

Exhibit No.: 554

Issues: Return on Equity
Interruptible Demand Response Pilot

Witness: Billie S. LaConte

Sponsoring Party: Missouri Energy Group

Type of Exhibit: Surrebuttal Testimony

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Service Commission

Case No. ER-2007-0002

**Before the
Missouri Public Service Commission**

Surrebuttal Testimony of Billie Sue LaConte

**on Behalf of the
Missouri Energy Group**

Project 061402
February, 2007

MEG Exhibit No. 554
Date 3-26-07 Case No. ER-2007-0002
Reporter RE

AmerenUE

Case No. ER-2007-0002

Affidavit of Billie S. LaConte

STATE OF MISSOURI)
)
COUNTY OF ST. LOUIS)

Billie S. LaConte, being of lawful age and duly affirmed, states the following:

1. My name is Billie S. LaConte. I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.
2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony consisting of Pages 1 through 12.
3. I have reviewed the attached Surrebuttal Testimony and hereby affirm that my testimony is true and correct to the best of my knowledge and belief.

Billie S. LaConte

Billie S. LaConte

Duly affirmed before me this 27th day of February, 2007.



SHERYL M. FENELON
My Commission Expires
December 29, 2010
St. Louis County
Commission #06514106

Sheryl M. Fenelon

Notary Public

My commission expires on December 29, 2010.

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1 **AmerenUE**

2 **Missouri Public Service Commission**
3 **Case No. ER-2007-0002**

4 **Surrebuttal Testimony of the Missouri Energy Group**

5 ***Introduction and Overview***

6 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

7 **A Billie S. LaConte, 8000 Maryland Avenue, Suite 1210, St. Louis, Missouri.**

8 **Q ARE YOU THE SAME BILLIE SUE LACONTE THAT FILED DIRECT TESTIMONY IN**
9 **THIS PROCEEDING?**

10 **A Yes, I am.**

11 **Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS**
12 **PROCEEDING?**

13 **A I shall address the rebuttal testimony filed by AmerenUE witnesses Kathleen**
14 **McShane and James Vander Weide regarding return on equity.**

15 In addition, I shall address the rebuttal testimony of AmerenUE witness Philip
16 Q. Hanser and the rebuttal testimony of the Office of Public Counsel witness Ryan
17 Kind regarding the proposed Industrial Demand Response (IDR) pilot.

1 ***Response to Ms. McShane's Rebuttal Testimony***

2 **Q PLEASE DESCRIBE MS. MCSHANE'S COMMENTS.**

3 A Ms. McShane takes issue with my conclusion that her market-to-book value upward
4 adjustment will lead to a larger disparity in the market-to-book value of AmerenUE
5 and require an even higher return on equity.

6 **Q WHY DOES MS. MCSHANE DISAGREE WITH YOUR CONCLUSION?**

7 A She states that "if the utility is allowed to earn (and does earn) the return on equity
8 that investors expect, the investor's market return will equal the cost of equity, and
9 the market/book ratio should remain unchanged" (Rebuttal Testimony of Kathleen
10 C. McShane, Page 13, Line 17). Ms. McShane provides an example where the
11 market-to-book ratio remains intact if the allowed return on equity for the regulated
12 utility is set at 11.5% and provides a return on equity of 9.5% for the market value
13 of the utility, i.e., the return on equity that the investors expect.

14 **Q IS THIS CORRECT?**

15 A Yes and no. The "yes" part is the mathematics based on the assumptions. The
16 "no" part is the underlying assumptions—in particular, that the market-to-book ratio
17 should remain at 1.50. If "investors expect" a return of 9.5%, then perhaps the
18 market-to-book ratio is greater because the allowed RoE was too high before. The
19 Commission should not determine the fair return on book value based on the return
20 on equity *on market value* that investors expect. The market will determine the fair
21 return on the market value of the utility. If we assume that investors expect a
22 9.5% RoE, then if we assume the market-to-book ratio is 1.50—and should remain

1 at that level—the utility must get an 11.50% RoE in order to maintain the ratio. But
2 if we were to start with a 1.20 market-to-book ratio, the required utility RoE
3 according to her view would be 10.4%. So, the question is why should the market-
4 to-book ratio be 1.50, or what is the “correct” market-to-book ratio?

