE's criticisms of the Staff's approach to rate of return

Q. Please summarize your understanding of AmerenUE's responses to the Staff's approach to rate of return.

A. Ms. McShane devoted the majority of her rebuttal testimony to criticizing the analysis I presented in my direct testimony. She also included her own analysis, which she concludes supports a return on equity of 12 percent to 14 percent. She uses a return on equity of 12.5 percent at Table 22 on page 114 to derive a rate of return of 10.13 percent. As I mentioned previously in this testimony, Ms. McShane has agreed to all the components of rate of return that I calculated with the exception of return on equity, weighted cost of equity and rate of return or cost of capital.

I will demonstrate where Ms. McShane attempts to mislead this Commission. I will show where she makes erroneous statements not supported by fact or financial theory. Furthermore, I will illustrate how she utilizes the same approach in her analysis for which she criticizes me and claims I used incorrectly.

Dr. Morin devoted his entire rebuttal testimony to criticizing my analysis in my direct testimony. He did not perform an analysis of the cost of capital for this case. In his response to the Staff's data request number 3831, Dr. Morin indicated he agrees with Ms. McShane's rebuttal of the Staff's testimony for this case. He also stated he hadn't even bothered to read the affirmative part of Ms. McShane's rebuttal testimony.

I will include statements made by Dr. Morin to show how his criticism of my analysis applies equally to Ms. McShane's analysis. And, I will show where Dr. Morin also attempts to mislead the Commission.

Q. What is your response to Ms. McShane's criticisms of the Staff's approach to determining rate of return?

A. On page 10, lines 20 through 23 and page 11, line 1 and 2 of her prefiled rebuttal testimony, Ms. McShane applies my recommended 9.41 percent return on equity for AmerenUE to Ameren's 2001 book value per share estimated by Value Line (January 2002). There are a number of problems with her approach and conclusions. First, she misrepresents how return on equity is used to determine revenue and earnings for a utility. Return on equity is never applied directly to rate base or book value to determine revenue or earnings. Return on equity is applied to common equity as a percent of total capital. The resulting weighted cost of equity is then grossed up for taxes so that it will produce enough after-tax revenue to meet the return-on-equity revenue requirement. After the weighted cost of equity (or return on equity) is grossed up for taxes it is applied to rate base to derive a before tax weighted return on equity (or cost of equity) revenue requirement. The before tax weighted return on equity revenue requirement is calculated into rates the company is allowed to charge. Those rates are designed to generate revenue that flows through expenses to result in an earnings figure for the company.

Ms. McShane left out several steps in the process in her effort to focus attention on the return on equity number itself, which could mislead the Commission as to the real importance of return on equity. Her assertion overstates the importance of return on equity in this case and ignores the relationship between return on equity and the percentage of equity in the capital structure. As I mentioned previously, ***it is not return on equity but the weighted return on equity or weighted cost of equity, and how it fits into the overall rate of***

return and before tax rate of return, that is important. Failure to examine all these factors will result in a flawed rate-of-return study.

The second error that Ms. McShane made in her referenced calculation is that she applied return on equity for AmerenUE to Ameren's book value per share. She seems to have confused which company we are setting rates for in this case. Any application of return on equity for AmerenUE should be to AmerenUE, not to Ameren.

The third and most fatal error that Ms. McShane makes is that, after applying AmerenUE's return on equity to Ameren's book value per share, she concludes that the resulting earnings are not sufficient to cover Ameren's existing dividend. It appears that Ms. McShane is attempting to mislead the Commission into thinking that somehow AmerenUE and its earnings generation are solely responsible for 100 percent of Ameren's dividend. The implication of this is that she would have the Commission set rates for AmerenUE that would result in Missouri ratepayers shouldering the entire burden of 100 percent of shareholder dividends for a company that includes AmerenCIPS, AmerenEnergy Generating Company and other non-regulated entities Ameren may own. At most, AmerenUE and its ratepayers should only be responsible for a portion of those dividends.

Q. Why is weighted return on equity or cost of equity more important than return on equity?

A. On page 11, Table 2 and page 16, Table 3, of her pre-filed rebuttal testimony Ms. McShane lists returns on equity she claims are from Regulatory Research Associates (RRA) studies, and that represent returns on equity allowed by other commissions. Then, on pages 12 and 13 of her pre-filed rebuttal testimony she cites returns on equity for companies supposedly comparable to AmerenUE. What is misleading is that she left out the common equity as a percent of total capital that these returns on equity are applied to. The implication of her presentation is that other regulatory jurisdictions have authorized higher returns that would allow the regulated companies to earn more revenue. As I mentioned previously, to be meaningful, return on equity must be applied to the capital structure of the company for which the rates are being set, and then grossed up for taxes.

To illustrate the importance of applying the return on equity to the company's capital structure and grossing the result up for taxes, I have included at Schedule 2, Major Rate Case Decisions published by Regulatory Research Associates from 1991 through the first quarter of 2002. This data includes 285 observations of rates of return, returns on equity and capital structures authorized by state commissions.

Focusing only on the ROE% (return on equity %) column shows that these 285 observations have resulted in an average authorized ROE of 11.46 percent. However, looking at Table 2, the weighted cost of equity column shows that the 5.56 percent weighted cost of equity that I am recommending for AmerenUE in this case is higher than the average authorized weighted cost of equity of 5.28 percent. This means that I am recommending a weighted cost of equity that is higher than the average weighted cost of equity that has been authorized by other state commissions in 285 decisions over the last 11 years and 3 months. In other words, the weighted cost of equity that I am recommending for AmerenUE in this case, will allow them to earn more revenue on their rate base, on the average, than they would earn based on the average decision by other state commissions over the last 11 years and 3 months. By looking only at return on equity numbers, this fact will not be revealed. That is likely why Ms. McShane focuses on return on equity in isolation.

Table 2
Regulatory Research Associates (RRA)
Major Rate Case Decisions

	ROR%	ROE%	Eq. as % Cap. Struc.	Weighted Cost of Equity
RRA Avg.	9.33%	11.46%	46.12%	5.28%
Bible Rec.	8.31%	9.41%	59.08%	5.56%

Q. Is there evidence that AmerenUE had Ms. McShane focus solely on return on equity?

A. Yes. In response to OPC data request number 519, AmerenUE provided a Treasurer's 3rd Quarter 2001 presentation from Ameren Services Company. On page one of the presentation is the following:

- Executive Summary -

External Environment

Missouri Electric Complaint Case

Working with consultants to dispute Staff's recommended return on equity of 9.04% - 10.04%.

Two things are clear from this executive summary. First, it was never the intention of AmerenUE to produce an objective analysis of return on equity and rate of return. Their only focus was to produce an analysis solely to dispute the Staff's position. Second, it was never AmerenUE's intent to look at anything but the return on equity component of rate of return. As a result, they totally ignored capital structure and investor's return expectations that would result from the lower risk profile of AmerenUE's high equity as a percent of total capital. Nowhere in her prefiled rebuttal testimony does Ms. McShane mention differences in capital structures and resulting risk profiles for AmerenUE and any of the companies she uses for comparison. In fact, the Regulatory Research Associates study she refers to in her prefiled rebuttal testimony shows how high AmerenUE's equity as a percent of total capital is when compared to other electric utilities. At Schedule 3 are the companies Ms. McShane provided in response to the Staff's data request number 3817. These are the companies she claims are included in the Regulatory Research Associates study cited in her prefiled rebuttal testimony. I included AmerenUE and its equity ratio (equity as a percent of total capital) in the group, and then sorted all the companies, by equity ratio, from highest to lowest. As can be seen in Schedule 3, AmerenUE's equity is higher than the average equity ratio for the group, and higher than any single company equity ratio in the group.

Q. If your weighted cost of equity number for AmerenUE is higher than the average for the 285 observations, why is your overall rate of return number lower than the average overall rates of return?

