

REDACTED
REBUTTAL TESTIMONY
of
MICHAEL McNALLY

CONFIDENTIAL INFORMATION IDENTIFIED AS
XXXXXXXX

FINANCE DEPARTMENT
FINANCIAL ANALYSIS DIVISION
ILLINOIS COMMERCE COMMISSION

ILLINOIS POWER COMPANY
APPLICATION FOR APPROVAL OF A REORGANIZATION

Docket No. 04-0294

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1

WITNESS IDENTIFICATION

2 **Q. Please state your name and business address.**

3 A. My name is Michael McNally. My business address is 527 East Capitol Avenue,
4 Springfield, IL 62701.

5 **Q. Are you the same Michael McNally who testified previously in this**
6 **proceeding?**

7 A. Yes, I am.

8 **Q. Please state the purpose of your rebuttal testimony.**

9 A. The purpose of my rebuttal testimony is to respond to the rebuttal testimony of
10 Applicants witnesses Nelson (Applicants' Ex. 23.0), Birdsong (Applicants' Ex.
11 22.0), and Lyons (Applicants' Ex. 24.1). Specifically, I will address: Mr. Nelson's
12 testimony regarding the estimation of anticipated purchased power and gas
13 savings and the appropriate adjustment to Illinois Power's ("IP") 11.5% debt; Mr.
14 Birdsong's testimony on the amount of debt redemption premiums and stock
15 issuance costs allowable for recovery in this proceeding; and Mr. Lyons'
16 proposed reporting of push-down accounting.

17

RESPONSE TO MR. NELSON

18

Purchased Power and Gas Savings

19 **Q. Mr. Nelson continues to assert that IP will be able to purchase power and**
20 **gas for approximately 4.7%, or \$42 million, less annually under Ameren**

21 **ownership than it would under continued Dynegy ownership.¹ Please**
22 **comment.**

23 A. Mr. Nelson has failed to sufficiently demonstrate that \$42 million is a reasonable
24 estimate of the impact of the difference between IP's creditworthiness under
25 those two scenarios. Mr. Nelson has not quantified the effect that each alleged
26 source of credit related savings that he cites would have on the ultimate cost of
27 purchased power or gas. Instead, he justifies his reliance on a proxy to estimate
28 the creditworthiness-related difference in energy costs on his admission that
29 "...there is no independent, market-provided source that identifies credit-related
30 costs in these commodities...."² Mr. Nelson's conceptual approach to estimating
31 the purchased power and gas savings is premised on the assertions that "[a]
32 *simple* and *reasonable* way to model this difference in supply costs is to compare
33 the costs associated with issuing debt" because "[i]f long-term debt holders
34 require this credit spread, so will long-term suppliers."³ (*Emphasis added*)
35 Although such a theoretical approach is relatively *simple*, Mr. Nelson has failed to
36 establish that it is *reasonable*. That is, he has not demonstrated that costs
37 associated with issuing long-term debt are sufficiently comparable to energy
38 supply costs to serve as a proxy.

39 Using bond yield spreads to establish credit-related energy pricing differences is
40 appropriate only if the bonds employed have similar payment patterns and similar
41 prospects for recovery in the event of default as the energy contract being
42 analyzed. The Applicants have not demonstrated that to be true. To the
43 contrary, the payment pattern of a long-term bond is likely to be quite dissimilar

¹ Applicants' Exhibit 23.0, pp. 2-4.

² *Id.*, p. 4.

³ *Id.*, pp. 3-4.

44 to that of an energy contract. Thus, the default risk the energy suppliers face,
45 and the corresponding premium they will charge, is unlikely to be similar to that
46 faced by unsecured lenders. Consider, for example, a 10-year purchased gas
47 contract that requires a supplier to deliver \$1 million of gas each month for 10
48 years (i.e., a total contract value of \$120 million). If the purchasing utility is
49 unable to make payments under that contract, the supplier would likely cease
50 further deliveries to that utility; the supplier would lose the value of the gas it had
51 delivered for which it may not be paid.⁴ In contrast, a typical 10-year, \$120
52 million bond would require the lender to deliver \$120 million at the outset of the
53 contract, with the expectation of periodic interest payments throughout the term
54 of the contract and principal repayment at the end of the contract. If the borrower
55 defaulted on the loan, the lender would risk losing the entire \$120 million principal
56 amount since that entire amount was delivered at the beginning of the contract
57 period.

