

305

EXHIBIT

Exhibit No.:
Issue: Rate of Return
Witness: Daniel J. Lawton
Type of Exhibit: Rebuttal
Sponsoring Party: OPC
Case No: ER-2010-0036
Date Prepared: February 11, 2010

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

§
In the Matter of Union Electric Company , §
d/b/a Ameren UE's Tariffs to Increase its annual § Case No. ER-2010-0036
Revenues for Electric Service §
§

**Rebuttal Testimony
of
Daniel J. Lawton**

On behalf of

Missouri Office of the Public Counsel

February 11, 2010

Public Counsel
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Date _____ Reporter _____
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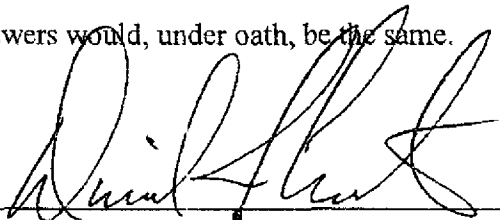
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AFFIDAVIT OF DANIEL J. LAWTON
FOR CASE NO. ER-2010-0036

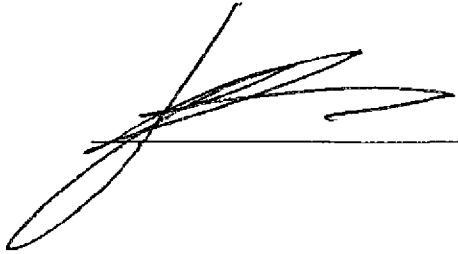
STATE OF TEXAS §

COUNTY OF TRAVIS §

Daniel J. Lawton, being duly sworn on oath, says that he is the person identified in the foregoing prepared rebuttal testimony and exhibits; and that such testimony was prepared by or under the direct supervision of said person; that such answers and/or information appearing therein are true and correct to the best of his knowledge and belief; and if asked the questions appearing therein, his answers would, under oath, be the same.


Daniel J. Lawton

Subscribed and Sworn to before me on this 11th day of February, 2010.





My Commission Expires 5-21-2013

REBUTTAL TESTIMONY OF

DANIEL J. LAWTON

CASE NO. ER-2010-0036

1 **Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Daniel J. Lawton. My business address is 701 Brazos, Suite 500, Austin,
3 Texas, 78701.

4 **Q2. ARE YOU THE SAME DANIEL J. LAWTON WHO PREVIOUSLY FILED**
5 **DIRECT TESTIMONY IN THIS PROCEEDING ON OR ABOUT DECEMBER**
6 **18, 2009?**

7 A. Yes, I am.

8 **Q3. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

9 A. The purpose of this testimony, in the rebuttal phase of these proceedings, is to address the
10 direct testimony of Union Electric Company d/b/a AmerenUE ("Company" or "Ameren")
11 witness, Dr. Roger Morin's, cost of capital recommendation in this proceeding, which
12 was filed on or about July 24, 2009. In addition, I will address other Company testimony
13 related to rate of return and/or financial risks and metrics.

14 **Q4. BEFORE ADDRESSING DR. MORIN'S SPECIFIC COST OF CAPITAL**
15 **ANALYSES AND RECOMMENDATIONS, DO YOU HAVE ANY GENERAL**
16 **COMMENTS?**

17 A. Yes. First, Dr. Morin's recommended 11.5% equity return is outdated and overstated
18 with the passage of time since his July 2009 direct testimony filing. Moreover, Dr.
19 Morin's recommendation of an 11.5% return on equity, which is driven in large measure
20 by his discounted cash flow ("DCF") results of 12% to 12.5%, is so extreme relative to
21 the equity returns currently being granted by regulatory authorities; little, if any,

1 consideration should be afforded his analysis. I would expect that Dr. Morin would
2 update his original analysis, which should show a much lower equity return is justified in
3 this proceeding. I should point out that Dr. Morin's DCF analyses indicating a 12% -
4 12.5% equity return are at the extreme high end when originally presented in July 2009.
5 Even though I expect an updated analysis to be provided, I will address a few general
6 issues regarding Dr. Morin's Capital Asset Pricing Model ("CAPM"), Historical Risk
7 Premium ("RP") and Discount Cash Flow ("DCF") analyses.