A. The answer lies in the differences in capital structure between the companies presented in the Regulatory Research Associates study and AmerenUE, and the associated weighted costs. The average equity as a percent of capital structure for the companies in the RRA study I present is 46.12 percent. The average equity as a percent of capital structure for the companies in the RRA study Ms. McShane presents is 46.46 percent (see Schedule 3). AmerenUE's equity as a percent of capital structure is 59.08 percent, a difference of almost 1300 basis points. AmerenUE's equity as a percent of total capital is significantly higher than the average for the companies in the study.

Financial theory states that a company with a higher equity ratio is less risky than a company with a lower equity ratio. Therefore, investors will expect a lower rate of return from the company with the higher equity ratio and resulting lower risk. Regulatory commissions from other jurisdictions embrace this theory. In its Order No. 01-777, entered August 31, 2001, for Portland General Electric Company, the Public Utility Commission of Oregon, on page 36 stated:

> It is well understood by finance practitioners and theoreticians that the cost of equity drops as the percentage of common equity in the capital structure increases. Because the average amount of common equity in the capital structure of the comparable group of electric companies was 45.14 percent compared to 52.16 percent for PGE, it necessarily follows that PGE has a lower cost of equity. PGE's capital structure is therefore less risky, and its cost of common equity should be adjusted accordingly.

Although my recommendation for AmerenUE's weighted cost of equity is higher than the average for the companies in the Regulatory Research Associates study, the weighted cost of debt and preferred are lower. This can be explained by the lower risk investors perceive for AmerenUE due to its higher equity ratio and lower debt ratio. With the lower risk associated with its capital structure, AmerenUE's fixed income investors require a lower return on the fixed income investments (debt and preferred) for the company. The lower required return on fixed income investments, coupled with a lower percentage of debt and preferred to total capital, result in a lower weighted cost of debt and preferred. This lower weighted cost of debt and preferred, combined with the company's weighted cost of equity, result in a lower overall rate of return.

However, my calculations at the bottom of Schedule 2 reveal even more. In these calculations I used a tax multiplier to gross up the returns on equity. The analysis shows that my return on equity figure, when grossed up for taxes, provides a higher before tax rate of return than the most recent RRA published observations for the first quarter of 2002. Therefore, the before tax rate of return I recommend for AmerenUE in this case is higher than the average before tax rate of return authorized by other commissions for the first quarter of 2002. This is shown in Table 3.

Table 3

	Ameren	RRA 2002 **
Weighted Cost of Equity	5.56%	5.02%
times Tax Multiplier	1.6231	1.6231
	9.02%	8.15%
plus Weighted Cost of Debt and Preferred	2.75%	3.49%
equals Before Tax Weighted Cost of Capital	11.77%	11.64%

** First quarter 2002, Jan-Mar.
Data includes 5 observations.

Q. Did you do an analysis of the Regulatory Research Associates (RRA) data Ms. McShane included in her prefiled rebuttal testimony?

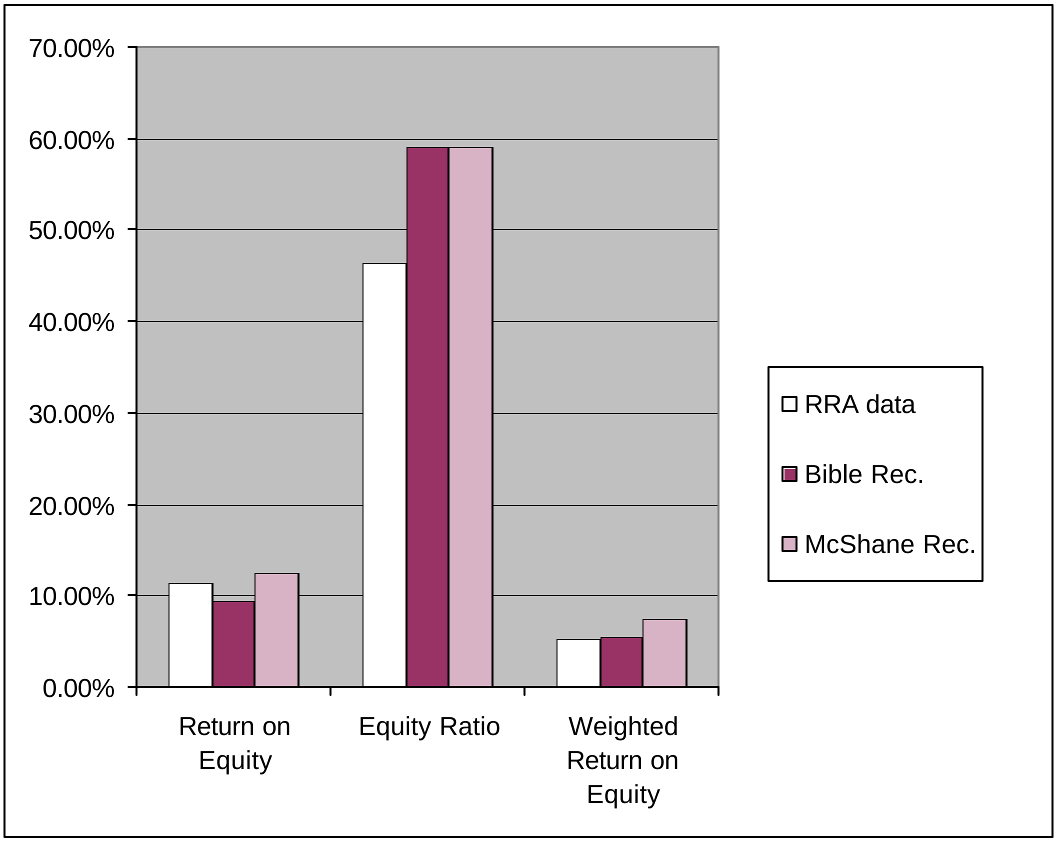
A. Yes. Ms. McShane did not include the equity ratios (equity as a percent of total capital) for the RRA return on equity information she included in her prefiled rebuttal testimony. In her response to the Staff's data request number 3817, she provided equity ratios for most of the companies in the RRA data included in her testimony (see Schedule 3). A summary of my analysis of her data is included in Table 4.

Table 4

	ROE%	Eq. as % Cap. Struc.	Weighted Cost of Equity
RRA Avg.	11.31%	46.46%	5.26%
Bible Recommendation	9.41%	59.08%	5.56%
McShane Recommendation	12.50%	59.08%	7.38%

As Table 4 shows, the weighted cost of equity I am recommending for AmerenUE in this case will allow them to earn more revenue on their rate base, than they would earn based on the average decision by other state commissions in the RRA data Ms. McShane included in her prefiled rebuttal testimony. I have also included Ms. McShane's recommendation to show its adoption would allow AmerenUE to earn far in excess of what they would earn based on the average decision by other state commissions in the RRA data.

To further illustrate the impact of capital structure and equity as a percent of total capital on rate of return, I have included a graph of the information in Table 4.



As the graph illustrates, the return on equity I am recommending is slightly lower than the average return on equity included in Ms. McShane's RRA data. However, the equity ratio I recommend is significantly higher and results in a higher weighted cost of equity. Ms. McShane's return on equity recommendation is higher than the average return on equity authorization in the RRA data she includes in her testimony, <u>and</u> she adopts the highest equity as a percent of total capital figure. Therefore, Ms. McShane is recommending a return on equity that is higher than the average return on equity in the RRA data she includes in her prefiled testimony, and at the same time adopts the higher equity as a percent of total capital that I recommend.

Q. Did you perform an analysis of the Public Utility Fortnightly survey Ms. McShane includes in her prefiled testimony?

A. Yes. Ms. McShane also mentions a Public Utilities Fortnightly survey on page 12 of her rebuttal testimony. At Schedule 4 of my testimony, I have included an analysis of authorized returns from this survey. Of the companies listed in the survey, I was able to access information on six from websites for regulatory jurisdictions where they are regulated. For these six companies, the common equity as a percent of total capital ranged from 39.78 percent to 52.16 percent with an average of 44.64 percent, well below AmerenUE's 59.08 percent. The weighted cost of equity ranged from 4.69 percent to 5.48 percent with an average of 5.02 percent, again well below my recommendation of 5.56 for AmerenUE. I have summarized these comparisons in Table 5 below.