58 The above example notwithstanding, IP's gas suppliers require IP to prepay its
59 gas purchases approximately one month in advance of delivery.⁵ Thus, IP's
60 suppliers' default risk is effectively eliminated. Accordingly, IP's suppliers would
61 not demand a premium on the commodity price to compensate for the risk of
62 default. However, the buyer typically incurs a cost associated with providing a
63 supplier with credit security, which is not directly related to the commodity cost.
64 For credit securitization in the form of prepayments, that cost is the financing
65 cost, which is the type of cost modeled in the hypothetical example presented in
66 my direct testimony (ICC Staff Exhibit 11.0, pp. 14-16).

⁴ The number of months of gas deliveries at risk would likely depend on the number of days a payment must be overdue before an event of default is triggered under the terms of the contract.

⁵ Applicants' response to Staff data request FIN 3.01.

67 **Q. Mr. Nelson argues that your approach to estimating purchased power and**
68 **gas savings under Ameren ownership fails to capture the full impact of the**
69 **credit differential.⁶ Please comment.**

70 A. Mr. Nelson acknowledges that the general approach used in the hypothetical
71 purchased power and gas savings example presented in my direct testimony is
72 reasonable for measuring the effect that the credit differential would have on
73 financing costs; he used that general approach to estimate financing cost savings
74 of \$19 million.⁷ However, he claims that the credit differential would also affect
75 other savings factors such as the number of suppliers and hedging
76 counterparties or price volatility (“Other Factors”).

77 It is theoretically possible that, in addition to financing cost savings, credit-related
78 savings could be derived from the Other Factors. Specifically, economic theory
79 suggests that multiple suppliers competing for contracts could bid down the price
80 the buyer ultimately pays. However, as Staff witness Lounsberry notes in his
81 rebuttal testimony, Mr. Nelson has failed to provide any facts or information to
82 establish the level of savings, if any, the Other Factors would produce.⁸ In fact,
83 when explicitly asked for documentation showing the effect a larger pool of
84 suppliers would have on commodity pricing, he provided no verifiable
85 documentation, only theoretical observations.⁹

86 Mr. Nelson’s theoretical \$42 million total credit-related savings estimate implies
87 savings of \$23 million from Other Factors, given his \$19 million financing cost

⁶ Applicants’ Exhibit 23.0, p. 5.

⁷ *Id.*, pp. 7-8.

⁸ Staff Exhibit 16.0, pp. 10-11.

⁹ Applicants’ response to Attorney General data request AG 4.4.

88 savings estimate. However, as explained above, he has not demonstrated that
89 the presumed credit spread provides a reasonable proxy for the total credit-
90 related savings. In addition, as a practical matter, he has provided no verifiable
91 information from which to independently establish the level of savings the Other
92 Factors would produce. Thus, he has failed to substantiate his estimate of \$42
93 million in savings from either a theoretical approach or from a practical approach.

94 **Q. Should the Commission adopt Mr. Nelson's \$19 million financing cost**
95 **estimate as an appropriate representation of expected purchased power**
96 **and gas savings?**

97 A. Without evidence establishing the level of savings the Other Factors would
98 produce, if any, the Commission's conclusion on purchased power and gas
99 savings should be based solely on the difference in IP's financing cost under
100 Dynegy ownership and under Ameren ownership. The financing costs can be
101 estimated from the difference in the lengths of time over which IP would finance
102 the purchase of energy under the two ownership scenarios and the applicable
103 interest rate available under each scenario.

104 Mr. Nelson's \$19 million financing cost estimate adopts the assumption from the
105 hypothetical example I presented in direct testimony that IP would incur two
106 months of financing costs under Dynegy ownership, but would incur no financing
107 costs under Ameren ownership. However, the hypothetical example presented in
108 my direct testimony (ICC Staff Exhibit 11.0, pp. 14-16) was not a recommended
109 estimate of IP's expected credit-related savings, but rather, an illustration
110 highlighting the information deficiencies in the Applicant's filing. Among those
111 deficiencies was a lack of evidence regarding the appropriate financing period

112 under each scenario. Thus, the lengths of the financing periods I assumed in
113 that example might be inaccurate. Mr. Nelson has presented no evidence to
114 demonstrate the applicability of those, or any other, assumptions regarding the
115 length of the financing period for IP's energy purchases under either Ameren or
116 Dynegy ownership.

