Exhibit No.:	
Issues:	Revenue Requirement and Missouri Regulatory Framework
Witness:	Michael P. Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Missouri Industrial Energy Consumers
Case No.:	ER-2012-0166
Date Testimony Prepared:	September 7, 2012

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

	)	
In the Matter of Union Electric Company,	)	**Case No. ER-2012-0166**
d/b/a Ameren Missouri's Tariff to Increase	)	Tariff No. YE-2012-0370
Its Annual Revenues for Electric Service	)	
	)	

Surrebuttal Testimony of

Michael P. Gorman

Revenue Requirement

On behalf of

Missouri Industrial Energy Consumers

September 7, 2012

BAI
BRUBAKER & ASSOCIATES, INC.

Project 9553

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company, d/b/a Ameren Missouri's Tariff to Increase Its Annual Revenues for Electric Service	)	**Case No. ER-2012-0166** Tariff No. YE-2012-0370

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

Affidavit of Michael P. Gorman

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

1. My name is Michael P. Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. ER-2012-0166.

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

Michael P. Gorman

Subscribed and sworn to before me this 6th day of September, 2012.

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2013
Commission # 09706793

Notary Public

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OF THE STATE OF MISSOURI

In the Matter of Union Electric Company, d/b/a Ameren Missouri's Tariff to Increase Its Annual Revenues for Electric Service	)))))	**Case No. ER-2012-0166** Tariff No. YE-2012-0370

Surrebuttal Testimony of Michael P. Gorman

1 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**
2 A Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,
3 Chesterfield, MO 63017.

4 **Q WHAT IS YOUR OCCUPATION?**
5 A I am a consultant in the field of public utility regulation and a Managing Principal of
6 Brubaker & Associates, Inc., energy, economic and regulatory consultants.

7 **Q ARE YOU THE SAME MICHAEL P. GORMAN WHO FILED TESTIMONY EARLIER**
8 **IN THIS PROCEEDING?**
9 A Yes.

10 **Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**
11 A I will respond to the rebuttal testimony of Ameren Missouri (or "Company") witnesses
12 Robert Hevert and John Reed.

1 <u>**Response to Ameren Missouri Witness Robert Hevert**</u>

2 **Q DID MR. HEVERT COMMENT ON THE USE OF OBSERVABLE UTILITY BOND**
3 **YIELDS AND DECLINING CAPITAL MARKET COSTS?**

4 A Yes. At pages 70 and 71 of Mr. Hevert's rebuttal testimony, he states that he does
5 not agree that declines in observable utility bond yields and capital market costs are
6 evidence that Ameren Missouri's cost of common equity has declined in this case
7 relative to its last rate case. In support of this assertion, he maintains that common
8 equity returns do not always move in line with changes to interest rates, because
9 equity risk premiums can go up as bond yields decline.

10 **Q PLEASE RESPOND.**

11 A Mr. Hevert is simply ignoring relevant concrete market evidence that capital market
12 costs have declined. In his testimony, Mr. Hevert supports the use of an inverse
13 relationship between equity risk premiums and interest rates. This would support a
14 lower equity cost as interest rates decline, albeit equity costs would not decline as
15 much as debt costs. I am not aware of (and Mr. Hevert has not offered) any
16 academic study or other evidence which suggests that equity costs would not decline
17 with significant declines to utility bond yields. Hence, Mr. Hevert may legitimately
18 argue that equity costs have not decreased as much as bond yields since Ameren
19 Missouri's last rate case, but it simply is not credible for him to argue, as he has, that
20 equity costs have stayed flat or increased while utility bond yields have declined.
21 Mr. Hevert's arguments are simply without merit.

1 **Q DID MR. HEVERT OBJECT TO YOUR STATEMENT THAT UTILITY**
2 **INVESTMENTS ARE "SAFE HAVEN" INVESTMENTS?**
3 A Yes. At page 71 of Mr. Hevert's rebuttal testimony, he takes issue with the quotes
4 from EEI and credit rating agencies regarding electric utilities' credit outlooks and low
5 risk profile. There he states that credit rating agencies' credit outlooks are not
6 optimistic for improved credit performance or lower financial risk for electric utility
7 companies.

8 **Q PLEASE RESPOND.**
9 A Mr. Hevert is ignoring clear statements from market participants (i.e., credit analysts
10 and security analysts). Contrary to Mr. Hevert's testimony, I did not represent (nor is
11 it necessary) that credit analysts state that utility credit outlooks are improving, or that
12 their financial risk is decreasing. Rather, my testimony observes that credit rating
13 agencies advised the markets that the credit outlook for electric utility companies is
14 stable, and the industry is a low risk investment option. A stable credit outlook during
15 periods of economic distress is an indication of sound fundamental principles
16 underlying the utility industry. Further, *Value Line* and other market participants state
17 support for the utility industry:

18 **Conclusion**

19 With most of 2011 completed, it seems almost certain that electric
20 utility stocks will have outperformed the broader market averages
21 when the year is over. As of mid-December, the Value Line Utility
22 Average is up slightly, while the Value Line Geometric Average is
23 down about 14%. Electric utility stocks have long been viewed as a
24 safe haven in volatile markets, due in large part to their generous
25 dividend yields. However, many of these issues are now trading within