Table 5

Public Utilities Fortnightly (PUF)
Return on Equity: How Regulators Doled Out The Dollars
December 2001

	Eq. as % Cap. Struc.	**Weighted Cost of Equity**
PUF Avg. (6 observations)	44.64%	5.02%
Bible Rec.	59.08	5.56%

Even more enlightening than rates of return authorized by regulators is to review the rates of return that companies have sought from them. At Schedule 5 of my testimony, I have included an analysis of returns sought by regulated electric utilities, as published in the Regulatory Research Associates, Quarterly Regulatory Study, March 2002. What is particularly interesting from this analysis is that AmerenUE is seeking a return on equity that is higher than the average for the survey group and at the same time seeking to use the second highest equity as a percent of total capital figure. This results in AmerenUE seeking a higher weighted cost of equity than the average of the entire group, as shown in Table 6. It is apparent that other companies recognize the need to request a more realistic number for return on weighted cost of equity.

Table 6

Regulatory Research Associates (RRA)
Quarterly regulatory Guide
March 2002

	Return sought on Orig. Cost Rate Base %	Return sought on Com. Equity %	Common Equity as % of Cap.	Return sought on Weighted Cost of Common Eq.
RRA Avg.	9.48%	12.18%	47.74%	5.77%
McShane Rec.	10.13%	12.50%	59.08%	7.38%

Q. Has AmerenUE made any other representations regarding return on equity that you feel need to be addressed?

A. Yes. On page 42, lines 3 through 9 of her prefiled rebuttal testimony, Ms. McShane references Dr. Bonbright and Mr. Parcell on criteria that govern the fair return. Then, on lines 9 and 10 of page 42 she concludes, “Consequently, if the return is set too low, the customer will be sent a faulty signal to over-consume scarce resources, e.g., electricity.” Her interpretation is that rates should be set at a level that will discourage consumption.

There is nothing in either established financial theory or utility regulation theory, that even suggests that the establishment of return on equity or rate of return should be based on setting rates at a level to discourage consumption. She would have this Commission believe that an appropriate guideline for setting reasonable rates is for this Commission to ensure ratepayers are discouraged from "over consuming scarce resources." She would also have the Commission set rates to discourage use of the product and, at the same time, include in rates funds, in the form of sales and marketing expenses, to promote use of the product.

Q. Has Ms. McShane done anything else that you question?

A. On pages 31 and 32 of her prefiled rebuttal testimony, Ms. McShane claims that the comparable companies I use are irrelevant because of comments in Value Line concerning merger, acquisition and non-regulated activities of the companies. She continues this argument through page 36 of her rebuttal testimony. Her basic conclusion is that the historical data that I used is unreliable because these companies are now so different.

Ms. McShane also uses historical data for the comparable companies she uses in her analysis. Despite her criticism of the comparable companies I selected, included in her comparable companies are companies that have undergone the same changes she claims makes my comparables unreliable. In fact, AmerenUE witness McShane's comparable companies are subject to the same activities that she claims make my comparable companies irrelevant. On page 55 of her rebuttal testimony she points out that the 1986-1997 Value Line historical betas for Ameren and my comparable companies averaged 0.70, before declining to 0.55 in the 1998-2001 timeframe. Then, on page 57 of her rebuttal testimony, she concludes that the appropriate beta to use is 0.70. This means she used data as far back as 1986 to support her conclusion.

Furthermore, she applies this same double standard to her group of eight comparable companies at Schedules 13 and 14 of her rebuttal testimony. In addition to Ameren, Ms. McShane includes the following companies in her group of comparable companies: American Electric Power, Exelon Corp., FPL Group, Inc., NSTAR, Potomac Electric Power, Southern Co., and Wisconsin Energy Corp. As this Commission is aware, Ameren was formed from the merger of Union Electric and Central Illinois Public Service Company in 1997. Changes affecting the other companies are:

- American Electric Power acquired Central and Southwest Corporation in 2000.
- Exelon did not even exist prior to 2000, and was formed in October of 2000 through the merger of PECO Energy Company and Unicom Corp.
- Potomac Electric Power is on the verge of acquiring Conectiv, which the March 8, 2002 Value Line report states will make the combined company the largest utility in the mid-Atlantic market.
- Southern Co. conducted an initial public offering in 2000, spinning off its global independent power marketing and trading operations into a subsidiary called Mirant.
- Wisconsin Energy is experiencing a decline in the number of its common shares outstanding due to its stock-repurchase program.

These companies have undergone the same type of activities that Ms. McShane claims make my group of comparable companies unreliable.

Ms. McShane does not stop there. She then goes on to conduct a comparable earnings analysis of a group of comparable industrial companies. She ends up with what she claims are 34 low risk industrials, as shown on Schedule 15 of her rebuttal testimony. She concludes from this analysis that a 14% return on equity is a fair opportunity cost return for AmerenUE. What Ms. McShane omits from her analysis is that of the 34 industrial companies in her group, nine have undergone significant merger and acquisition activity in recent years. Another three have executed stock buy-back plans that have increased their returns on equity. In spite of this activity in the companies she claims are comparable to AmerenUE, and her criticism of the group of companies I used for comparison purposes based on irrelevance of historical data, she poses on page 111, lines 18 and 19, and page 112, line 1 of her rebuttal testimony the following:

> Q. Are the historic returns on equity of the sample compatible with the forecast returns for the same company?
> A. Yes.

In its October 5, 2001 report for Eaton Corp., one of the companies in Ms. McShane's industrial sample, Value Line states: "Eaton's long-term growth strategy remains intact. Through acquisitions and divestitures (Eaton has made more than 20 since 1995), the company intends to transform itself…." In its December 21, 2001 report for Sigma-Aldrich, another company in her sample, Value Line states: "Return on equity has increased over the last couple of years, but that's only because SIAL (Sigma-Aldrich) has used its excess cash flow, plus some borrowed funds, to help buy back a whopping 25 million shares. And the share repurchases continue…. This may very well take ROE close to 20% and keep per-share earnings moving up, but it doesn't eliminate the fundamental problem of lack of growth in profits from operations."

In both of her samples Ms. McShane uses historical data to forecast the future. She does this despite these companies having undergone the same activities that she claims make my comparables irrelevant, and my use of historical data inappropriate.

Q. What position has this Commission taken in the past on the use of historical and projected growth?

A. This Commission has a long-standing and successful practice of using both historical and projected growth calculations to estimate future growth. In its Report and Order for Case No. ER-2002-299, 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.

Ms. McShane chooses to ignore historical data and use only forecast growth rates. She does this in her adjustments to my analysis, as well as in her own analysis.

Q. What has this Commission's practice been regarding the use of the DCF model for estimating return on equity?

A. This Commission has a long-standing and successful practice of relying on the DCF model to estimate return on equity. In its Report and Order for Case No. GR-99-315 the Commission stated:

> The Commission finds that it is reasonable to use the DCF analysis.

Ms. McShane should be aware of this statement and the Commission's practice because she was the company's rate of return witness for this case. Furthermore, in its Report and Order for Case No. WR-2000-844, the Commission stated:

> The Commission has for many years judged the DCF to be the most reliable for calculating a utility's cost of equity:
>
> > The Commission has consistently found the Discounted Cash Flow (DCF) analysis to be appropriate for determining a rate of return on equity. …This is because it is relatively simple to apply and measures investor expectations for a specific company. …[T]he DCF analysis is consistently

> systematic and allows the Commission to treat all utilities it regulates in a consistent manner.[7]

[7] In the Matter of the Joint Application of Missouri Cities Water Company, 26 Mo. P.S.C. (N.S.) 1, 26-27 (1983).