5 Additionally, the relationship of market value to book value can be
6 determined by factors having nothing to do with the regulated utility in question.
7 Unregulated affiliates can affect the parent company’s share value. General market
8 developments can affect investors’ perceptions. In any event, investors know that
9 utilities are regulated on the basis of a fair return on book value. It is not the
10 obligation of the Commission to support any particular market value.

11 **Q DO YOU HAVE ANY OTHER COMMENTS REGARDING MS. MCSHANE’S**
12 **REBUTTAL TESTIMONY?**

13 **A** Yes. Ms. McShane states:

14 *[I]f the allowed return on equity underestimates the higher financial risk*
15 *inherent in AmerenUE’s book value capital structure relative to the*
16 *market value capital structure, then the logical outcome is that the value*
17 *of shareholders’ investment would decline as they bid down the price of*
18 *the shares in reaction to a non-compensatory return. That outcome*
19 *follows from basic principles of finance. (Rebuttal Testimony, Page 15,*
20 *Line 3)*

21 However, the opposite is true, too—that is, if the allowed return *overestimates* the
22 higher financial risk, the value of the shareholders’ investment would *increase* as
23 they bid *up* the price of the shares in reaction to the higher return that was
24 awarded. The utility could then, in turn, argue for an even higher return on equity,
25 to compensate for the larger disparity in the market-to-book value.

1 **Response to Dr. Vander Weide's Rebuttal Testimony**

2 **Q PLEASE COMMENT ON DR. VANDER WEIDE'S REBUTTAL.**

3 A In his rebuttal testimony, Dr. Vander Weide disagrees with my argument regarding
4 his financial risk adjustment—specifically, that it can lead to an illogical conclusion
5 that higher returns on equity require even higher returns on equity, and it obliges
6 the Commission to support a particular market value for the Company's stock. Dr.
7 Vander Weide believes that I have misunderstood his financial risk adjustment. He
8 states that:

9 *[F]inancial risk adjustment depends on the average market value capital*
10 *structure of my proxy companies. The percentage of equity in the*
11 *market value capital structure of my proxy companies would not increase*
12 *if the Commission were to allow AmerenUE a higher allowed rate of*
13 *return because the market value capital structure for the proxy*
14 *companies does not depend on AmerenUE's allowed rate of return on*
15 *equity. Thus, my financial risk adjustment does not lead to any*
16 *connection between current allowed returns on equity and future allowed*
17 *returns on equity. (Rebuttal Testimony, James. H. Vander Weide, Ph.D.,*
18 *Page 104, Line 12).*

19 **Q IS THIS CORRECT?**

20 A No. My criticism is not that this adjustment will lead to a higher percentage of
21 equity in the market value capital structure of the proxy companies, but would lead
22 to a higher return on equity for AmerenUE.

23 **Q PLEASE EXPLAIN.**

24 A Dr. Vander Weide's financial risk adjustment is based on the average market-to-
25 book value ratio of his proxy group, as compared to AmerenUE's actual market-to-
26 book value ratio used by Ms. McShane. He uses this ratio basis for increasing
27 AmerenUE's return on equity. In either case, the effect of the upward adjustment is

1 the same; the higher (than needed) return on equity awarded to AmerenUE would
2 lead to even higher returns on equity for the Company.

3 Q WHAT OTHER ARGUMENTS DOES DR. VANDER WEIDE HAVE IN FAVOR OF HIS
4 FINANCIAL RISK ADJUSTMENT?

5 A He argues that:

6 *[U]tility rates depend on the estimated cost of equity for the proxy*
7 *companies, and the estimated cost of equity for the proxy companies is*
8 *lower as a result of the greater percentage of equity in their market value*
9 *capital structure. (Rebuttal Testimony, Page 104, Line 21)*

10 He is incorrect because he compares the *book* value capital structure of AmerenUE
11 to the average *market* value capital structure of the proxy group. If he were to
12 compare the average book value capital structure of the proxy group to AmerenUE,
13 it would show that the Company does not have higher financial risk.

Table 1

Book Value vs. Market Value

	<u>AmerenUE Book Value</u>	<u>Proxy Group Book Value*</u>	<u>Proxy Group Market Value</u>
% Equity	52.49%	45.65%	57.32%

*From Data Request AG/UTI-127.

1 Q WHY DO DR. VANDER WEIDE AND MS. MCSHANE INCLUDE THE FINANCIAL RISK
2 ADJUSTMENT?

3 A The reason for their financial adjustment is the same, that AmerenUE has higher
4 financial risk due to its lower equity ratio and higher debt ratio.