117 Further, Mr. Nelson's \$19 million financing cost estimate assumes that the
118 interest rate applicable for power and gas purchases equals IP's pre-tax
119 weighted average cost of capital because, he claims, IP's prepayments should
120 be included in rate base as working capital.¹⁰ Thus, the validity of Mr. Nelson's
121 \$19 million estimate depends on whether or not the Commission concludes that
122 any additional financing costs IP might incur under Dynegy ownership should be
123 recognized in an adjustment to working capital. This issue is complex, as it
124 involves assessing the amount of financing costs IP is incurring for its gas
125 purchases and whether retail customers should pay for those costs. Given that
126 Ameren did not raise this argument until the rebuttal phase in this proceeding
127 and that the ratemaking treatment for prepaid gas purchases could be an issue in
128 Docket No. 04-0476, IP's gas rate case, Staff believes that resolution of that
129 issue should be left to the gas rate proceeding.

130 **Q. What purchased power and gas savings do you recommend?**

131 A. Ultimately, the only savings the Commission can be confident that IP will achieve
132 under Ameren ownership, relative to Dynegy ownership, are those that can be
133 satisfactorily verified. As explained above, the Applicants have provided no
134 verifiable information to independently establish the level of savings the Other

¹⁰ Applicants' Exhibit 23.0, pp. 7-8.

135 Factors would produce and have failed to provide evidence demonstrating the
136 appropriate financing periods underlying IP's expected financing cost savings.
137 Therefore, for the reasons explained above, I recommend that the Commission
138 disregard the credit-related savings on electricity and gas purchases that the
139 Applicants contend will be achieved under the proposed transaction.

140 **Adjustment to 11.5% Debt**

141 **Q. Applicants' witness Nelson questions your assumption that all of the**
142 **incremental risk reflected in the 11.5% debt is related to Dynegy, stating**
143 **that such an assumption represents an extreme case in the possible range**
144 **of outcomes.¹¹ Do you agree?**

145 A. As Mr. Nelson correctly observes, the Commission could conclude that some, all,
146 or none of the incremental risk reflected in the 11.5% debt is related to Dynegy.¹²
147 Obviously, the assumption that all of the incremental risk is related to Dynegy
148 reflects the upper bounds of those possible conclusions. Nonetheless, for the
149 reasons set forth in my direct testimony, I believe that conclusion is correct. (ICC
150 Staff Exhibit 11.0, pp. 4-5)

¹¹ Id., p. 19.
¹² Id.

151 **Q. Please respond to Mr. Nelson’s claims that if the Commission were to**
152 **determine that IP’s allowable embedded cost of debt was equal to your**
153 **6.84% estimate, IP’s rates would incorporate only \$50 million of a projected**
154 **\$157 million of interest expense.¹³**

155 A. Mr. Nelson’s rebuttal testimony on this subject is misleading. The question
156 specifically requests that Mr. Nelson discuss the financial consequences for IP of
157 the adjustments that I made to IP’s 11.5% debt. In his answer, Mr. Nelson
158 asserts “[t]he financial consequences could very well be devastating...,” and cites
159 a \$107 million difference between IP’s total actual interest expense and the
160 interest expense that would be allowable in rates according to Staff’s analysis.¹⁴
161 However, my adjustments only account for approximately \$16 million of that \$107
162 million difference. The bulk of the \$107 million difference is due to the fact that
163 IP’s projected capital structure under Dynegy ownership would be much larger
164 than its rate base. Indeed, Mr. Nelson estimated that IP’s total capitalization
165 under Dynegy ownership would be approximately \$3.58 billion, while its rate base
166 would only be approximately \$1.6 billion.¹⁵ That large difference between IP’s
167 rate base and capitalization resulted from IP’s acceptance of an unsecured note
168 from Illinova, which currently amounts to \$2.3 billion, rather than cash in
169 exchange for IP’s fossil-fuel power plants. That capitalization produces the
170 “excess interest expense,” which Mr. Nelson acknowledges is not recoverable
171 through rates.¹⁶ Obviously, only interest expenses IP incurs for the purpose of
172 serving its customers should be reflected in rates.

¹³ *Id.*, p. 20.

¹⁴ *Id.*

¹⁵ Applicants’ revised response to Staff data request FIN 2.03.

¹⁶ Applicants Exhibit 13.0, p. 12; Applicants’ revised response to Staff data request FIN 2.03.