1 their 2014-2016 Target Price Ranges. This is often an indication that
2 they have become expensively priced.[1]

3 Utility security valuations are in strong demand (robust valuations) and utilities
4 are safe, low risk investments.

5 **Q DID MR. HEVERT COMMENT ON YOUR CONCLUSIONS RELATED TO THE**
6 **VALUATION OF ELECTRIC UTILITY STOCKS?**

7 A Yes. At pages 74 and 75 of his rebuttal testimony, Mr. Hevert takes issue with
8 whether or not the valuation measures for price-to-earnings ratio and price-to-cash-
9 flow ratios suggest that stock valuations for the proxy group are robust. Further, he
10 states that the valuation measures historically have been supported by authorized
11 returns on equity which have averaged around 10.5%.

12 **Q DO MR. HEVERT'S COMMENTS CONCERNING UTILITY STOCK VALUATIONS**
13 **CHANGE YOUR RECOMMENDATIONS AND FINDINGS IN THIS PROCEEDING?**

14 A No. My observations of utility valuations suggest that again during these difficult
15 economic times utility bond yields have been low relative to historical periods and
16 utility stock prices have been relatively high. This robust market for utility securities is
17 clear evidence that utility capital costs are low today.

18 I would also note that Mr. Hevert mischaracterizes my analysis when he
19 suggests that my return on equity recommendations were tied to the price-to-earnings
20 ratio and price-to-cash-flow ratios discussed in my direct testimony. That assertion is
21 simply false.

[1] *Value Line Investment Survey*, "Electric Utility (Central) Industry," December 23, 2011, emphasis added.

1 Rather, my return on equity recommendations are based on my cost of equity
2 studies including discounted cash flows, risk premium studies, and capital asset
3 pricing model studies. While valuation of utility stock impacts the results of these
4 models, the actual return on equity estimate was based on the DCF and risk premium
5 models, and not my observation of utility valuation factors. For these reasons,
6 Mr. Hevert simply mischaracterizes my study and the support for my return on equity
7 recommendations.

8 **Q DID MR. HEVERT RESPOND TO YOUR CONSTANT GROWTH DCF STUDY AND**
9 **PROVIDE UPDATED ESTIMATES?**

10 A Yes. At pages 78 and 79 of his rebuttal testimony, Mr. Hevert offered a four-step
11 adjustment to my constant growth DCF analysis. Importantly, his adjustment to my
12 analysis really ended after his Step 2. His Step 3 and Step 4 included revising my
13 proxy group, to use his proxy group, and to manipulate the results of his own updated
14 constant growth DCF analysis to increase the return estimate.

15 As shown in his Table 12 at page 79 of his rebuttal testimony, Mr. Hevert's
16 Step 1 actually produced DCF results lower than my results offered in my direct
17 testimony. In his Step 2, he revised my consensus analysts' growth rate estimates,
18 for a single analyst growth rate estimate (*Value Line*) and an alternative consensus
19 analysts' growth rate estimate produced by First Call. His Step 1 and 2 adjustments
20 changed my proxy group median and average return estimates to 9.58% and 9.73%,
21 respectively.

22 In his third step, Mr. Hevert included Empire District ("EDE") in the proxy
23 group. Including EDE in the proxy group increased the median and average return
24 estimates to 9.90% and 9.92%, respectively. I do not agree it is appropriate to

1 include EDE in the proxy group because EDE eliminated its dividend in 2011, and just
2 recently restored paying a dividend. EDE eliminated its dividend payment due to a
3 need to retain cash to allow it to recover from the devastating tornado damage to its
4 service territory which occurred a little more than a year ago. Because of this tragic
5 event and the suspension of its dividend, EDE is not appropriate to include in the
6 proxy group for Ameren Missouri at this time.

7 Finally, Mr. Hevert's last step was to exclude certain return on equity
8 estimates which he characterized as "outliers." Excluding these estimates had the
9 effect of increasing the return on equity estimates produced in his Step 3.

10 Mr. Hevert's Step 4, by excluding low group estimates, was not shown to be
11 reasonable because it is not clear whether or not he should have also excluded
12 outlier high estimates from his study. Hence, Mr. Hevert's Step 4 is simply
13 uncorroborated and does not show his updated DCF studies were not manipulated.

14 Indeed, if Mr. Hevert had concerns about certain companies of the proxy
15 group having outlier results, then his median estimate produced in Step 3 would have
16 produced a more reliable estimate of the central tendency of the proxy group.
17 However, as shown in the results of his Step 3, the proxy group average and median
18 were approximately the same. This is an indication that outliers were not significantly
19 impacting the proxy group average estimate. Mr. Hevert's proposal to exclude low
20 estimates, however, did make a significant impact and unjustly raised the proxy group
21 DCF return.

