

Exhibit No.:
Issue(s): Return on Equity
Witness: Julie M. Cannell
Sponsoring Party: Union Electric Company
Type of Exhibit: Surrebuttal Testimony
Case No.: ER-2010-0036
Date Testimony Prepared: March 5, 2010

MISSOURI PUBLIC SERVICE COMMISSION

Case No. ER-2010-0036

SURREBUTTAL TESTIMONY

OF

JULIE M. CANNELL

ON

BEHALF OF

**UNION ELECTRIC COMPANY
d/b/a AmerenUE**

**St. Louis, Missouri
March 5, 2010**

SURREBUTTAL TESTIMONY

OF

JULIE M. CANNELL

CASE NO. ER-2010-0036

1 **Q. Please state your name, employer, and business address.**

2 A. My name is Julie M. Cannell. I am the president of my own advisory firm,
3 J.M. Cannell, Inc. My business address is P.O. Box 199, Purchase, NY 10577.

4 **Q. Are you the same Julie M. Cannell who filed rebuttal testimony and**
5 **additional rebuttal testimony regarding the fuel adjustment clause in this case?**

6 A. Yes, I am.

7 **Q. What is the purpose of your surrebuttal testimony?**

8 A. The purpose of my surrebuttal testimony is to respond to portions of the rebuttal
9 testimony of Missouri Public Service Commission (“PSC” or “Commission”) Staff witness
10 David Murray.

11 **Q. Does Mr. Murray rely on reports authored by financial analysts in his**
12 **rebuttal testimony?**

13 A. Yes, he does.

14 **Q. In your opinion, does Mr. Murray properly utilize the analyses contained in**
15 **those reports in reaching his recommendation for Union Electric Company’s**
16 **(“AmerenUE” or “Company”) return on common equity (“ROE”)?**

17 A. No, I don’t believe he does. As he did in his direct testimony, Mr. Murray
18 references the analytical methodology contained in investor reports, incorrectly pointing to some

1 of the elements and assumptions in the analysts' models as representing their required return on
2 equity.

3 **Q. Please elaborate.**

4 A. In his rebuttal testimony, Mr. Murray points to a recent Goldman Sachs report and
5 the authors' baseline price/earnings ("P/E") assumption for valuing regulated utilities. He
6 averred that because this P/E figure was higher than the P/E assumption incorporated by the
7 analysts in early summer 2009 but the same as had been used by them in March 2008, that this
8 implied "a cost of equity that is similar or possibly even lower than that which was estimated in
9 March 2008."¹

10 **Q. What is incorrect about Mr. Murray's conclusion?**

11 A. My rebuttal testimony addressed Mr. Murray's referencing the cost of equity
12 discount rates incorporated in investor reports as support for his lower ROE proposal. I noted
13 that this was an incorrect comparison on his part, as the discount rate in a dividend discount
14 model is a valuation tool, used for stock selection. The argument made in his rebuttal testimony,
15 which is based on P/E assumptions by the analysts, is similarly off the mark. As is the case of a
16 discount rate in a dividend discount model, investors use P/E ratios to value common stocks.
17 These ratios do not reflect their required return on equity for a utility investment.

18 **Q. Please explain why a P/E ratio does not represent the cost of equity.**

19 A. The P/E ratio is the multiple of earnings at which a stock is expected to sell. The
20 earnings figure used in this ratio is the company's financial earnings: either the actual historic
21 financial earnings of the company or the investor's projection of future financial earnings at a
22 specific point in time (e.g., the current year or the next year). These are the earnings either the

¹ Rebuttal testimony of David Murray at 26.

1 company has earned or what the analyst expects the company to earn, and are the earnings that
2 are publicly reported. These actual, financial earnings over a particular period of time do not
3 reflect normalizations or annualizations that are a standard part of the ratemaking process, and
4 they certainly do not reflect the investor's required return for an investment. To take an extreme
5 example, let's assume that, for a variety of reasons, a company's earnings are expected to be zero
6 or negative one year. That does not mean that the investor's required return on his equity
7 investment is similarly zero or a negative number. In other words, the expected return as related
8 to financial earnings is not equal to what the authorized return on common equity as established
9 in a regulatory proceeding should be. A related point is that the P/E ratio is connected with the
10 common stock of a company, not with that company's subsidiaries. In the case of Ameren
11 Corporation, the P/E applies to the corporation's publicly traded common stock, not to
12 AmerenUE.

13 **Q. As a practicing investor, did you use P/E ratios in your work? If so, how?**

14 A. I used P/E ratios frequently in relation to my responsibilities as a utility securities
15 analyst and portfolio manager. These ratios were one means I had of assessing whether an
16 existing or potential stock investment was undervalued, fairly valued, or overvalued in relation to
17 other available investment choice.

18 **Q. Specific to your previous utility investment responsibilities, in any analysis**
19 **you performed involving P/E ratios, were those ratios ever synonymous with your required**
20 **return for a utility operating company?**

21 A. No. My use of P/E ratios consistently related to stock valuation and the expected
22 performance of a stock. In no way did such ratios relate to fair, required equity returns.

1 **Q. Please summarize why a P/E ratio, as pointed to by Mr. Murray, does not**
2 **reflect an investor's required return on equity.**

3 A. Investors have a wide range of investment choices available to them. They must
4 determine how attractive one investment is relative to another. This determination can be made
5 through a variety of means, including utilization of P/E ratios. A P/E ratio represents the
6 magnitude by which the common stock price is expected to sell compared to the company's
7 historic or expected financial earnings. In short, this ratio is a valuation tool used by investors.
8 It is not an indicator of the required, fair return on a utility's common equity, which is
9 established through consideration of various methodologies and attendant factors in rate cases.

10 **Q. Does this conclude your surrebuttal testimony?**

11 A. Yes, it does.

In the Matter of Union Electric Company d/b/a AmerenUE's Tariffs to Increase its Annual Revenues for Electric Service.) Case No. ER-2010-0036
) Tracking No. YE-2010-0054
) Tracking No. YE-2010-0055

STATE OF NEW YORK)
) ss
CITY OF PURCHASE)

1. My name is Julie M. Cannell. I work in Purchase, New York, and I am the President of my own advisory firm, J.M. Cannell, Inc.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Julie M. Cannell

Subscribed and sworn to before me this 4th day of ~~May~~ March, 2010.

Rosemary K. Cook
Notary Public

~~My commission expires:~~ My commission expires on November 17, 2016