In addition, in its Report and Order for Case No. ER-2001-299, the Commission stated:

> Historically, the Commission has relied upon the Discounted Cash Flow ("DCF") Method of determining the appropriate return on equity ("ROE") for a regulated utility company.

Other regulatory commissions also share this philosophy. In the December 2001 issue of Public Utilities Fortnightly, the article, Return on Equity: How Regulators Doled Out The Dollars states: "The results of our annual survey of authorized rates of return on equity for state-regulated energy utilities show a continued reliance on traditional cost-of-service ratemaking in many states. A reading of this year's rate orders indicates that the Discounted Cash Flow analysis (DCF Method) continues as a staple for estimating the cost of equity capital sought by energy utilities."

Q. How has the Commission reacted to suggestions to make adjustments to the DCF Method?

A. The Commission has found that upward adjustments are not warranted.

Q. Has the Commission approved the use of a parent company as a proxy for a regulated company in the DCF method?

A. Yes. It has also found that the use of the parent company in the analysis of the cost of equity more closely approximates the cost of equity for the regulated company. In its Report and Order for Case No. ER-93-37, the Commission stated:

> The Commission finds that MoPub's proposed return on equity is not warranted. MoPub makes several upwards 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 the 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 upward adjustment for floatation costs is not warranted since MoPub does not issue common stock. Likewise, an upward adjustment to reflect current market circumstances is also unnecessary since the DCF method is a forward-looking model.

Q. Has Ms. McShane adhered to the Commission's past practice with respect to the DCF method and the use of adjustments and parent companies as proxies?

A. No. In her rebuttal testimony, Ms. McShane makes several adjustments to both my analysis and her own in order to derive higher cost of equity numbers. Examples of the adjustments she makes are: (1) elimination of the use of historical growth rates and using only forecast growth which ignores a long-standing and successful practice of this Commission, and (2) adjusting the betas she uses for the CAPM analysis using data as far back as 1986, ignoring current betas. Ms. McShane also argues for a floatation cost adjustment in spite of the fact that AmerenUE does not issue its own stock.

In its Report and Order for Case No. WR-2000-844, the Commission stated:

> The Commission concludes that the evidence in this case shows the DCF model to be the best approach. The Commission also concludes that, of the applications of the DCF model in this case, Staff's DCF analysis of AWK is the most pertinent to the determination of the Company's cost of capital. Staff's approach is the best because it is the purest application of the DCF model in the sense that it relies primarily on publicly reported data with little adjustment by the analyst. It is also the most appropriate because it uses the best proxy for the Company the Company's parent. The analysis performed by Public Counsel witness Burdette and Company witness Walker do not as accurately reflect the cost of equity for the Company because their proxy groups do not as closely approximate the Company as does AWK. In addition, they both made significant adjustments to the results of their DCF

> analysis. Mr. Walker's use of electric utilities to determine the Company's ROE is a significant flaw.

Including floatation costs as an adjustment to return on equity, as Ms McShane proposes at Appendix C of her rebuttal testimony will result in making floatation costs a recurring cost, when it is not. It will also result in not recognizing any tax benefits from these costs, since as part of return on equity, it will be grossed up for taxes before it is applied to rate base.

Q. Is there any reason to believe that AmerenUE may doubt Ms. McShane's analysis and recommendation for return on equity and rate of return?

A. Yes. Ms. McShane was AmerenUE's rate of return on equity witness in Illinois Commerce Commission (ICC) Docket No. 00-0802. In those proceedings, she filed testimony supporting a return on equity range of 12.75 percent to 13.25 percent, with a midpoint of 13.00 percent. In these same proceedings, AmerenUE witness Nickloy filed overall rate of return testimony. According to the ICC's Order (a copy of which is attached as Schedule 6), the AmerenUE recommendation was for 58.227 percent equity as a percent of total capital, 13 percent cost of equity and 7.569 percent weighted cost of equity. The ICC's Order for Docket No. 00-0802 also states that AmerenUE accepted a weighted average cost of capital (rate of return), of 9.04 percent and a weighted cost of debt of 3.22 percent. AmerenUE had also proposed a weighted cost of preferred stock in this case of .211 percent, and the ICC Staff had proposed a weighted cost of preferred stock of .28 percent. This indicates that AmerenUE accepted a weighted cost of common equity in this case of 5.54 percent to 5.61 percent, with a midpoint of 5.575 percent. This is illustrated in Table 7.

Table 7

	ICC Staff	AmerenUE
Weighted Cost of Capital	9.04%	9.04%
Weighted Cost of Debt	-3.22%	-3.22%
Weighted Cost of Preferred Stock	-.28%	-.211%
Weighted Cost of Common Stock	**5.54%**	**5.61%**
Midpoint Weighted Cost of Common Stock	**5.575%**	
Staff Recommended Weighted Cost of Common Stock, EC-2002-1	**5.56%**	

AmerenUE's settlement of this case at an implied midpoint weighted cost of common equity of 5.575 percent compares very favorably to, and supports the Staff's recommended midpoint weighted cost of equity of 5.56 percent in EC-2002-1. In addition it is significantly lower than the 7.569 percent weighted cost of equity recommended by Ms. McShane in the ICC proceedings, and significantly lower than the 7.38 percent weighted cost of equity she recommends in this proceeding.

Q. Do you have recent rate of return information for any other states that border Missouri?

A. Yes. In addition to the ICC Docket previously mentioned, the Kansas Corporation Commission (KCC) recently issued an Order for Docket No. 01-WSRE-436-RTS. In that Order (a copy of which is attached as Schedule 7), the KCC authorized Western Resources, Inc. (WRI) and its wholly owned subsidiary, Kansas Gas and Electric Company (KGE), a weighted cost of equity of 4.8645 percent. Table 8 illustrates the comparison between the weighted cost of equity recommended in this case, and recently decided weighted costs of equity for Kansas and Illinois.

Table 8

State	**Weighted Cost of Equity**
Missouri (EC-2002-1)	5.56%
Kansas (01-WSRE-436-RTS)	4.8645%
Illinois (00-0802)	5.575%

Q. What is your response to Dr. Morin's criticisms of the Staff's approach to determining rate of return?

A. Dr. Morin states in his executive summary, his summary of his criticisms of my analysis. In the body of his rebuttal testimony he states that the Staff's recommended cost of equity lies well outside the zone of currently authorized rates of return for electric utilities in the United States and would result in the lowest rate of return award for an electric utility in the country by a wide margin. These statements are not true. I have already addressed the Regulatory Research Associates study and the Public Utilities Fortnightly survey, ***demonstrating the importance of evaluating weighted cost of equity rather than just cost of equity, and comparing before tax costs of equity***. Again, the importance here is to look at the costs of equity that are applied to rate base to determine the company's rates and revenue. Like Ms. McShane, Dr. Morin wants the Commission to focus on return on equity in isolation, with the implication that the Staff's recommendation will result in lower revenue for AmerenUE than it would get in other regulatory jurisdictions.

A specific example will illustrate how this is not true. In its Order for Docket No. 01-10001, the Public Utilities Commission of Nevada found that a 10.1 percent return on equity with common equity at 42.59 percent of its capital ratio, resulting in a rate of return of 8.37 percent, was appropriate for the Nevada Power Company. At first glance one could ascertain that indeed the 8.37 percent rate of return the Nevada Commission authorized is higher than the Staff's midpoint recommendation of 8.31 percent for AmerenUE.

However, closer scrutiny reveals that the Staff's recommendation would result in more revenue than that the Public Utilities Commission of Nevada authorized. The 8.37 rate of return the Nevada Commission authorized is based on 10.1 percent return on equity applied to a capital structure comprised of 42.59 percent common equity, and a 4.07 percent weighted cost for the other components of capital structure, which comprise the remaining 57.41 percent of total capital. The 10.1 return on equity applied to the 42.59 percent common equity as a percent of capital results in a weighted cost of equity of 4.30 percent. Weighted cost of equity grossed up for taxes results in a before tax weighted cost of equity of 6.98 percent. Adding the before tax weighted cost of the other components of rate of return to the before tax weighted cost of equity results in a before tax rate of return (the number actually applied to rate base) of 11.05 percent. This compares to the before tax rate of return of 11.77 percent the Staff recommends for AmerenUE, as shown in Table 9.