1 **Q WHAT DO THE UPDATED CONSTANT GROWTH DCF ESTIMATES SHOWN AT**
2 **PAGE 79 OF MR. HEVERT'S REBUTTAL TESTIMONY SUGGEST CONCERNING**
3 **AMEREN MISSOURI'S COST OF EQUITY IN THIS CASE?**

4 A My constant growth DCF analysis indicated a fair return on equity for Ameren
5 Missouri in the range of 9.3% to 9.9%. Using Mr. Hevert's first three steps (excluding
6 his self-serving low outlier estimate exclusion) indicates that a fair return on equity is
7 approximately 9.9%. I would note, that these results are based on my proxy group
8 and consensus analysts' growth rate estimates produced by Zacks, SNL Financial
9 and Reuters. Mr. Hevert's revised constant growth DCF analysis using growth rate
10 estimates from First Call and *Value Line* clearly indicates that a return on equity for
11 Ameren Missouri is in the range of 9.3% to 9.9%.

12 **Q DID MR. HEVERT OFFER ANY COMMENTS CONCERNING YOUR**
13 **SUSTAINABLE GROWTH DCF ANALYSIS?**

14 A Yes. He believes that the model is not valid, because it is predominantly based on
15 changing earnings growth derived by changes in the earnings retention ratio. He is
16 also critical of the model because it requires an estimate of the earned return on
17 equity in order to produce a future growth rate estimate.

18 **Q PLEASE RESPOND TO MR. HEVERT'S CRITICISM OF THE SUSTAINABLE**
19 **GROWTH DCF MODEL.**

20 A The sustainable growth DCF model is a widely accepted academic model. However,
21 like all economic structures, the sustainable growth DCF model's reliability is only as
22 good as the data used in the model. In my analysis, I used projected data by *Value*
23 *Line*. Hence, earnings retentions and earned returns on book equity for publicly

1 traded parent companies are all based on *Value Line* projections of the economic
2 parameters for those companies. These projected outlooks by *Value Line* are data
3 typically used by security analysts to project growth rate estimates.

4 The basic parameters of the sustainable growth DCF model are quite simple.
5 That is, the utility's earnings will increase as its invested capital or rate base
6 increases. There is an intuitive simplicity to this model, which makes it particularly
7 useful in producing a common sense outlook on what future earnings for a utility can
8 be. Indeed, the Edison Electric Institute ("EEI") advised investors about growth using
9 the simple logic of a sustainable growth DCF. EEI's highlights of utility stock
10 investments include the following:

11 Industry business fundamentals remain reasonably healthy and
12 analysts continue to expect mid-single-digit earnings growth for many
13 utilities driven by sizeable ongoing capital investment programs.[2]

14 As noted by EEI, earnings growth outlooks for utilities are related to invested
15 capital, which fuels rate base growth, and in turn earnings growth. The sustainable
16 growth DCF model produces growth rate estimates based on these very basic
17 transparent fundamental earnings parameters. That is, capital expenditures and rate
18 base growth are funded in part by retained earnings which expand book value per
19 share and future earnings per share.

20 Further, and importantly, Mr. Hevert's criticism of my sustainable growth DCF
21 model largely repudiates the construct of his own multi-stage growth DCF model. In
22 his multi-stage DCF model, Mr. Hevert projects earnings growth, and develops
23 dividend projections based on target dividend payout ratios. His assumption on the
24 payout ratio is that it will eventually converge to a long-term steady-state dividend

[2] EEI Q2 2012 Financial Update, "Stock Performance" at 1.

1 payout ratio. The fundamental construct of Mr. Hevert's multi-stage DCF model is the
2 sustainable growth model.

3 **Q DID MR. HEVERT COMMENT ON YOUR MULTI-STAGE GROWTH DCF MODEL?**
4 A Yes. He took several issues with the development of my multi-stage growth DCF
5 model. Those include the following:
6 1. Use of a year-end cash flow convention,
7 2. Assuming a long-term steady stage begins in Year 11, and
8 3. My GDP growth rate.

9 **Q PLEASE DESCRIBE MR. HEVERT'S CRITICISMS OF YOUR MULTI-STAGE**
10 **GROWTH DCF MODEL CONCERNING THE YEAR-END CASH FLOW**
11 **ASSUMPTION.**
12 A Mr. Hevert properly recognized that utilities pay dividends on a quarterly basis, not an
13 end-of-year basis. Therefore, he believes I have understated the value of the DCF
14 return estimates by using annual dividends rather than quarterly dividends. He also
15 attempts to support his flawed method for recognizing dividend payments in his own
16 multi-stage growth DCF model.

17 **Q DOES A QUARTERLY COMPOUNDING DCF MODEL PRODUCE A FAIR RETURN**
18 **ON EQUITY ESTIMATE FOR AMEREN MISSOURI?**
19 A No.

1 **Q MR. HEVERT ALSO SUPPORTS HIS PREFERRED METHOD FOR REFLECTING**
2 **QUARTERLY DIVIDENDS IN A MULTI-STAGE GROWTH DCF MODEL. PLEASE**
3 **RESPOND.**
4 A At pages 85 through 87 of his rebuttal testimony, Mr. Hevert goes through an
5 explanation of why his multi-stage growth DCF analysis reflects quarterly dividend
6 payments. However, in effect, Mr. Hevert is simply overstating cash flows in every
7 year. As shown in his Chart 8 at page 86 of his testimony, his multi-stage growth
8 DCF analysis assumes an investor will receive four quarterly dividend payments two
9 quarters after the stock is purchased, and eight quarters of dividend payments are
10 received by the investor after the stock is owned for six quarters. This exaggeration
11 of dividend payments is repeated throughout the study. By accelerating the receipt of
12 cash flows by investors, he is erroneously inflating his DCF return estimate.