5 Q IS AMERENUE'S DEBT LEVEL CAUSE FOR INCREASED RISK?

6 A No. The amount of debt the utility has is comparable to the debt levels of other
7 regulated electric utilities, as shown in Table 2.

Table 2

Regulated Electric Utilities Equity Ratio and Awarded ROEs

<u>Company</u>	<u>Allowed ROE</u>	<u>Equity/ Total Cap</u>	<u>Date</u>
AEP Texas Central Co.	10.1%	40.0%	8/15/2005
Aquila Networks	10.5	33.6	1/28/2005
Arizona Public Service Co.	10.3	45.0	4/7/2005
Atlantic City Electric Co.	9.8	46.2	5/26/2005
Avista Corp.	10.4	40.0	12/21/2005
Cincinnati Gas and Electric Co.	10.3	47.5	12/21/2005
Consolidated Edison Co. of NY	10.3	48.0	3/24/2005
Consumers Energy Co.	11.2	36.3	12/22/2005
Jersey Central Power and Light Co.	9.8	46.0	6/1/2005
Madison Gas and Electric Co.	11.0	56.7	12/12/2005
Oklahoma Gas and Electric Co.	10.8	55.7	12/13/2005
PacifiCorp (OR)	10.0	47.6	9/28/2005
Puget Sound Energy Inc.	10.3	43.0	2/18/2005
South Carolina Electric and Gas	10.7	50.3	1/6/2005
Westar Energy Inc.	10.0	44.6	12/28/2005
Wisconsin Power and Light Co.	11.5	61.8	7/19/2005
Central Hudson Gas and Electric	9.6	47.0	7/20/2006
Central Vermont Public Service	10.8	55.6	12/7/2006
Delmarva Power and Light Co.	10.0	47.7	4/25/2006
Empire District Electric Co.	10.9	49.7	12/21/2006
Green Mountain Power Corp.*	10.3	52.8	12/22/2006
Interstate Power and Light Co. (MN)	10.4	49.1	3/3/2006
Kansas City Power and Light	11.3	53.7	12/21/2006
Maine Public Service Co.	10.2	50.0	7/6/2006
Northern States Power Co.	11.0	53.7	1/5/2006
PacifiCorp (UT)*	10.3	N/A	12/1/2006
PacifiCorp (WA)	10.2	46.0	4/17/2006

Public Service Corporation of Colorado*	10.5	60.0	11/20/2006
Sierra Pacific Power Co.	10.6	40.8	4/26/2006
United Illuminating Co.	9.8	47.0	1/27/2006
Upper Peninsula Power Co.	10.8	47.2	6/27/2006
Wisconsin Public Service Corp.	11.0%	59.7%	12/22/2006
2005 Average	10.4%	46.4%	
2006 Average	10.5%	50.7%	
2005-2006 Average	10.4%	48.5%	

From Edison Electric Institute Rate Case Summary Q4 2006 Financial Update, Appendix I.

*Settlement.

1 The average debt level is 48.5% and the average awarded return on equity is
2 10.4%. Compared to the list of regulated utilities, AmerenUE's debt/equity ratio
3 does not imply that the Company has higher risk. Therefore, the financial risk
4 adjustment should be rejected.

5 **Q PLEASE COMMENT ON DR. VANDER WEIDE'S CRITIQUE OF MY CONCLUSION**
6 **THAT AMERENUE HAS LOWER BUSINESS RISK THAN THE PROXY COMPANIES.**

7 **A Dr. Vander Weide assesses business risk based on Standard & Poor's bond rating**
8 system. Based on their bond rating alone, he states that the group of proxy
9 companies have similar business risk as compared to AmerenUE. However, to get a
10 better understanding of AmerenUE's specific business risk, it is important to
11 determine: (1) how significant is its risk; (2) what is the *relative* risk of AmerenUE
12 versus other utilities; and (3) are there devices to mitigate the risk? As outlined in
13 my direct testimony, the business risk that AmerenUE faces is lower than that of
14 other utilities. AmerenUE has proposed devices (e.g., cost recovery clauses) to
15 further reduce its business risk.