8 **Q5. IN LIGHT OF CURRENT ECONOMIC CONDITIONS AND IMPACTS FROM**
9 **THE RECESSION HAVE REGULATORS BEEN AUTHORIZING HIGHER**
10 **EQUITY RETURNS?**

11 A. No, my experience is that lower equity returns are being granted by regulatory
12 authorities. There is no question that the recent financial crisis has spared few in its
13 devastating impacts. Moreover, the impacts of the economic recession have greatly
14 stressed business conditions and consumer economics. For business, including utilities,
15 demand has declined and many pressing capital projects have been put off to the future
16 periods where demand is expected to bounce back. Many consumers are dealing with
17 record levels of unemployment, home foreclosures, the loss or serious erosion of
18 retirement accounts and/or life savings. These conditions are not the ideal for increasing
19 consumer electric rates.

20 In two recent cases decided in the past two months by the Florida Public Service
21 Commission, in both of which I submitted testimony on financial integrity and cash flow
22 issues, the regulator denied most, or all, of the requested rate increase and set authorized
23 equity returns at between 10% and 10.5%. For example, in Docket Nos. 080677-EI and
24 090130-EI, Florida Power & Light Company requested an annual base rate increase of
25 \$1.250 billion with an equity return midpoint of 12.5%. The Florida Commission
26 recently rejected the request and authorized a \$75 million increase, about 6% of the
27 original increase request, and adjusted the equity return request to a 10.0% equity return.

28 In Docket No. 090079-EI, Florida Progress requested approximately a \$500 million

1 annual base rate increase with a 12.50% equity return. The Florida Commission denied
2 the entirety of the \$500 million annual base rate increase and set the equity return at
3 10.5%.

4 **Q6. YOU HAVE DESCRIBED TWO RECENT CASES WEHRE THE REGULATOR**
5 **HAS RECENTLY ESSENTIALLY DENIED RATE INCREASES AND SET**
6 **EQUITY RETURNS AT 10.0% TO 10.5% - DID THESE COMPANIES HAVE**
7 **LARGE CAPITAL EXPENDITURE PROGRAMS SIMILAR TO THE LEVELS**
8 **CLAIMED BY AMEREN IN THIS PROCEEDING?**

9 A. Yes. Both Florida utilities discussed above proposed enormous capital expenditure
10 programs involving infrastructure issues and the construction of nuclear power facilities.
11 Their construction programs are on a much larger scale than that proposed by Ameren.

12 **Q7. SHOULD THIS COMMISSION CONSIDER THESE RECENT FLORIDA**
13 **DECISIONS IN SETTING RATES IN THIS CASE?**

14 A. At page 57:17 through page 59:2, Dr. Morin discusses “zone of reasonableness”
15 considerations employed by this Commission when evaluating and considering equity
16 return recommendations. Thus, to the extent consideration or weight is given to other
17 regulatory authority decisions, I would recommend serious consideration of the recent
18 Florida cases described above. Both these Florida utilities are included in my comparable
19 group analysis as well as Dr. Morin’s comparable group and, like Ameren, are vertically
20 integrated electric companies. Thus, Dr. Morin’s concerns of comparing to a “wires
21 only” company are addressed.¹ Moreover, these Florida decisions are very recent and
22 reflect the current impact of the ongoing economic and financial market conditions.

23 Employing a 100 basis point band or range against the 10.25% average (10% and 10.5%)
24 of the recent Florida decisions would indicate Dr. Morin’s outdated and overstated 11.5%
25 is outside the zone of reasonableness, but Missouri Staff and interveners’ most current
26 recommendations are within the updated zone of reasonableness.

¹ Dr. Roger Morin direct testimony at 58:13.

1 **Q8. DO YOU HAVE ANY COMMENTS REGARDING DR. MORIN'S DCF MODEL?**

2 A. Yes. As noted earlier, Dr. Morin's DCF results are outdated and overstated with the
3 passage of time. I expect Dr. Morin will cure this problem with an update of his analysis.
4 In addition, I do have comments with regard to Dr. Morin's dividend yield and growth
5 rate assumptions.