13 **Q BUT DIDN'T MR. HEVERT AT PAGE 86 OF HIS REBUTTAL TESTIMONY**
14 **SPECIFICALLY STATE THAT THIS APPROACH DOES NOT ACTUALLY**
15 **ASSUME THAT UTILITIES WILL ACCELERATE ANY QUARTERLY DIVIDEND**
16 **PAYMENTS?**
17 A Yes, but Mr. Hevert's argument is simply wrong. His multi-stage growth DCF model
18 projects four quarterly dividend payments will be received by investors two quarters
19 after they buy a stock. This cash flow projection accelerates dividend payments and
20 inflates his DCF model returns.

21 **Q DID MR. HEVERT ALSO TAKE ISSUE WITH YOUR GDP GROWTH RATE USED**
22 **IN YOUR MULTI-STAGE DCF ANALYSIS?**
23 A Yes. He asserts the following concerning my GDP growth outlook:

1. The consensus *Blue Chip Financial Forecasts* growth rates only reflected the next 10 years whereas I used the GDP growth rates for a longer term.

2. He believes that a GDP growth rate estimate should not be used for a period different than the period it is intended.

3. He asserts that historic data shows that the GDP growth in the decade following an economic crisis exceeds the GDP growth in following periods. While he does not reach any specific conclusions, it would appear as though Mr. Hevert believes that my 4.9% GDP growth rate will overstate long-term sustainable growth rate data because my GDP growth rate effectively reflects the decade following the recovery of the current U.S. economic crisis.

In any event, Mr. Hevert continues to recommend his use of a nominal real GDP growth rate based on actual historical data and his forecast of future inflation.

Q DO YOU BELIEVE IT IS APPROPRIATE TO USE *BLUE CHIP FINANCIAL FORECASTS* OF GDP GROWTH OVER THE NEXT 10 YEARS?

A Yes. While this is not perfect information, it is the best information available that reasonably reflects investor outlooks. The *Blue Chip* publication is a reputable source of data, and represents a consensus of independent economists' projections of future GDP growth outlooks. The historical review shown in Mr. Hevert's rebuttal testimony in Table 14 at page 91, would suggest that this 10-year growth rate may overstate GDP growth over longer periods of time. That is, Mr. Hevert's data shows that GDP growth in the 10 years following an economic crisis overstates GDP growth rate for the decades that follow the crisis. My GDP growth rate reflects the next 10 years, which is the decade that follows the current U.S. economic crisis. Hence, the current GDP growth rate is likely to be higher than the GDP growth in subsequent decades. Mr. Hevert's GDP growth, on the other hand, suggests that my GDP growth is too low, not too high. His conclusion contradicts his own historical data.

1 **Q DO YOU BELIEVE IT IS APPROPRIATE TO USE A GROWTH RATE ESTIMATE**
2 **FOR A PERIOD DIFFERENT THAN WHAT IT WAS INTENDED?**
3 A Ideally, no, however rate of return analysts are simply forced to make assumptions for
4 growth rate data because perfect growth rate projections are not available. For
5 example, both Mr. Hevert and I used three-to five-year earnings growth rate
6 projections as estimates of long-term sustainable growth in our constant growth DCF
7 studies. We both know that the analysts' growth projections are not intended to be
8 perpetual growth rate projections but we both are using them as though they are in
9 our constant growth DCF studies.

10 **Q DO YOU BELIEVE HISTORICAL GDP GROWTH DATA IS MORE REFLECTIVE OF**
11 **INVESTORS' OUTLOOKS THAN ANALYSTS' GDP PROJECTIONS?**
12 A No. Analysts' projections can capture expectations of changes in the future relative
13 to what has happened in the past. For example, in the past the U.S. has faced less
14 economic competition from other countries around the world compared to the current
15 world economy. Going forward, the U.S. will compete with major economies including
16 China, Brazil and Europe. This new world-wide economic competition is relatively
17 new compared to the historical 80 years of data used by Mr. Hevert to measure
18 historical real GDP. The significant change in the economic competitive structure of
19 the world economy likely will result in different real GDP growth for the U.S. economy
20 going forward relative to what has been achieved in the past.
21 Consensus economists have captured this changed world market structure
22 and the competitive world economy in their projections of U.S. GDP growth.
23 Mr. Hevert's historical review did not capture this change to the world economy.

1 Hence, I believe analysts' projections are far more likely reflective of the market's
2 view than is Mr. Hevert's simple historical view.

3 **Q DID MR. HEVERT REVISE YOUR MULTI-STAGE GROWTH DCF STUDY?**

4 A Yes. Again, at page 93 of his rebuttal testimony in Table 15, he shows a six-step
5 adjustment to my multi-stage growth DCF analysis. As shown in that table, he
6 proposes to increase the multi-stage growth DCF analysis by approximately 80 basis
7 points. However, for the reasons discussed below, Mr. Hevert's adjustments indicate
8 a return for Ameren Missouri in the range of 9.4% to 9.6%.