Dr. Morin should have been aware of this because he was Nevada Power Company's witness in that case.

Table 9

	Equity as % Capital	x	ROE	=	Weighted Cost of Eq.	x	Tax Factor	=	Before Tax Weighted Cost of Eq.	Weighted Cost of Other Cap.	=	Before Tax ROR
Nev. Pwr. Co. 01-10001	42.59%		10.10%		4.30%		1.6231		6.98%	4.07%		11.05%
Bible Rec.	59.08%		9.41%		5.56%		1.6231		9.02%	2.75%		11.77%

Another example that supports my position is the New Mexico Public regulation Commission's recent decision involving Texas-New Mexico Power (TNP). According to Regulatory Research Associates, in January 2002, the New Mexico Public regulation

Commission reached an agreement with TNP for a 10 percent return on equity and a 7.35 percent rate of return on TNP's original cost rate base. Furthermore, as I mentioned in my discussion above, the Regulatory Research Associates study for the first quarter of 2002 shows that, on a before tax basis, the Staff’s rate-of-return recommendation for AmerenUE is higher than the average for the five observations included in that study.

Furthermore, Ameren sponsored a presentation on February 26, 2001 for members of the Missouri State Legislature. The purpose of the presentation was to show the differences between state utility regulation and regulation by the Federal Energy Regulatory Commission (FERC). The consultant hired by Ameren provided information for the presentation that included equity return authorizations by the FERC. According to the information provided (a copy of which is attached as Schedule 8), from October 1, 1999 to September 30, 2000, the FERC decided equity returns for nine cases. The FERC equity returns the ranged from 8.25 percent to 12.45 percent. The 8.25 percent equity return the FERC authorized, is 160 basis points **lower** than the midpoint of the Staff's recommended return on equity range of 9.41 percent.

Therefore, Dr. Morin's accusation that my recommended cost of equity lies well outside the zone of currently authorized rates of return for electric utilities in the United States, would result in the lowest rate of return award for an electric utility in the country, and by a wide margin, is factually incorrect.

Q. Please respond to Dr. Morin's criticism of the Staff’s approach for relying on a single method to derive its recommended return on equity, an approach he claims is wholly at odds with recognized standards for cost of capital analysis.

A. Once again, Dr. Morin is factually incorrect in his accusation. I have already mentioned this Commission's long-standing and successful practice of relying on the DCF method in my discussion of Ms. McShane's rebuttal testimony. In addition, in the Nevada Power Company case mentioned previously, the Public Utilities Commission of Nevada, in its Order, stated:

> In the past, this Commission has primarily relied on the DCF analysis, with various Risk Premium analyses used to check the reasonableness of the result. The Commission, based in large part on the testimony of Mr. Knecht, still believes the DCF model, especially the three-stage model, provides the best estimate of the appropriate rate of return. The Commission concurs with Mr. Knecht that the DCF model avoids the problem of bias introduced by the way historic data is used in Risk Premium models. However, it is clear that Dr. Morin's DCF model suffers from the failure to use dividend growth estimates, rather than earnings growth estimates. Additionally, the Commission agrees with Mr. Knecht that, "…at this time little or no weight can reasonably be given to the ROEs (returns on equity) estimated by the CAPM or other RP (Risk Premium) (CA+I) models, even when they are implemented correctly." (Exhibit 7 at p. 8) This view is supported by Dr. Morin's observation that the current fast-changing environment makes it difficult to implement the traditional methodologies.

Again, Dr. Morin should have been aware of Nevada Commission's policy of relying on the DCF model, because he was the company's witness in that case. Also, the December 2001 issue of Public Utilities Fortnightly article I mentioned previously confirms that other regulatory commissions rely on the DCF model in determining rates of return.

Q. Please respond to Dr. Morin's criticism of the Staff’s reliance on electric utility historical growth and use of historical dividend growth.

A. Dr. Morin criticizes the Staff for using historical data because the companies in my analysis have undergone mergers and, according to Dr. Morin, the pre-merger data is not comparable to the post-merger data. As indicated above, companies that Ms. McShane uses in her comparable groups have undergone the same changes. In his response to the Staff's data request number 3831, Dr. Morin indicated he agrees with Ms. McShane's rebuttal of the Staff's testimony for this case. He also stated he hadn't even bothered to read the affirmative part of Ms. McShane's rebuttal testimony.

As I pointed out above, Ms. McShane used in her group of comparable companies, utility companies that have undergone mergers and other activities that make them historically different than they are today. In addition, she used as a group of comparable companies, industrial companies that have undergone the same types of activity, yet she still refers to their historical data and uses that data in her analysis. Dr. Morin wants this Commission to believe is that it is okay for Ms. McShane to use companies that have undergone change in her analysis, but it is not okay for the Staff to use them in its analysis.

Furthermore, in Case No. ER-2001-299, excerpted on page 17 of my testimony, the Commission rejected the notion of using only earnings per share growth without including dividend and book value growth. In that same case, the Commission also rejected the notion of relying only on projected growth while ignoring historical growth.

Q. What criticism has Dr. Morin's made of the Staff's CAPM analysis?

A. Dr. Morin claims that the Staff's CAPM analysis is incorrect because the historical data, in particular betas, do not reflect changes in the industry. Ms. McShane also relies on historical betas for her analysis in her rebuttal testimony, using data from as far back as 1986 to arrive at her beta estimate. Once again, Dr. Morin would have this Commission believe that it is okay for Ms. McShane to use this approach in her analysis, but that I should not use it in mine.

Q. Has Dr. Morin said anything else to which you wish to respond?

A. Yes. In her rebuttal testimony, Ms. McShane cites texts by Dr. Morin and David C. Parcell. Dr. Morin's book is Regulatory Finance: Utilities Cost of Capital, and Mr. Parcell's book is The Cost of Capital - A Practitioner's Guide. As I mentioned previously, Dr. Morin did not develop a cost of capital in this case. However, he was the rate of return witness for Nevada Power Company in Docket No. 01-10001, before the Public Utilities Commission of Nevada. It just so happens that Mr. Parcell was also a witness in that case, in opposition to Dr. Morin. In its Order for this case, the Nevada Commission cited several areas where Mr. Parcell did not agree with Dr. Morin's methodology for developing rate of return. Therefore, we have two authorities who have both authored texts that are referred to in cost of capital analysis, and they do not agree with each other on the correct methodology to use to develop cost of capital. This is likely the type of situation the Supreme Court had in mind when it decided that the methodology used to develop rate of return is not as important as the results.

Response to Mr. Fetter's rebuttal testimony

Q. Do you have any response to Mr. Fetter's rebuttal testimony?

A. Yes. Mr. Fetter provides an overview of what he calls the electric utility crisis occurring in California, and claims he sees similar things happening in Missouri in the event of a rate reduction. He also discusses credit ratings and actions taken by Fitch, a credit rating agency, in regard to Ameren's credit. Finally, Mr. Fetter talks about the harm that would be caused to AmerenUE as a result of the rate reduction proposed by the Staff.

Q. What are the similarities Mr. Fetter claims he sees between the situations in California and Missouri?

A. Mr. Fetter blames the California crisis on the actions taken by policymakers in that state. He claims that that California's policymakers forced the state's three investor-owned electric utilities to divest most of their generating assets. Mr. Fetter also claims these actions then exposed the state's electric utilities to price risk in managing generation procurement, because they were required to purchase their supply needs on what became an incredibly volatile wholesale market. He concludes that the same thing could happen in Missouri because the Staff's proposed rate reduction would lead to investor concerns, which would lead to shortages and a capacity squeeze similar to what happened in California. Mr. Fetter wants this Commission to believe that it was solely the actions of its state policymakers that caused California's energy problems.