Response to Philip Q. Hanser's Rebuttal Testimony

Q PLEASE DESCRIBE AMERENUE WITNESS HANSER'S COMMENTS REGARDING THE PROPER DEMAND CREDIT FOR THE INTERRUPTIBLE DEMAND RESPONSE PILOT.

A Mr. Hanser states that although he agrees, in principle, that the credit for the interruptible load should be based on the cost of avoided peaking capacity, he does not believe that in the case of AmerenUE's pilot program, the credit should be equal to the estimated cost of a new CT.

Q WHAT IS HIS REASON FOR THIS?

A He states that "the interruptible demand, at least as defined in AmerenUE's proposed pilot program, does not provide the same level of reliability and security as a CT" (Rebuttal Testimony, Philip Q. Hanser, Page 12, Line 21). The examples he provides include:

- Interruptible customers have the right not to reduce demand when requested to do so;
- The one hour notice provision provided to customers, as compared to the ability of a CT to be up and running at full capacity within 10 -30 minutes; and
- Interruptible customers can be interrupted a maximum of 200 hours, whereas a CT could generate electricity during most of the year.

1 Q WHAT IS YOUR RESPONSE TO MR. HANSER'S ARGUMENT?

2 A To start with, although Mr. Hanser points out some perceived disadvantages of
3 interruptible load relative to CTs, he ignores some of the relative advantages of
4 interruptible loads and/or disadvantages of CTs. For example, using interruptible
5 load to shave system peaks instead of building and running CTs has a lower
6 environmental impact. It avoids the land use required to site the CTs and the
7 carbon dioxide output of running them. Losses are reduced. Plus, CTs are not
8 100% reliable. Regarding his first specific point, although interruptible customers
9 have the right not to reduce demand when requested to do so, it is not without
10 penalty. A customer may elect (if the Company offers) to use a buy through
11 option, where the customer would pay 110% of the MISO hourly market clearing
12 price. Although the customer has elected not to reduce demand, it will pay a much
13 higher price for the energy it purchases from AmerenUE. The Company will not
14 suffer as any energy the customer uses is covered by purchases through the MISO.
15 As noted above, a CT may not start up when dispatched. In this case, AmerenUE
16 would have the option of buying power to make up for the lost CT generation.
17 Furthermore, if a customer refuses to interrupt and has not been offered the option
18 to buy through, AmerenUE has the right to penalize that customer, by essentially
19 removing them from the demand response tariff and charging a much higher rate.

20 Regarding his second point, the tariff states that:

21 *Company will attempt to provide customer with up to two hours advance*
22 *notice of any interruption or curtailment. Such notices shall be no*
23 *shorter than the lesser of 30 minutes or any such time specified in a*
24 *directive from MISO or the applicable Balancing Authority in their*
25 *operation of such load curtailment tariffs. No other obligation exists*
26 *under this tariff to provide such advance notice of any interruption or*
27 *curtailment nor any assumption of any liability for failure to do so.*

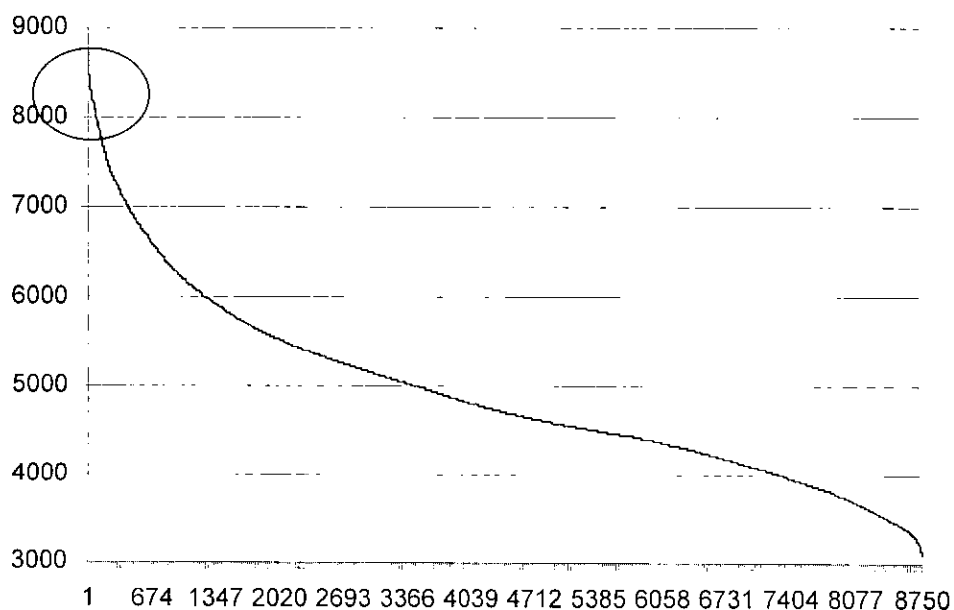
1 The Company has not promised a one hour notice provision. Nor does it seem to
2 guarantee even a 30-minute notice to the customer.