9 **Q ARE MR. HEVERT'S REVISED MULTI-STAGE GROWTH DCF ANALYSES**
10 **ADJUSTMENTS APPROPRIATE?**

11 A No. His Step 1, update market data through July 13, 2012, and Step 2, revise the
12 short-term growth rates to use the *Value Line* and First Call estimates rather than my
13 consensus analysts' growth rate estimates, produced DCF return estimates that are
14 reasonably comparable to my own study. Through Step 2, Mr. Hevert's revised mean
15 estimate is 9.42% compared to my 9.38%. Both of these average approximately
16 9.40%. For the proxy group median, Mr. Hevert's revisions would reduce the median
17 estimate relative to my own study. By including EDE in this study, Mr. Hevert simply
18 increases the return estimates up to approximately 9.6%. Again, this 20 basis point
19 increase reflects the circumstances for EDE, which are not reflective of any other
20 electric utility company which I am aware. Therefore, EDE's results are distorted
21 based on its unique circumstances, and therefore this revision to the DCF study is not
22 appropriate.

1 Mr. Hevert's proposed adjusted timing of the cash flows (Step 4), adjusted
2 payout ratios (Step 5) and use of his GDP growth forecasts (Step 6) are unreliable
3 and not reflective of rational investor outlooks and should be rejected. These
4 adjustments are self-serving, not based on widely accepted industry data, and were
5 designed by Mr. Hevert based on his own assumptions and outlooks. Mr. Hevert did
6 not attempt to measure the consensus investor outlook in his DCF studies.
7 Therefore, his Steps 4 through 6 should be disregarded.
8 As a result, the appropriate DCF return estimate for the proxy groups lies
9 somewhere in the range of 9.4% to 9.7% based on Mr. Hevert's own revised multi-
10 stage growth DCF study.

11 **Q DID MR. HEVERT TAKE ISSUE WITH CERTAIN ASPECTS OF YOUR CAPM**
12 **STUDY?**
13 A Yes. While I disagree with his criticisms, I will not provide a detailed response to
14 them in this case. For the reasons outlined in my direct testimony, I place minimal
15 weight on the results of the CAPM study because of the current low Treasury bond
16 yield environment, and the spreads between Treasuries and corporate bond
17 securities. For those reasons, I found it more reliable to not place significant weight
18 on the results of the CAPM study in this case. However, I stand by my criticisms of
19 Mr. Hevert's CAPM study as being severely flawed, manipulated and not reflective of
20 investor return requirements.

21 **Q DID MR. HEVERT TAKE ISSUE WITH YOUR RISK PREMIUM STUDY?**
22 A Yes. Mr. Hevert's primary argument is that I did not embrace a simple inverse
23 relationship between equity risk premiums and interest rates. He believes if I would

1 ignore all other facts and circumstances, and simply focus only on an inverse
2 relationship, that my return on equity estimate would have been increased by
3 approximately 104 to 164 basis points based on his Table 16 at page 102 of his
4 rebuttal testimony.

5 **Q ARE MR. HEVERT'S CRITICISMS OF YOUR RISK PREMIUM STUDY**
6 **REASONABLE?**

7 A No. For the reasons outlined in my direct testimony at pages 54-55, changes in
8 interest rates are one factor that help gauge an appropriate equity risk premium,
9 however they are not the only factor. Rather, academic literature supports gauging
10 an appropriate equity risk premium based on an assessment of changes in
11 investment risk between equity securities and bond securities. It is this change in
12 investment risk outlooks which primarily drives changes to equity risk premiums.
13 Importantly, changes in nominal interest rates is one such factor, but it is not the only
14 factor.

15 **Q WHY WOULD IT BE INAPPROPRIATE TO CONSIDER ONLY CHANGES IN**
16 **NOMINAL INTEREST RATES TO GAUGE AN APPROPRIATE EQUITY RISK**
17 **PREMIUM IN THE CURRENT MARKET?**

18 A An inverse relationship in equity risk premiums simply assumes that equity risk
19 premiums will increase as interest rates decline. However, one factor that would
20 equally change a required return in an equity security and a debt security, would be
21 changes to the expected rate of future inflation. All else equal, a decline in inflation
22 rates will have a comparable impact on all long-term debt return and common equity
23 return.

1 One reason bond yields are very low right now is because future inflation
2 outlooks are low. Indeed, Mr. Hevert himself reflected a relatively low inflation outlook
3 in his multi-stage measurement of a nominal GDP growth forecast. There, Mr. Hevert
4 assumed a long-term inflation outlook of 2.28%, which is lower than long-term
5 historical inflation (1929-2010) of 3.1%, which occurred during the period Mr. Hevert
6 measured the real GDP growth (Hevert Direct at 28). An expected return for both
7 debt and equity securities will include an inflation outlook and a real return. The real
8 return reflects changes in risk, where the inflation component simply reflects a need
9 for an increased investment return to maintain the nominal spending power of the
10 investment. As inflation decreases, so will a required return on a bond and an equity
11 security – all else equal.

