

ILLINOIS COMMERCE COMMISSION

DOCKET NO. 04-0294

REBUTTAL TESTIMONY

OF

WARNER L. BAXTER

Submitted On Behalf

Of

AMEREN CORPORATION

July 20, 2004

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4 **WARNER L. BAXTER**

5
6 **Q. Please state your name and business address.**

7 A. My name is Warner L. Baxter. My business address is One Ameren Plaza, 1901
8 Chouteau Avenue, St. Louis, Missouri 63103.

9 **Q. Are you the same Warner L. Baxter who previously submitted direct testimony in**
10 **this proceeding?**

11 A. Yes.

12 **Q. What is the purpose of your testimony?**

13 A. The purpose of my rebuttal testimony is to respond to the testimony of various Staff and
14 intervenor witnesses who have submitted testimony requesting that the Commission
15 approve the acquisition subject to conditions inconsistent with the terms of the Stock
16 Purchase Agreement ("SPA") between Ameren Corporation ("Ameren") and Dynegy Inc.
17 ("Dynegy"). Ameren believes that many of the conditions, restrictions and modifications
18 to the SPA terms proposed by the Staff and intervenors would, if adopted by the
19 Commission, fundamentally alter the value of the transaction to Ameren and excuse
20 Ameren from closing the transaction. Ameren entered into the transaction based on an
21 analysis of the value it would deliver to its stakeholders (including shareholders,
22 customers and employees) and negotiated a set of closing conditions that would enable it

23 to deliver that value and preserve the financial strength of companies in the Ameren
24 system. Ameren cannot responsibly close the transaction if those conditions are not met.

25 In particular, I will be responding to the direct testimony of Staff and intervenors
26 regarding the recapitalization (capital structure of Illinois Power Company, the Ameren
27 Utility Money Pool Agreement, the treatment of Illinois Power's deferred tax balances at
28 closing, the dividend restriction under which Illinois Power would operate post-closing,
29 the regulatory asset Applicants have asked for authority for Illinois Power to book, and
30 the HMAC Rider.

31 **Q. Please identify the terms of the SPA to which you are referring and which are**
32 **addressed by the Staff and intervenor witnesses to whom you are responding.**

33 A. The terms of the SPA to which I am referring are contained on Schedule 8.2(b), which I
34 have attached as Exhibit 21.1

35 As I respond to the Staff and intervenor witnesses, I will discuss individual items
36 on this list. It is important to note, however, that each of these items is an important part
37 of an arms-length transaction. These conditions, as negotiated in the SPA, are required
38 for closing; if they are not met, Ameren believes it need not close.

39 Ameren has a responsibility to all of its stakeholders. It specifically negotiated the
40 closing conditions in the SPA to protect its stakeholders and will exercise its rights under
41 the SPA, if necessary, to prevent its strong financial position from being jeopardized to
42 the detriment of its stakeholders. Accordingly, all other things being equal, if the
43 Commission approves the acquisition subject to conditions inconsistent with the
44 approvals required under the SPA, Ameren will not close the transaction.

45 **Capital Structure**

46 **Q. AG witness James Rothschild and IIEC witness Michael Gorman contend that the**
47 **proposed post-acquisition capital structure for Illinois Power Company ("IP")**
48 **contains excessive equity. Please respond.**

49 A. Mr. Jerre Birdsong responds to the specific arguments of Mr. Rothschild and Mr. Gorman
50 in his rebuttal testimony. I will offer a general response. Under the SPA, approval of
51 Ameren's proposed capital structure for IP is a condition to closing. Accordingly, if the
52 Commission does not approve our proposed capital structure, Ameren does not need to
53 close.