However, there is ample evidence to suggest there were other forces involved with the problems in California. A recent article from NYTimes.com, <u>A Collision on Risks of Energy Trading</u>, June 2, 2002 states:

> The California attorney general's office is investigating whether natural gas prices were manipulated during the state's energy crisis, which stretched from the summer of 2000 to 2001….
>
> The latest wave of investor concern and regulatory scrutiny roiling the power industry arises from questions about the ethics and profitability of electricity trading. Enron released memos a few weeks ago detailing methods that its traders used to manipulate electricity prices in California in 2000. Other energy companies have acknowledged that they tried similar tactics, while some - including Dynegy, CMS Energy and Reliant Resources - have said they made questionable power trades that inflated revenue….

The July 2002 issue of Consumer Reports includes an article, <u>DEREGULATED, Deregulation was supposed to cut prices, expand choice, enhance service-improve your life. So how come you're not smiling?</u> The articles states that rates have fallen because of regulated cuts, not free markets. It cites that of the mandated rate cuts and freezes in 11 states they studied, they found declining prices in all but California. The article also states:

> But when the wholesale cost of electricity rose to 40 cents per kWh in February 2001, Enron abandoned its customers. That forced the Snyders back to the so-called default provider, PG&E, which with the state was then forced to meet the unanticipated demand by buying electricity on the sky-high spot market-where Enron was selling. "The amazing thing here is Enron had electricity to sell because they had, in a sense, booked it up to serve customers," says Lynch of the California Public Utility Commission. The commission and state and federal agencies are investigating the extent to which Enron, its affiliates and other companies exploited - even caused - the state's energy crisis for their own gain.

The June 6, 2002 issue of the Kansas City Star an article, <u>Energy stocks drop after federal threat</u>, that states:

> Shares of Williams Cos., Avista Corp. and El Paso Electric Co. plunged Wednesday after federal regulators threatened to revoke their authority to set prices on sales of electricity and natural gas.
>
> The Federal Energy regulatory Commission said the three energy companies and an Enron Corp. utility in Oregon, Portland General Electric, failed to cooperate in an investigation of allegations that traders manipulated prices during California's energy crisis in 2000 and 2001.

It is too early to tell what the results of the investigations will be, but there is ample evidence available now that shows there was more to the problems in California than the decisions made by regulators.

While Mr. Fetter states that California's problems were caused by its investor-owned utilities being forced to divest their generating assets, the Staff's complaint in this case is based on AmerenUE building and maintaining its own generation capacity. In fact, the Staff's case includes an additional $221 million for generation that AmerenUE did not include in its case, and decided not to build for itself.

Q. Do you have a response to Mr. Fetter's comments about Fitch's credit report for Ameren?

A. Mr. Fetter claims that the negative outlook Fitch issued for Ameren reflects the potential that this Commission will order a rate reduction for AmerenUE. He implies that the potential rate reduction is what caused Fitch to issue the negative outlook. However, Fitch did not issue the negative outlook for Ameren until December 7, 2001, more than five months after the Staff filed its original complaint case indicating a potential rate reduction for AmerenUE. Futhermore, Fitch did not place Ameren on Ratings Watch Negative until after Ameren announced it would buy lower rated CILCORP. The Ratings Watch Negative was issued April 29, 2002, almost nine months after the Staff filed its original complaint. The following chronology of releases from Standard and Poor's, Ratings Direct reflects the recent impacts on Ameren's credit ratings:

> **Ameren Corp. & Affls Ratings Affirmed; Outlook Revised To Negative**
> NEW YORK (Standard and Poor's Creditwire) Jan. 26, 2000--Standard and Poor's today affirmed its ratings on Ameren Corp. and primary subsidiaries, Union Electric Co. (UE, doing business as AmerenUE) and Central Illinois Public Service Co. (CIPS, doing business as AmerenCIPS), and revised the outlooks from stable to negative….
> The negative outlook reflects Ameren's challenge to maintain financial performance measures commensurate with the increasing business risk, which is inherent in the company's strategy to aggressively grow its unregulated generation operations….
> …The expansion of these unregulated activities will weaken the consolidated business risk profile….
> OUTLOOK: NEGATIVE
> The outlook reflects Ameren's challenge to maintain bondholder protection commensurate with the higher business risk associated with the company's strategy to aggressively expand its unregulated generation operations, standard and Poor's said. --CreditWire

Standard and Poor's had concerns about Ameren's credit quality well in advance of the Staff's original filing of its complaint in this case. Those concerns were driven by Ameren's strategy to aggressively expand into unregulated operations. Nine months later, Standard and Poor's, Ratings Direct issued the following:

> **Various ratings Actions Taken on AmerenCorp., Subsidiaries**
> NEW YORK (Standard and Poor's Creditwire) Sept. 26, 2000…
> …At the same time Standard and Poor's affirmed its ratings on Ameren, but lowered its ratings on Ameren's regulated utilities, Union Electric Co. (UE, doing business as AmerenUE) and Central Illinois Public Service Co. (CIPS, doing business as AmerenCIPS). The outlooks for Ameren, UE, and CIPS were revised to stable from negative (see ratings list below).
> Ameren's corporate credit rating is based on the consolidated financial and business risk profiles of the Ameren family of companies, which include the regulated utility businesses of UE and CIPS, the unregulated generating activities of AEGC, and energy marketing and trading operations. Although there are no regulatory mechanisms or other structural barriers in Missouri that sufficiently restrict access by the parent to the cash flow of UE, Standard and Poor's views the default risk of UE as being the same as that of Ameren.
> OUTLOOK: STABLE
> …Upside credit potential will be limited by commodity price risks associated with company's growing generation activities, Standard and Poor's said. --CreditWire

Ameren Corp.		
Corporate credit rating	A+/A-1	
RATINGS ASSIGNED		
AmerenEnergy Generating Co.	BBB+	
RATINGS LOWERED		
Union Electric Co.		
	TO	FROM
Corporate credit rating	A+/A-1	AA-/A-1+

With this announcement, Standard and Poor's started its credit rating of AmerenEnergy Generating Co. (AEGC) at BBB+, or two notches above the lowest investment grade rating, and lowered AmernUE's credit rating a notch. The continued emphasis for Ameren by Standard and Poor's is on the risks associated with the unregulated generating business, AmerenEnergy Co. Again, these events occurred well in advance of the Staff filing its original complaint in July 2001. Almost 13 months later and three months after the Staff filed its complaint, Standard and Poor's, Ratings Direct issued the following:

> **Ameren Corp. Outlook Revised To Negative**
> NEW YORK (Standard and Poor's Creditwire) Oct. 5, 2001-- Standard and Poor's today revised its credit outlook for Ameren Corp. (single-'A'-plus) and its subsidiaries, Union Electric Co. (UE, single-'A'-plus) Central Illinois Public Service Co. (CIPS, single-'A'-plus), and AmerenEnergy Generating Co. (AEGC, triple-'B'-plus)-- to negative from stable.
> The outlook change reflects the company's eroding consolidated financial profile that just last year was robust for current ratings. Potentially significant rate reductions at UE, lower forward energy prices, additional financing requirements for a block of combustion turbines, and higher operating expenses will pressure cash flow, earnings protection measures, and capital structure balance…. Although Standard and Poor's credit analysis is prospective, financial improvement may not be as dramatic or as rapid as required to sustain current ratings.
> OUTLOOK: NEGATIVE
> The negative outlooks reflect expectations for continued deterioration in key consolidated financial measures, as well as weakness in the financial profiles of AEGC and CIPS, whose ratings are based more on a stand-alone basis.