12 This is one example of why declines in nominal interest rates will not always
13 fully explain changes to the equity risk premium (as Mr. Hevert assumes). However,
14 it is not the only factor which goes against the inverse relationship assumption used
15 by Mr. Hevert.

16 Mr. Hevert's inverse relationship assumption is simplistic, does not reflect
17 changes in investment risk and required return outlooks, and is an inexact and
18 unreliable method of estimating a fair return on equity for Ameren Missouri using the
19 risk premium methodology.

20 **Q DID MR. HEVERT COMMENT ON YOUR RESPONSE TO HIS REGULATORY RISK**
21 **ASSESSMENT OF AMEREN MISSOURI?**

22 A Yes. While Mr. Hevert does not revise any conclusions he had reached, he responds
23 to two issues:

24 1. He believes Ameren Missouri has greater fuel cost recovery risk because its
25 purchased power adjustment clause allows for 95% of the variability between

1 projected fuel costs and actual fuel costs, while (he claims) the vast majority of
2 the companies in the proxy group allow for 100% of fuel and purchased power
3 cost recovery.

4 2. He states that many of the companies in the proxy group are allowed to earn a
5 cash return of construction work in progress ("CWIP") which is not allowed in
6 Missouri.

7 Based on this, he concludes that he believes the proxy group companies have
8 a better opportunity to earn their authorized return on equity than does Ameren
9 Missouri.

10 Q **DOES MR. HEVERT PROVIDE ANY EVIDENCE THAT CHANGES YOUR VIEW ON**
11 **THE REGULATORY MECHANISMS IN MISSOURI?**

12 A No. Indeed, his rebuttal testimony further supports my belief that Ameren Missouri's
13 witnesses are making assertions without adequate backup. Specifically, Mr. Hevert
14 provided no backup for his belief that most of the companies in the proxy group have
15 fuel adjustment mechanisms that allow for 100% recovery of fuel and purchased
16 power costs. Further, Mr. Hevert ignored other major considerations in fuel or
17 commodity cost management. For example, what is the treatment of off-system sales
18 margins in measuring recoverable fuel costs, and whether the proxy utilities and
19 Ameren Missouri are able to hedge fuel costs through supply contracts or financial
20 agreements to mitigate the fuel cost risk. Importantly, commodity risks can be
21 managed with mechanisms other than only a fuel adjustment clause. Overall,
22 assessing whether or not Ameren Missouri has more or less commodity risk, requires
23 a far more detailed assessment of commodity risk and hedging options than
24 Mr. Hevert performed.

25 His other issue does not even relate to the issue he claims to be addressing
26 -- stable and predictable earnings. Specifically, earning a cash return on CWIP does

1 not improve a utility's ability to earn its authorized return on equity. Ameren Missouri
2 and other utilities that do not include CWIP in rate base and earn a current return on
3 it, instead accrue an allowance for funds used during construction ("AFUDC") return.
4 An AFUDC return is far more stable than is a cash return on CWIP. It is more stable
5 because the accrued AFUDC return is not subject to variability of sales and other
6 factors whereas a cash return on CWIP can vary due to these factors. Hence, if
7 stability and predictability of the return on equity are the objectives, the AFUDC return
8 is far more stable than a cash return on CWIP.
9 For all these reasons, Mr. Hevert's conclusion, that Ameren Missouri is less
10 likely to earn its authorized return on equity than the companies in the proxy group, is
11 based on flawed analyses and unsupported conjecture.

12 **Response to Ameren Missouri Witness John Reed**

13 **Q AT PAGE 4 OF HIS REBUTTAL TESTIMONY, MR. REED ASSERTS THAT THE**
14 **MISSOURI REGULATORY MECHANISMS DO NOT PROVIDE AMEREN**
15 **MISSOURI WITH A REASONABLE OPPORTUNITY TO EARN ITS AUTHORIZED**
16 **RETURN ON EQUITY. HAS HE OFFERED ANY NEW EVIDENCE IN SUPPORT**
17 **OF THIS ASSERTION?**
18 A No. Mr. Reed continues to reference the Company's actual earned return since June
19 of 2007, rather than a longer-term review that does not support his claim. Ameren
20 Missouri's actual return on equity is highly dependent on the time period reviewed.
21 Mr. Reed also asserts that a principal reason for Ameren Missouri's chronic
22 under-earnings is its non-revenue producing capital investments. He states that a
23 principal reason to adopt Ameren Missouri's proposed plant in-service accounting is
24 to enhance Ameren Missouri's ability to earn its authorized return on equity.