3 As to his third point, AmerenUE has CT capacity that is expected to run for
4 fewer than 200 hours. The need to maintain its reserve margin implies that some
5 peaking capacity is needed for fewer than 50 hours.

6 **Q PLEASE COMMENT ON MR. HANSER'S STATEMENT THAT "100 MW SEEMS TO**
7 **BE A REASONABLE LIMIT FOR THE PURPOSE OF A PILOT PROGRAM..."**
8 **(REBUTTAL TESTIMONY, PAGE 13, LINE 15).**

9 **A** Mr. Hanser states that this is a reasonable amount because in 1999 there was only
10 47 MW of participating interruptible load on AmerenUE's Rate 10M interruptible
11 tariff. This does not show a need to *limit* the amount of interruptible load. As this
12 graph shows, currently the Company has available 800 MW of "super peak" load
13 that lasts for 100 hours or less. If the Company had 800 MW of interruptible load
14 that could be interrupted for 200 hours, it could reduce its peak demand by at least
16 that much.

AmerenUE Load Duration Curve 2005



1 Q WHAT IS YOUR RESPONSE TO MR. HANSER'S CLAIM THAT YOU HAVE
2 OVERSTATED THE RISK TO INDUSTRIAL CUSTOMERS REGARDING THE LENGTH
3 OF THE PROPOSED PILOT PROGRAM?

4 A Mr. Hanser is correct when he states that "industrial customers take risks into
5 account all the time when considering energy-related investments. For example, a
6 customer's decision to invest in energy-saving equipment will be based, in large
7 part, on projections of future energy prices" (Rebuttal Testimony, Page 14, Line 1).
8 This means that by increasing the risk that AmerenUE will terminate the program
9 after two years, it reduces customers' willingness to make the investments. This
10 would also be true for the utility. It is unlikely that the Company would take the
11 risk of building a new CT if it faced a likely risk of losing it after two years.
12 Likewise, an industrial customer should not be expected to participate in the
13 demand response program and perhaps make costly investments that allow it to
14 participate, when it may face the prospect of losing the rate after two years.

15 *Response to Ryan Kind's Rebuttal Testimony*

16 Q WHAT CONCERNS DOES OFFICE OF PUBLIC COUNSEL WITNESS RYAN KIND
17 HAVE REGARDING THE INDUSTRIAL DEMAND RESPONSE RIDER?

18 A Mr. Kind believes that the proper forum to decide whether to accept or deny the
19 IDR is the AmerenUE DSM IRP Workshops and not the current rate case. He
20 believes that the workshops provide technical expertise and the ability to evaluate
21 the cost-effectiveness of programs like the IDR.

1 Q DO YOU AGREE?

2 A No. The DSM IRP workshops are not a forum for setting rates; that requires an
3 application to the Commission. Interruptible rates are, by their design, a form of
4 demand-side management. Industrial Demand Response programs have been
5 accepted and used for over 25 years. So, there is no substantive question as to
6 their cost-effectiveness or usefulness. This proceeding is the proper forum to
7 determine the terms for the tariff.

8 *Summary*

9 Q PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

10 A Based on my review of AmerenUE witnesses' rebuttal testimony, the upward
11 adjustment for the market-to-book ratio of equity should be rejected and a
12 downward adjustment to AmerenUE's RoE is warranted.

13 Furthermore, the Industrial Demand Response tariff that AmerenUE is
14 proposing should have a higher demand credit in the range of \$3.15-
15 \$3.55/kW/month; the amount of eligible load should be increased from 100 MW up
16 to 800 MW and the length of the program should be extended to at least five years.
17 Additionally, the current rate case is the proper forum to determine the proper terms
18 for the IDR.

19 Q DOES THIS CONCLUDE YOUR TESTIMONY?

20 A Yes.