6 **Q9. WHAT COMMENTS DO YOU HAVE WITH REGARD TO DR. MORIN'S**
7 **DIVIDEND YIELD CALCULATION FOR THE DCF?**

8 A. First, Dr. Morin employs spot prices for his dividend yield calculation (see Dr. Morin
9 direct at 48:3-12), while I employed a recent six week average price. I explained in my
10 direct testimony why a spot price may distort and bias the yield analysis. Had I
11 employed spot prices rather than a six-week average, my dividend yield recommendation
12 would have been lower.

13 **Q10. DO YOU HAVE ANY COMMENTS REGARDING DR. MORIN'S**
14 **APPLICATION OF THE FULL GROWTH RATE TO ARRIVE AT EXPECTED**
15 **DIVIDENDS AND DIVIDEND YIELD AS HE DISCUSSES AT PAGE 47:21**
16 **THROUGH PAGE 48:2 OF HIS DIRECT TESTIMONY?**

17 A. Yes, his analysis will result in overstating the expected dividend yield by one-half the
18 growth rate. The proper analysis is to calculate the expected dividend by increasing the
19 current dividend by one-half the growth rate. The goal is to capture an estimate of next
20 year's dividend, as an investor who is purchasing shares of stock will factor into his
21 purchase decisions the expected dividend he will receive. When I calculated the dividend
22 yield for the DCF analysis in this case, as shown in my direct testimony at
23 Exhibit_Schedule (DJI-6), I could have employed the Value Line estimated 2010
24 dividend (next year's dividend) or increase the current dividend by one half the growth
25 rate. Dr. Morin's approach overstates the dividend yield by one-half the growth rate.

26

1 **Q11. DO YOU HAVE ANY COMMENTS ON DR. MORIN'S GROWTH RATE**
2 **CALCULATION?**

3 A. The major comment I would have is that this growth analysis needs to be updated. Dr.
4 Morin employed Value Line and Zacks growth rates in his study. I also employed, albeit
5 more current forecasts of, Zacks and Value Line growth estimates along with consensus
6 estimates from Thomson or Yahoo Finance. Thus, there is not disagreement as to
7 employing earnings per share forecasts for the DCF model.

8 **Q12. AT PAGE 51:14 THROUGH PAGE 55:15 OF DR. MORIN'S DIRECT**
9 **TESTIMONY, HE DISCUSSES THE NEED FOR A FLOTATION COST**
10 **ADJUSTMENT; DO YOU HAVE ANY COMMENTS?**

11 A. Yes, I have a number of comments. In my opinion, Dr. Morin's proposed 30 basis point
12 upward adjustment for "claimed" flotation costs should be rejected. If there are any
13 flotation costs then those flotation expenses should be presented and requested in cost of
14 service, just like any other cost requested by the Company. To include a 30 basis point
15 adjustment as compensatory for assumed, or unidentified, flotation costs is not sound
16 ratemaking.

17 The Company has not identified a single dollar of flotation expense incurred during the
18 test year – yet the Company requests 30 basis points on equity or about \$13,127,000 in
19 higher revenue requirements to cover this claimed and un-quantified cost. Regulatory
20 authorities, which I am familiar with, do not allow utility companies to inflate equity
21 return for unknown and un-quantified flotation expenses.

22 I would urge the Commission to reject a flotation cost adjustment for equity return.

23 **Q13. DO YOU HAVE ANY COMMENTS ON DR. MORIN'S CAPM AND ECAPM**
24 **ESTIMATES?**

25 A. Yes. Dr. Morin's original CAPM and ECAPM were a 9.3% to 9.7% equity return. These
26 are Dr. Morin's original estimates without a 30 basis point adjustment for phantom

1 flotation expenses. A review of current market rates indicate Dr. Morin's CAPM and
2 ECAPM results would be about the same 9.3% to 9.7% estimates.