54 The SPA designates approval of the proposed recapitalization of IP as a closing
55 condition to protect the credit ratings of Ameren and its affiliates, including
56 AmerenCIPS, AmerenCILCO and AmerenUE, and to ensure that "AmerenIP" is
57 capitalized in a manner that allows it to attain an investment grade rating upon or about
58 closing from one rating agency and get it significantly closer to investment grade at the
59 other (i.e., improving IP's credit rating by approximately three to eight notches from its
60 present position, depending on the rating agency). The capital structure proposed by
61 Ameren will do that; the capital structures offered by Messrs. Rothschild and Gorman
62 will not. Mr. Birdsong provides the detail in this regard, but I would like to note that our
63 proposal is based on actual conversations with the ratings agencies; the AG's and IIEC's
64 views are suppositions based on data they have seen for composites of other companies.

65 Ameren took great pains when constructing this transaction to assure that it would
66 not damage the ratings of the other Ameren affiliates or impair their business operations.
67 Ameren insisted on this protection in order to continue to effectively manage its
68 financing costs for its overall operations and to address the significant financial risks

69 Ameren is undertaking in connection with this transaction. This was done not simply to
70 benefit its bondholders and shareholders. Rather, it was intended to also benefit its
71 existing customers and employees, as well as those of Illinois Power.

72 To properly do so, Ameren consulted with the major ratings agencies to see what
73 level of equity (and what other steps) would be required to achieve (for one agency) or
74 significantly approach (for the other) an investment grade credit rating for IP and –
75 equally important - to maintain ratings at Ameren and its other subsidiaries. Thus, the
76 level of equity that both Messrs. Rothschild and Gorman deem excessive for ratings
77 purposes is simply incorrect. Mr. Birdsong discusses this in detail. My purpose is to
78 emphasize that this is a significant issue for Ameren in this transaction. An IP
79 chronically below investment grade would have serious negative implications for the
80 entire Ameren system. Supposition is no substitute for fact, and the fact is that the
81 agencies view what Ameren is doing as merely adequate, not excessive, in returning IP to
82 financial health and maintaining Ameren's ratings.

83 **Money Pool Agreement**

84 **Q. Staff witness Sheena Kight recommends that IP's entry in the money pool be**
85 **conditioned on IP only participating as a borrower "until such time as it can show**
86 **that it has sufficient cash flows to" lend to the Ameren money pool. Does Ameren**
87 **believe that this condition is inconsistent with the terms of the SPA?**

88 A. Yes, Ameren believes that this proposed condition is inconsistent with both the terms of
89 the SPA and the proper operation of a money pool. Mr. Birdsong addresses the latter
90 point in his rebuttal testimony. The SPA requires as a condition of closing that the
91 Commission approve IP's entry into a money pool with Ameren. If the Commission

92 materially modifies the proposed agreement or materially impairs IP's participation in it,
93 the conditions to close will not have been satisfied.

94 The Staff's position is difficult to fully understand – the mechanics are clear but
95 the underlying rationale is not. The Staff is contending, in essence, that IP would be
96 better off continuing with a below investment grade rating and no effective access to the
97 capital markets than it would be with an investment grade rating, access to the capital
98 markets and a parent with solid investment grade ratings – all because in the latter
99 scenario, IP would be lending into the Ameren Utility Money Pool, on a short term basis,
100 with virtually instantaneous call rights, to companies with investment grade ratings. In
101 other words, the Staff is concerned that IP would participate in the Ameren Utility Money
102 Pool in exactly the same manner as all of the other Ameren utilities do today.

103 Staff's concern is overstated and misplaced. The Utility Money Pool agreement
104 poses no threat to IP, and the Commission should approve it as proposed and allow the
105 transaction to close.