1 **Q ARE AMEREN MISSOURI'S ASSERTIONS CONCERNING THE BALANCE OF**
2 **MISSOURI'S REGULATORY MECHANISMS SUPPORTED BY INDUSTRY**
3 **MARKET PARTICIPANTS?**

4 A No. While the Missouri regulatory environment is ranked below average, as I noted in
5 my direct testimony, Standard & Poor's ("S&P") has found that the last several rate
6 case orders for Ameren Missouri have been credit supportive. Further, in its most
7 recent Missouri regulatory review, Regulatory Research Associates in *Regulatory*
8 *Focus* provided the following evaluation of the Missouri regulatory environment:

9 **RRA Evaluation:** <u>Missouri regulation is relatively balanced from an</u>
10 <u>investor perspective</u>. Historically, authorized equity returns had
11 approximated or, in certain instances, exceeded prevailing industry
12 averages at the time established; however, authorized ROEs in
13 several more recent cases have been slightly below average. Several
14 electric utilities have fuel adjustment clauses in place, and these
15 mechanisms all include unique provisions that allocate to shareholders
16 a portion of variations in fuel and purchased power costs. <u>Statutes</u>
17 <u>permit the PSC to approve environmental cost recovery mechanisms</u>
18 <u>for the utilities</u>; however, no such mechanisms have been authorized
19 to date. In the gas arena, the state's local gas distribution companies
20 (LDCs) are permitted to adjust rates to reflect changes in gas
21 commodity costs on a timely basis, and the Commission has approved
22 the use of surcharges for recovery of infrastructure improvement costs
23 between base rate cases. The PSC has also authorized the use of
24 sharing mechanisms for capacity release and gas procurement
25 activities for several LDCs. We continue to accord Missouri regulation
26 an <u>Average/2</u> rating. (Section updated 10/12/11)[3]

27 Mr. Reed's assertions simply exaggerate Ameren Missouri's problems, and
28 fail to recognize that regulatory mechanisms in Missouri are reasonably balanced.
29 For example, Mr. Reed claims that non-revenue producing plant is a major cause of
30 Ameren Missouri's regulatory lag. However, Ameren Missouri and other Missouri
31 utilities have the option of implementing an environmental cost recovery mechanism
32 that would allow for tracker mechanism adjustments to major modifications of

[3]Regulatory Research Associates *Regulatory Focus*, "Missouri Regulatory Review," October 12, 2011, emphasis added.

1 coal-fired units. However, no Missouri utility has made a case to implement the
2 environmental cost recovery rider. These environmental improvements are material
3 non-revenue producing investments. For these reasons, Missouri's current regulatory
4 mechanisms and options are adequate to maintain a balance between customers and
5 investor interests, and new regulatory mechanisms proposed by Ameren Missouri are
6 not necessary.

7 **Q AT PAGE 5 OF MR. REED'S REBUTTAL TESTIMONY, HE TAKES ISSUE WITH**
8 **YOUR GENERALIZATION THAT REGULATORY MECHANISMS SHOULD**
9 **BALANCE CUSTOMERS' NEEDS FOR COMPETITIVE AND PREDICTABLE**
10 **RATES WITH AMEREN MISSOURI'S NEED TO RECOVER REASONABLE AND**
11 **PRUDENT COSTS. WHAT DOES MR. REED DISAGREE WITH HERE?**
12 A Mr. Reed contends that regulatory mechanisms need not be concerned with
13 competitive and predictable rates, but rather they should be focused on setting rates
14 to recover <u>"just and reasonable" costs</u>. There are two apparent distinctions between
15 Mr. Reed and me concerning traditional regulatory mechanisms: (1) should
16 regulatory mechanisms balance the interests between investors and customers
17 (I believe they should), and (2) should costs be just and reasonable, and also
18 prudent. (I believe that a prudent cost is a traditional standard). It appears that Mr.
19 Reed believes customers have no (or limited) protections under traditional regulatory
20 mechanisms. Clearly, there is a material divide between Mr. Reed's understanding of
21 traditional regulatory mechanisms and mine.

1 **Q DOES MR. REED ACKNOWLEDGE THE BENEFITS TO INVESTORS AND**
2 **CUSTOMERS IF UTILITIES' RATES ARE COMPETITIVE?**
3 A At certain points of his rebuttal testimony he appears to. For example, at page 6,
4 lines 12 and 13, Mr. Reed concludes that the Company's proposed measures
5 ultimately will benefit the Company's customers through a more reliable electric
6 system at "rates that remain among the lowest in the nation."

7 **Q HAVE MISSOURI'S REGULATORY MECHANISMS HELPED SUPPORT AMEREN**
8 **MISSOURI'S COMPETITIVE RATES?**
9 A Yes. Indeed, Ameren Missouri's proposed rate increases in the rate cases I have
10 been involved in over the last 10 years or so have not been fully adopted by the
11 Missouri Public Service Commission ("Commission"). Indeed, the Commission has
12 consistently made what I believe to be fair and balanced adjustments to Ameren
13 Missouri's proposal to increase rates. Hence, the regulatory practices of the
14 Commission have resulted in Ameren Missouri's rate increases being much lower
15 than that proposed by Ameren Missouri, and have played a large part in Ameren
16 Missouri's rates being as competitive as they are today. As such, the regulatory
17 mechanisms in Missouri have helped support Ameren Missouri's competitive rate
18 structure.