3 **Q14. THERE HAS BEEN A GREAT DEAL OF DISCUSSION IN THIS CASE**
4 **CONCERNING THE FINANCIAL METRIC FREE CASH FLOW AND**
5 **NEGATIVE FREE CASH FLOW. DO YOU HAVE ANY GENERAL**
6 **COMMENTS ON THIS MATTER?**

7 A. Yes. First, it is important to understand what free cash flow is and what exactly is being
8 measured. Simply, free cash flow is net income plus amortization and depreciation less
9 changes in working capital less capital expenditures.

10 A firm with a large capital expansion program will often have a negative free cash flow
11 measure.

12 **Q15. DOES A HIGH VALUE OF FREE CASH FLOW METRIC INDICATE**
13 **FINANCIAL STRENGTH?**

14 A. Not always, higher values can sometimes indicate problems and weakness rather than
15 strength. As an example, a company with high levels of free cash flow may be serving a
16 low growth or declining market where it has minimal investment needs and declining or
17 no investment prospects. On the other hand, growth companies will often exhibit thin or
18 negative free cash flow because added investment is required to support growth.

19 A review of the low growth company financials will indicate that high free cash flow
20 might not be sustainable, while the high growth company with low or negative free cash
21 flow will have enhanced financial metrics once the current investment levels begin
22 yielding cash returns.

23 The bottom-line is that interpretation of free cash flow or negative free cash flow ratios is
24 not simple and straightforward. The above examples demonstrate that there is no simple
25 correlation between a company's credit worthiness and the current level of free cash
26 flow. There are numerous underlying considerations behind the numbers and particular

1 facts and circumstances.

2 **Q16. IS NEGATIVE FREE CASH FLOW A NEW OR UNEXPECTED OCCURANCE**
3 **IN THE UTILITY INDUSTRY?**

4 A. Negative free cash flow isn't new or unexpected in the electric industry. A "...June 2009
5 Edison Electric Institute (EEI) survey,...estimates shareholder owned electric utility
6 capex will reach \$84.2 billion in 2009, \$84.8 billion in 2010, \$86.6 billion in 2011."²
7 Such levels of capital expenditures are likely to lead to negative free cash flow. The
8 electric industry has been in a negative pre-dividend free cash flow position since 2007
9 and the trend continues.³ Thus, any claims by Ameren that negative free cash flow is
10 suddenly a problem are just not accurate. Instead, negative free cash flow reflects large
11 investment that will be funded by borrowings, equity and internally generated capital.

12 **Q17. CAN DR. MORIN'S EXTREME EQUITY RETURN RECOMMENDATION BE**
13 **EXPLAINED BY HIGHER SPECIFIC RISKS IMPACTING AMERENUE?**

14 A. Not in my opinion. I have found no basis to conclude that the Company should receive
15 an upward adjustment in equity return because of specific or unique risk factors relative
16 to the industry.

17 **Q18. HAVE YOU REVIEWED THE COMPANY'S CLAIM REGARDING UNIQUE**
18 **REGULATORY LAG IN MISSOURI?**

19 A. Yes, I have reviewed the Company's claim and do not agree with the higher risk
20 conclusion. Regulatory lag, under their definition, can be defined as the time between a
21 rate case filing and a decision by the regulatory authority – regulatory lag represents the
22 time period between when the utility requests a change in rates and the new rate.

23 As I understand the Company's testimony regarding interim rates, the Company asserted

² Edison Electric Institute, *Electric Perspectives* September/October 2009 at 84.

³ *Id.*

1 a regulatory lag in Missouri of 11 months.⁴ The average regulatory lag (period between
2 rate request and rate decision) in the electric industry is about 10 months. Thus, Missouri
3 regulation is certainly consistent with rate review and processing periods found around
4 the country.⁵

5 I would also point out, based on my understanding of the true-up process as used in
6 Missouri; it significantly impacts any asserted regulatory lag. The true-up period in this
7 case is through January 31, 2010. Thus, the revenue requirement will be based on actual
8 data as of a date that is less than five months prior to the operation of law date.

9 **Q19. DOES THIS CONCLUDE YOUR TESTIMONY?**

10 A. Yes.

⁴ Direct testimony on Interim Rates of Warren L. Baxter, at 5:13-14, October 2009

⁵ Edison Electric Institute Financial Update Quarter 4, 2009