106 **Deferred Tax Balances**

107 **Q. IIEC witness Gorman recommends that the Commission reject the proposed**
108 **acquisition because the change in deferred tax balances will cause an adverse effect**
109 **on rates. Please respond.**

110 A. Mr. Craig Nelson and Mr. Birdsong address Mr. Gorman's concerns regarding the effect
111 on rates of this transaction in their rebuttal testimony. I would like to respond to Mr.
112 Gorman by explaining with respect to this transaction that there are no options with
113 respect to the change in deferred tax balances. As I explained in my direct testimony, and
114 as also explained by Mr. James Warren in his direct testimony, this transaction is being

115 treated as an asset sale for federal income tax purposes under Section 338(h)(10) of the
116 Internal Revenue Code. As a result of this treatment, the deferred tax balances are
117 eliminated from IP's books at closing. As I also explained in my direct testimony, there
118 is no other basis on which the parties could transact – either this was an asset sale for
119 federal income tax purposes, or there was no transaction at all. In a stock sale such as
120 this one, the Section 338(h)(10) election would have been made regardless of the identity
121 of the buyer. No matter who bought IP, the deferred taxes would either go to zero at
122 closing or stay with the seller.

123 Mr. Gorman does not assess whether customers would ultimately be better with or
124 without the sale. By urging the Commission to reject this transaction, he assumes –
125 implicitly or otherwise – that customers would be better off without this transaction,
126 because there is no alternative sale. But as I said, any buyer would have to, with Dynegy,
127 make a Section 338(h)(10) election in order to reach an agreement to buy IP. Given this
128 circumstance the Commission must then assess whether the status quo is best for IP's
129 customers.

130 In making that assumption, he further assumes that there is some painless means
131 of restoring IP to full financial health. In other words, Mr. Gorman assumes that, under
132 continued Dynegy ownership, IP's revenue requirement would be static, and that there is
133 no realistic scenario in which IP's customers would face any cost of service impact.

134 If Mr. Gorman is assuming that Ameren could make this transaction work by
135 freezing the cost of service at the preacquisition level or making other rate concessions,
136 he is mistaken. In this transaction, Ameren is assuming substantial risks and costs to
137 acquire and recapitalize IP. Ameren fully acknowledges that this is not a charitable act;

138 this is a business transaction in which Ameren perceives meaningful opportunities for the
139 Ameren system and all of the Ameren stakeholders. This business transaction, however,
140 must not pose excessive risks and must yield a solid return on our investment. Without
141 the step-up that results from the elimination of the deferred taxes, this transaction would
142 not be economically feasible from Ameren's perspective, as it would deny Ameren the
143 opportunity to earn a reasonable return on its full investment .

144 Ameren is paying \$2.175 billion to acquire utility assets with a book (and rate
145 base) value of approximately \$1.9 billion. Ameren would view any approval condition
146 that limited its rate base to the preclosing level (about \$1.6 billion) as materially adverse
147 to its interests, and Ameren would not close. Ameren simply will not pay \$2.175 billion
148 for a company with a \$1.6 billion rate base.

149

150 **Regulatory Asset**

151 **Q. AG witness Efron and IIEC witness Gorman both oppose establishment and**
152 **recovery of the regulatory asset treatment listed on Schedule 8.2(b) as a required**
153 **approval; Staff witness Bonita Pearce questions the components of the regulatory**
154 **asset. Please respond.**

155 A. As I explained in my direct testimony, and as Mr. Marty Lyons explains in his rebuttal
156 testimony, Ameren is incurring substantial costs to acquire and restructure IP. Ameren is
157 not seeking to recover all – or even a quarter – of those costs from customers. Rather,
158 Ameren is seeking only to amortize \$67 million over the period 2007-2010: less than
159 15% of the total costs of over \$450 million.

160 Mr. Lyons addresses what costs are properly recoverable and why, and answers
161 the questions raised by Ms. Pearce. Mr. Nelson explains that the savings produced by the
162 costs exceed the costs. My purpose here is to explain that the regulatory asset that
163 Messrs. Effron and Gorman oppose is critical to the closing of this transaction. As I
164 explained above, there are limits to the costs and risks that Ameren will bear in
165 connection with this transaction. Ameren requires the \$67 million to bring this
166 transaction within its cost and risk tolerances. Without recognition and amortization of
167 this asset, Ameren need not close.