173 **Q. Do you have any other concerns with Mr. Nelson’s revenue requirement**
174 **comparison presented as Applicants’ Exhibit 23.1?**

175 A. Yes. The interest tax savings presented in Applicants’ Exhibit 23.2, Case A is
176 \$21 million, whereas the interest tax savings presented in Applicants’ Corrected
177 Revised Exhibit 3.4, Case 1 is only \$20 million. To my knowledge, none of the
178 inputs used to calculate that figure changed, so there should be no difference.
179 Mr. Nelson should either make a correction to one of the numbers or explain why
180 they differ if both numbers are valid.

181 **RESPONSE TO MR. BIRDSONG**

182 **Debt Redemption Premiums**

183 **Q. Do you agree with Mr. Birdsong’s assessment that ***x x x x x x x x*** of**
184 **debt redemption premiums should be eligible for recovery through the**
185 **amortization of a regulatory asset?**

186 A. No. First, Mr. Birdsong’s calculation is speculative. He contends that the
187 appropriate redemption premium is the “make-whole” redemption premium,
188 which depends on the U.S. Treasury rate at the time of redemption.¹⁷ Given the
189 uncertainty of future Treasury rates, the Commission cannot know the precise
190 level of debt redemption premiums IP would incur. Thus, I do not believe the
191 Commission should authorize recovery of such a precise amount without
192 knowing if IP will ever incur that amount. Second, prior to December 15, 2005,
193 IP can redeem up to 35% of the 11.5% debt through a “claw-back” provision for a
194 premium of 11.5%. Moreover, IP can redeem that entire issue after December

¹⁷ Applicants’ Exhibit 22.0, pp. 24-25.

195 15, 2006 for a premium of 5.75%. It is reasonable to assume IP would have at
196 least as favorable provisions had it issued that debt while rated BBB+.
197 Nevertheless, Mr. Birdsong applied his 13.5% premium to the entire 11.5%
198 issuance. Thus, his estimate is overstated. Finally, adding a 25 basis point
199 spread to the average of the 5-year and 7-year U.S. Treasury rates as of August
200 2, 2004 and assuming a January 2005 redemption, I estimated a make-whole
201 redemption premium of approximately 12.8% as opposed to Mr. Birdsong's
202 13.5% estimate.

203 **Q. What is your debt redemption premium estimate for IP's 11.5% debt?**

204 A. At current U.S. Treasury rates, a reasonable estimate of the maximum
205 recoverable debt redemption premium for IP's 11.5% debt does not exceed
206 \$64.8 million.

207 **Q. How did you calculate that amount?**

208 A. That estimate assumes that 35% of IP's 11.5% debt is redeemed through the
209 claw-back provision for a premium of 11.5%, or \$21.1 million (35% x \$525 million
210 x 11.5%). The remaining 65% was assumed to be redeemed through a make-
211 whole redemption in January of 2005. As noted above, my estimate of the make-
212 whole redemption premium is 12.8%, which produces a premium of \$43.7 million
213 (65% x \$525 million x 12.8%). Combining the premiums for those two portions
214 produces a total recoverable amount of \$64.8 million for the 11.5% debt. Adding
215 the \$3.7 million call premium for the other debt issues Ameren intends to call
216 raises that produces a maximum recoverable amount of \$68.5 million. However,
217 should IP elect to exercise its right to call the remaining 65% of the 11.5% issue
218 in December 2006, the redemption premium would be much lower since the call

219 price falls to 105.75% of face value. IP should not be permitted to recover a
220 greater amount of debt redemption premiums than it incurs.

221 **Q. Do you have any further comments regarding the recoverability of IP's debt**
222 **redemption premium?**

223 A. Yes. The method I presented in my direct testimony (ICC Staff Exhibit 11.0, pp.
224 18-19) for determining the amount of allowable call premium on the 11.5% debt
225 assumes that, pursuant to Section 9-230 of the Illinois Public Utilities Act ("Act"),
226 the Commission would disallow all costs on that debt issue in excess of that on
227 comparable debt rated BBB+. In contrast, in Docket No. 04-0476, IP presents an
228 alternative approach that assumes the 11.5% debt was never issued.¹⁸ If the
229 Commission accepts that approach, then no call premium for the 11.5% would be
230 recoverable since it never existed for ratemaking purposes.

231 **Stock Issuance Costs**

232 **Q. Do you agree with Mr. Birdsong's assessment of the level of stock**
233 **issuance expenses that should be eligible for recovery through the**
234 **amortization of a regulatory asset?**

235 A. No. In its Order in ICC Docket No. 91-0586, The Peoples Gas Light and Coke
236 Company's proposed general increase for rates for gas service, the Commission
237 disallowed a utility from recovering common stock flotation costs incurred by that
238 utility's parent. In that proceeding, the Commission found:

¹⁸ ICC Docket No. 04-0476, Prepared Direct Testimony of Daniel L. Mortland, IP Exhibit 3.1, pp. 10-11.