While this release mentions the potential rate reduction, there are several other reasons listed by Standard and Poor's for assigning a negative outlook. The most significant reason given is the "continued deterioration in key consolidated financial measures, as well as weakness in the financial profiles of AEGC and CIPS…". The reference to continued deterioration means that they had already been observing financial parameters weaken for Ameren. This is a situation that had already been developing, and not caused, as Mr. Fetter would have the Commission believe, by the Staff's complaint. Standard and Poor's also cites lower forward energy prices, additional financing requirements and higher operating expenses as reasons for its negative outlook. One of the most recent Standard and Poor's, Ratings Direct releases states:

> **Summary Ameren Corp.**
> **Rationale**
> On April 29, 2002, Standard and Poor's placed its ratings of Ameren Corp. and subsidiaries Union Electric Co. and Central Illinois Public Service Co. on CreditWatch with negative implications. Ameren's generating subsidiary AmerenEnergy Generating Co. was placed on CreditWatch with positive implications.
> At the same time, Standard and Poor's changed the CreditWatch implications on its ratings of AES Corp.'s subsidiary CILCORP Inc. and subsidiary Central Illinois Light Co. (CILCO) to positive from developing.
> These rating actions followed Ameren's announcement that it reached a definitive agreement with AES to acquire CILCORP and its subsidiaries, including CILCO and AES' Medina Valley Cogeneration project, for $1.4 billion. This includes assumption at the closing of about $875 million of debt and $41 million of preferred stock. The $500 million cash portion of the acquisition price is expected to be significantly funded with proceeds from new equity financings by Ameren….
> …When this acquisition is completed, Standard and Poor's expects the corporate credit ratings of Ameren and its subsidiaries to be in the 'A' rating category.

As the release above indicates, just like Fitch, Standard and Poor's did not issue its CreditWatch with negative implications until after Ameren announced its agreement to acquire lower rated CILCORP. Even more significant is that the CreditWatch implications for UE and CIPS went to negative, while the implications for AEGC as well as CILCORP went to positive. In other words, this acquisition has put downward pressure on UE's credit rating for the benefit of AEGC and CILCORP. It is also important to note that the CreditWatch applied to CIPS, which would not be impacted by the Staff's rate reduction complaint case.

The above chronology shows that credit rating agencies have had concerns about the credit quality of Ameren long before the Staff filed its complaint. And, the reasons for those concerns were Ameren's policy to aggressively expand into riskier, unregulated generation operations and Ameren's already deteriorating financial profile. A deteriorating financial profile caused by the activities of non-AmerenUE subsidiaries.

Q. What is the difference between a Rating Outlook and a Credit Watch?

A. Standard and Poor's provides specific definitions for its Rating Outlook and CreditWatch:

> **Rating Outlook** - A standard and Poor's Rating Outlook assesses the potential direction of a long-term credit rating over the intermediate to longer term. In determining a Rating Outlook, consideration is given to any changes in the economic and/or fundamental business conditions. An Outlook is not necessarily a precursor of a rating change or future CreditWatch action.
>
> * Positive means that a rating may be raised.
> * Negative means that a rating may be raised.
> * Stable means that a rating is not likely to change.
> * Developing means a rating may be raised or lowered.
> * N.M. means not meaningful.
>
> **CreditWatch** - CreditWatch highlights the potential direction of a short-term or long-term rating. It focuses on identifiable events and short-term trends that cause ratings to be placed under special surveillance by Standard and Poor's analytical staff. These may include mergers, recapitalizations, voter referendums, regulatory action or anticipated operating developments. Ratings appear on CreditWatch when such an event or a deviation from an expected trend occurs and additional information is necessary to evaluate the current rating. A listing, however, does not mean a rating change is inevitable, and whenever possible, a range of alternative ratings will be shown…The "positive" designation means that a rating may be raised; "negative" means a rating may be lowered; and "developing" means that a rating may be raised, lowered, or affirmed.

The basic difference is that an Outlook is longer term and related to economic and fundamental business conditions. A CreditWatch is based on shorter-term trends and specific events. Standard and Poor's did not put Ameren or AmerenUE on CreditWatch at any time immediately after the Staff filed its complaint, but did put them on CreditWatch immediately after Ameren announced its acquisition of lower rated CILCORP. This indicates Standard and Poor's views the CILCORP acquisition as having a greater potential impact on Ameren and AmerenUE's credit rating than the Staff's complaint.

Response to Mr. Burdette's and Mr. Gorman's rebuttal testimony

Q. Do you have any observations about the methodologies used by the parties in this case to determine the returns on equity that they sponsor?

A. Yes. Mr. Mark Burdette filed testimony on behalf of the Office of the Public Counsel (OPC) and Mr. Michael Gorman filed testimony on behalf of the Missouri Industrial Energy Consumers (MIEC) Group. Previously in this testimony, I cited two Supreme Court cases: *Federal Power Commission et al. v. Hope Gas Company and Verizon Communications Inc. et al. v. Federal Communications Commission et al.* In these cases the Supreme Court has made it clear that it views the results of rate case proceedings to be more important than the methodologies used to develop those results.

Both Mr. Burdette and Mr. Gorman used methodologies that were somewhat different than mine, or AmerenUE witness McShane's. Comparison of the results of these different methodologies, however, is very informative. Among the differences between my methodology and Mr. Burdette's methodology is his use of retention growth. The notable differences between my methodology and Mr. Gorman's methodology is his use of what he believes to be a more representative capital structure as well as return on equity. In addition to comparing the returns for the witnesses in this case, I have included the Regulatory

Research Associates study for the fist quarter of 2002, which includes five regulatory decisions. The comparison is shown in Table 10.

Table 10

	Equity as % Capital	x	ROE	=	Weighted Cost of Eq.	x	Tax Factor	=	Before Tax Weighted Cost of Eq.	+	Weighted Cost of Other Cap	=	Before Tax ROR
McShane EC-2002-1	59.08%		12.50%		7.38%		1.6231		11.99%		2.75%		**14.74%**
Bible EC-2002-1	59.08%		9.41%		5.56%		1.6231		9.02%		2.75%		11.77%
Burdette EC-2002-1	59.08%		9.62%		5.68%		1.6231		9.22%		2.75%		11.97%
Gorman EC-2002-1	51.20%		10.40%		5.33%		1.6231		8.65%		3.34%		11.99%
RRA 1st Qtr 2002	46.15%		10.87%		5.02%		1.6231		8.15%		3.49%		11.64%

What stands out is how close the witnesses before tax rates of return are to each other, with the exception of Ms. McShane. In addition, the witnesses before tax rates of return, with the exception of Ms. McShane, are also very close to the before tax rates of return authorized by other commissions in the Regulatory Research Associates study. In fact, the witnesses before tax rates of return, with the exception of Ms. McShane, and the Regulatory Research Associates study comprise a range of before tax rates of return that differ by only 35 basis points.

By contrast, Ms McShane's before tax rate of return recommendation is 310 basis points higher than the average of the five decisions in the Regulatory Research Associates study and 290 basis points higher than an average which includes the RRA study and the recommendations from the other witnesses in this case. This comparison is shown in Table 11.

Table 11

	Before Tax ROR	McShane Before Tax ROR	Difference
Staff	11.77%	**14.74%**	2.97%
Burdette	11.97%	**14.74%**	2.77%
Gorman	11.99%	**14.74%**	2.75%
RRA	11.64%	**14.74%**	3.10%
	Average		**2.90%**

Historical perspective of rate of return issues decided by the Commission

Q. AmerenUE's witnesses discuss changes that have taken place in both the financial and regulatory arenas, do you have any perspective that you can share in response to their testimony?

A. There is a lot of news in the popular press today about interest rates being at their 30 to 40 year lows. To gain a better perspective on the current financial environment, I decided to look at interest rates when they were at the historical levels we see today, and the corresponding rates of return that were being authorized by this Commission at that time. I looked at utility bond yields as being a good proxy for the cost of capital for utilities. Ms. McShane agrees with me that utility bond yields are a good proxy for the cost of capital for utilities. On page 59 of her testimony she states: "The comparison of a utility's expected return on equity and utility bond yields is a common-sense comparison….Hence, utility bond yields should track changes in the business and financial risks faced by the companies…As a result, changes in utility bond yields should provide a more direct measure of the changes in the return required by utility common equity investors…." On page 75 of her rebuttal testimony, she refers to the history of yields on Mergent's Public Utility Bonds as "clear evidence the cost of capital has not declined since the EARP was first implemented."