168 **Dividend Restriction**

169 **Q. Staff witness Kight recommends that the Commission maintain the current**
170 **restriction on IP's declaration and payment of dividends on common stock or**
171 **modify the current restriction in a manner different from that proposed by**
172 **Applicants. Please respond.**

173 A. Mr. Birdsong addresses the specifics of Ms. Kight's proposal in his rebuttal testimony. I
174 wish to emphasize that the modification of the dividend restriction is critical to Ameren
175 for three reasons:

- 176 1) Ameren has issued a substantial (over \$1 billion) amount of equity to fund this
177 transaction and recapitalize IP. Ameren must pay dividends on that new
178 equity, which it intends to fund, in part, from dividends paid by IP to Ameren;
- 179 2) In reaching their conclusions that Ameren should not be downgraded as a
180 result of this transaction, the ratings agencies are assuming that IP will pay
181 dividends to Ameren beginning in 2005; and

182 3) Payment of dividends up to Ameren keeps IP’s common equity ratio from
183 growing even larger than the level that some parties believe is already
184 excessive.

185 This is a critical issue to Ameren. A condition of approval trapping cash at IP even after
186 that company attains an investment grade rating is not necessary to protect IP and will
187 only jeopardize the ratings of Ameren and its public utility affiliates. If the Commission
188 does not approve the modification of the dividend restriction proposed by Applicants,
189 Ameren need not close.

190 **HMAC Rider**

191

192 **Q. Staff witness Hathhorn states that “...Applicants’ have inextricably tied**
193 **consummation of the proposed reorganization to establishment of the HMAC**
194 **Rider...” Please respond.**

195 A. Ms. Hathhorn is correct that Ameren requires Commission approval of the HMAC Rider.
196 Schedule 8.2(b) of the SPA requires approval of an electric automatic adjustment clause
197 tariff rider not materially and adversely different than what has been proposed by
198 Ameren, to become effective on January 2, 2007, under which Illinois Power may
199 recover the prudent cost net of insurance recoveries and other contributions associated
200 with claims or damages related to asbestos exposure, and if failure of that condition
201 creates a material adverse effect on the business, financial condition or results of
202 operation of IP or its business (and Ameren believes it would), Ameren is not required to
203 close the transaction.

204 The approval of the HMAC Rider is critically important and is, in fact, an
205 important element to the overall transaction. From Ameren's perspective, this acquisition
206 is mostly the purchase of Illinois Power's transmission and distribution assets; there is
207 only the purchase of the 20% interest in Electric Energy, Inc. in terms of generation
208 assets. The facts that the current asbestos claims, and anticipated future asbestos claims,
209 are largely due to workers' exposure while working at the Illinois Power generating
210 plants, and that Ameren will not have an ownership interest in these generation plants,
211 and, therefore, have no opportunity to mitigate the claims exposure with a generation
212 asset acquisition, makes the economic risks associated with purchasing Illinois Power
213 become materially adverse for Ameren. While it may be argued that the purchase price
214 takes into account this exposure, in reality that is not the case. As I explained above,
215 Dynegy was demanding a certain price for IP, and the very best Ameren could do in
216 accounting for this exposure was to make the HMAC Rider a condition of closing.
217 Moreover, as explained by Mr. Steve Sullivan, the costs and risks associated with present
218 and future asbestos claims are so difficult to quantify that one could not determine a
219 purchase price increment for accepting them. These claims, it bears noting, relate to
220 work performed on IP facilities as far back as the 1950's through and including October
221 1, 1999. Ameren cannot reliably predict the number of actual claims that will be made
222 or the actual costs it will incur as a result of the claims made. Ameren knows the number
223 of claims is increasing and the liability is unknown. Given these concerns, Ameren
224 bargained hard for this particular regulatory approval. If the HMAC Rider is not
225 approved in substantially the form proposed by the Applicants, Ameren believes that it is
226 not required to consummate the transaction.

227

228 **Q. Does this conclude your rebuttal testimony?**

229 A. Yes, it does.