1 **Q AT PAGES 7 AND 8 OF HIS REBUTTAL TESTIMONY, MR. REED ASSERTS**
2 **THAT THE COMPANY'S PROPOSED REGULATORY MECHANISMS ARE NOT**
3 **DESIGNED TO SHIFT RISK FROM THE COMPANY'S INVESTORS TO**
4 **CUSTOMERS. PLEASE RESPOND.**
5 A I disagree. I believe that the Company's regulatory mechanisms are designed to
6 provide it with accounting and rate adjustment mechanisms that allow the Company
7 to exercise great discretion to defer costs, or adjust rates in order to reflect increases
8 in cost of service. However, the Company's proposals do not allow for the recognition
9 of cost decreases for other components of the Company's cost of service or
10 unexpected sales growth that could offset the increased cost of service caused by
11 plant in-service costs and other non-revenue producing cost increases. Therefore, I
12 believe that the Company's proposed regulatory mechanisms are not balanced
13 because they primarily focus on expected cost increases and ignore the possibility of
14 offsetting cost decreases to other cost of service components, or other unexpected
15 increases in sales revenue.

16 **Q AT PAGE 18 OF HIS REBUTTAL TESTIMONY, MR. REED RESPONDS TO YOUR**
17 **CONTENTION THAT THE PLANT IN-SERVICE ACCOUNTING FAILS TO**
18 **CONSIDER THE OFFSETTING CHANGES TO OTHER COMPONENTS OF COST**
19 **OF SERVICE. PLEASE RESPOND.**
20 A Mr. Reed acknowledges my concern about the Company's proposed plant in-service
21 accounting not considering all components of the Company's cost of service,
22 therefore providing for deferred accounting for line item cost increases when a price
23 change would otherwise not be necessary if all cost of service components were
24 considered. Beyond that, Mr. Reed's response is simply that during the time period

1 before the one he chooses to focus on, investment was tied to revenue-producing
2 investments. However, that simply does not respond to my concern that regulatory
3 mechanisms should balance investors' and customers' interests, and rate
4 adjustments should be based on a complete study of cost of service. Ameren
5 Missouri's proposed regulatory mechanisms in this case simply do not comply with
6 this objective.

7 **Q ON PAGES 24 AND 25 OF HIS REBUTTAL TESTIMONY, MR. REED RESPONDS**
8 **TO YOUR OBSERVATIONS CONCERNING CREDIT RATING AGENCIES'**
9 **REVIEW OF AMEREN MISSOURI. WHAT ARGUMENTS DOES MR. REED MAKE**
10 **AT THIS POINT IN HIS TESTIMONY?**
11 A He acknowledges that S&P has regarded the last few regulatory commission orders
12 as credit supportive, but notes that S&P still ranks the Missouri regulatory
13 environment as less credit supportive. He also believes that the credit rating
14 agencies have provided adequate detail describing how they rate a commission's
15 regulatory climate.

16 **Q PLEASE RESPOND.**
17 A As noted earlier, credit rating agencies have found that the Missouri Public Service
18 Commission's orders in Ameren Missouri's last few rate cases to be credit supportive.
19 This is clear evidence that the Commission's regulatory practices are reasonable.
20 Further, Mr. Reed's conclusion, that credit rating agencies clearly define what
21 they consider to be regulatory risk, is without basis. Mr. Reed goes through S&P's
22 general credit rating category guidelines that relate to both utility and other corporate

1 bond issuances. Further, he outlines Moody's general practices for the weight it
2 gives to specific factors including a review of the regulatory environment.

3 However, Mr. Reed has failed to demonstrate how S&P and Moody's
4 distinguish their regulatory risk distinctions between a cost disallowance caused by
5 imprudent or unreasonable utility management, compared to a cost disallowance
6 caused by unreasonable regulatory practices. In the credit rating reviews he cites, a
7 disallowance of a cost is simply regarded as a regulatory risk whether it is caused by
8 unreasonable regulatory decisions, or failure of utility management to effectively
9 manage costs. It appears that, from a credit rating analyst's perspective, if a cost is
10 not allowed to be recovered in rates, it represents a regulatory risk.

11 Therefore, if the Commission chooses to implement regulatory mechanisms in
12 order to improve its ranking before credit rating agencies, it should have more
13 information on how a credit analyst distinguishes between the risk of effective
14 regulation to balance the interests of investors and customers, and the risk of failed
15 utility management to effectively manage costs.

16 **Q DID MR. REED OFFER ANY ADDITIONAL EVIDENCE AT PAGES 28 AND 29 OF**
17 **HIS REBUTTAL TESTIMONY WHERE HE COMPARES REGULATORY**
18 **TIMELINES IN MISSOURI WITH THOSE OF OTHER JURISDICTIONS?**

19 A Mr. Reed's opinion on the timing of rate cases is that a shorter case improves the
20 utility's ability to earn its authorized rate of return. In reaching this conclusion, he
21 observes that if inflation increases expenses during the rate case, then the rates
22 implemented may not fully recover actual costs when those rates are in effect. This
23 simplistic assessment of Mr. Reed is simply not reliable enough to support his
24 conclusion.

1 Developing rates to provide a utility a fair opportunity to recover its actual
2 prudent and reasonable costs when the rates are in effect is far more complex than
3 the simplistic example offered by Mr. Reed.

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

5 A Yes.

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