I have attached Schedule 9 to this testimony to show the utility bond yields from 1935 to the end of 2001. The graph is from the 2001 edition of the Mergent Public Utility Manual. According to the graph, recent bond yields are seven percent to eight percent. Keeping in mind that the popular press states that interest rates are at 30 to 40 year lows, I looked at that time period in the past. According to the graph, the last time utility bond yields were about seven percent to eight percent was approximately 1969 to 1974. I then researched this Commission’s rate of return decisions from 1969 to 1974. This information is included on Schedule 10 attached to this testimony. Closer scrutiny of this schedule reveals some very interesting insights. I was able to find information on four rate cases filed by Union Electric during 1969 to 1974. The average Commission authorized rate of return for Union Electric was 7.92 percent, and the average cost of capital as measured by "A" rated utility bonds was 8.23 percent. By comparison, my recommended rate of return is 8.31 percent and "A" rated bonds average 7.57 percent for the first four months of 2002. This is shown at Table 12.

Table 12

Company	Case No.	Rate of Return on Net Original Cost Rate Base	Year	Moody's A avg. Util. Bond Yields	Moody's Baa avg. Util. Bond Yields
Union Electric	16,654	7.23%	1969	7.54%	7.93%
	17,107	7.87%	1971	8.16%	8.63%
	17,433	8.15%	1972	7.72%	8.17%
	17,972	8.42%	1974	9.50%	9.84%
	Average	**7.92%**		**8.23%**	
Ameren	EC-2002-1	**8.31%**	2001	**7.48%**	8.03%
		(Staff midpoint)	2002*	**7.57%**	8.16%

*Jan-Apr 2002

In other words, I am recommending a higher rate of return for AmerenUE in this case than the Commission authorized in the past in a similar financial market climate, even though the cost of capital, as measured by utility bond yields is lower.

In addition to data for 1969 to 1974, I also included data for the time period when the cost of capital, as measured by utility bond yields, was at historically high levels. I chose 10 percent as the threshold based on the January 1990 Moody's Bond Record graph at Schedule 11. This graph shows that some utility bond yields exceeded 10 percent during the 1932 to 1933 time period. Utility bond yields did not exceed 10 percent again until approximately 1980 to 1985, according to the graph at Schedule 9. Remembering that Ms. McShane recommended a 10.13 percent rate of return in this case, I averaged the two authorized returns during the 1980 to 1985 time period that were close to hers. These are the two authorized rates of return for Union Electric in 1980 and 1981. The average happened to be the same rate of return as her recommendation, 10.13 percent. I then averaged the two "A" rated average bond yields for those years to approximate the cost of capital for that time period. This is shown at Table 13.

Table 13

Company	Case No.	Rate of Return on Net Original Cost Rate Base	Year	Moody's A avg. Util. Bond Yields	Moody's Baa avg. Util. Bond Yields
Union Electric	ER-80-17	9.52%	1980	13.34%	13.95%
	ER-81-180	10.73%	1981	15.95%	16.60%
	Average	**10.13%**		**14.65%**	
McShane	EC-2002-1	**10.13%**			
Ameren	EC-2002-1	**8.31%**	2001	**7.48%**	8.03%
		(Staff midpoint)	2002*	**7.57%**	8.16%

*Jan-Apr 2002

What is enlightening about this analysis is that it indicates that Ms. McShane is recommending that the Commission authorize a rate of return for AmerenUE that is identical to the average rate of return it authorized Union Electric during a time period when the cost of capital, as measured by the average "A" rated utility bond yield, was nearly twice what it is today.

Q. Why is this historical perspective important?

A. There are two reasons why this historical perspective is important. First, it tells us that the cost of capital and authorized rates of return can be at relatively low levels, and because of changes in economic and financial conditions, the cost of capital and authorized rates of return can go higher. It also tells us that economic and financial conditions can change again, causing the cost of capital and authorized rates of return to decrease. Second, and probably the most important thing this analysis can tell us is, that if we do not recognize that the cost of capital and rates of return can go down as well as up, we run the risk of setting rates at inappropriately high levels. We are at such a point in time now. The cost of capital has gone from historically high levels down to a level much lower than most of us have ever experienced. It is appropriate to authorize rates of return be set at levels commensurate with the current lower cost of capital.

Summary

Q. Please summarize your testimony

A.

1. AmerenUE has made misleading statements since the beginning of this case. It claimed that its parent company's stock price, as well as access to capital, would suffer at the mere announcement of the Staff's complaint, neither has occurred.

2. ***In setting the rate of return, the before tax weighted cost of equity and before tax rate of return are the most important aspects to consider***. On this basis, comparison of the Staff's recommendation to that of recent decisions by other state commissions and recommendations by the OPC and MIEC group witnesses show the ***Staff's recommendation is reasonable***. The **comparison shows AmerenUE's position to be unreasonable.**

3. ***The Supreme Court has decided that it is the rates that are important, not the method used to arrive at them.***

4. Comparison of the Staff's weighted cost of equity, before tax weighted cost of equity and before tax rate of return to those authorized by other regulatory commissions, as published in Regulatory Research associates and Public Utilities Fortnightly, shows that the Staff's recommendation is adequate, if not excessive.

5. AmerenUE's primary rate of return witness, Ms. McShane seeks to mislead the Commission. She criticizes the historical data the Staff uses, but then uses similar historical data herself. She makes numerous adjustments both to the Staff's analysis and her analysis to arrive at her final inflated rate of return result.

6. AmerenUE's other rate of return (cost of capital) witness, Dr. Morin claims the Staff's rate of return recommendation would result in the lowest authorized rate of return by a commission. The Nevada Power Company and Texas-New Mexico cases establish that it is not. He claims the Staff's use of the DCF methodology and historical data is inappropriate. Past Commission precedent and the policy of other regulatory commissions prove him mistaken.

7. AmerenUE's credit rating witness, Mr. Fetter uses scare tactics, claiming California's energy crisis was caused by the decisions of regulators and that the same thing can happen in

Missouri. Unfolding events strongly suggest that manipulation of energy prices by energy companies contributed largely to, and may have caused, the crisis. Mr. Fetter states that it was the removal generation assets from the control of the utilities in California that caused that state's problems. It is the Staff in this case that continues to promote AmerenUE having its own generation assets. Mr. Fetter suggests that the Staff's complaint caused credit agencies to potentially downgrade Ameren's and AmerenUE's credit rating. Chronological events show the credit agencies had concerns about Ameren's and AmerenUE's financial conditions well in advance of the Staff's complaint. Negative credit watches were not issued until after Ameren announced it would acquire lower rated CILCORP.

8. Both the OPC and MIEC group witnesses used methodologies that were different than the Staff's methodology to arrive at a rate of return. Correctly comparing OPC's, MIEC's and the Staff's before tax rate of return with the before tax rates of return authorized by other commissions in the first quarter of 2002, shows a variation of only 34 basis points. In contrast AmerenUE’s recommended before tax rate of return exceeds the average of these rates by approximately 300 basis points, making its recommendation well above that of the other parties in this case.

9. ***An historical perspective on authorized rates of return shows that in the past this Commission has authorized rates of return that are consistent with the rate of return that the Staff recommends in this case, when the cost of capital, as measured by utility bond yields, were at this historically similar and low a level***. The historical perspective also shows that AmerenUE's recommended rate of return in this case is consistent with rates of return authorized by this Commission when the cost of capital, as measured utility bond yields, has been twice as high as it is now.

10. The Staff's recommended return on equity and rate of return is the logical and correct choice for the Commission in this case. When correctly compared on a before tax basis, the Staff's recommendation lies between the recommendations by the OPC and MIEC group witnesses, and the decisions made by other regulatory commissions as of the first quarter for 2002. AmerenUE's recommendation exceeds these recommendations and decisions by approximately 300 basis points.

Q. Does this conclude your testimony?

A. Yes.