239 “Respondent did not incur any flotation costs in connection with the
240 issuance of common stock in 1992 by Peoples Energy,
241 Respondent’s parent corporation. It is unlikely that Respondent will
242 ever incur any flotation costs due to the fact that future common
243 stock issuances will also be made by Peoples Energy. In addition,
244 the Commission is of the opinion that flotation costs are included in
245 the cost of equity calculation. In an efficient market, the
246 participants are aware of all of the expenses that a company is
247 subject to. The Commission has not been convinced that flotation
248 costs need to be added to a cost of equity analysis for Peoples.”¹⁹

249 Consistent with the Commission’s conclusion in that docket, such costs would
250 not be eligible for recovery in the instant docket or any future rate case.

251 Nevertheless, if the Commission should elect to deviate from that policy, no more
252 than ***x x x x x x*** should be recoverable. This estimate is the product of
253 the face amount of IP’s debt to be redeemed from proceeds from the common
254 stock issuances (i.e., ***x x x x x x***), the maximum recoverable debt
255 redemption premium (i.e., \$68.5 million), and the weighted average common
256 stock issuance cost (i.e., 2.67%). Of course, that amount is subject to
257 adjustment based on the Commission’s decision regarding the reasonableness
258 of the equity infusion that gave rise to those stock issuance expenses. The
259 difference between Mr. Birdsong’s and my estimates of the maximum
260 recoverable equity issuance expense results from differences in our estimates of
261 the maximum recoverable debt redemption premium. Finally, unless the
262 Commission intends to make this a general policy, the Order in this proceeding
263 should state explicitly that the Commission’s decision to allow IP to recover
264 through its rates equity issuance costs incurred by Ameren is based on
265 circumstances unique to the proposed transaction.

¹⁹ Order, ICC Docket No. 91-0586, p. 53, October 6, 1992.

266 **RESPONSE TO MR. LYONS**

267 **Push-Down Accounting**

268 **Q. Please comment on the Applicant's proposed use of push-down**
269 **accounting.**

270 A. While Mr. Lyons acknowledges that the Uniform System of Accounts ("USoA")
271 does not permit adjustments for push-down accounting in any liability account, he
272 notes that it is silent on the concept and application of purchase accounting.²⁰
273 Thus, he states that Ameren intends to fully reflect push-down accounting
274 adjustments to long-term debt and preferred stock in Accounts 221 and 204,
275 respectively.

276 The USoA does not permit the inclusion of push-down accounting adjustments in
277 Accounts 221 and 224, regardless of whether or not those are the "logical"
278 accounts in which to reflect purchase accounting entries. Furthermore, the
279 USoA's silence on the matter does not imply consent. The USoA states
280 affirmatively what is to be reflected in those accounts; it does not attempt, and
281 one should not expect it, to state what is not to be reflected in those accounts.

282 In its recent order regarding this same proposed transaction, the Federal Energy
283 Regulatory Commission voiced similar concerns:

284 The Applicants' proposed accounting generally appears to comply
285 with the Commission's accounting requirements. However, the
286 Commission cannot determine whether the proposed accounting
287 complies with the Uniform System of Accounts' requirements in all

²⁰ Applicants' Exhibit 24.1, lines 182-202.

288 aspects of the transaction, as it is unclear from the filing as to the
289 basis of assigning the values to the items pushed down to Illinois
290 Power. Accordingly, the Commission directs the Applicants to
291 submit complete details of all merger-related accounting entries,
292 along with appropriate narrative explanations describing the basis
293 for the entries in their proposed accounting for the merger within 60
294 days of the date on which the merger is consummated. (Federal
295 Energy Regulatory Commission, Order, Docket No. EC04-81-000,
296 p. 27.)

297 **Q. If the Commission should decide to allow IP to reflect long-term debt and**
298 **preferred stock-related push-down accounting adjustments in IP's**
299 **regulatory books, which accounts would you recommend be used?**

300 A. First, as an alternative to reporting for the effects of push-down accounting in
301 Accounts 221 and 224, Staff witness Pearce recommends reporting the
302 cumulative net effects of push-down accounting entirely in Account 114.²¹
303 However, if the Commission is averse to that proposal, I recommend that IP use
304 Accounts 225 ("Unamortized premium on long-term debt") and 226
305 ("Unamortized discount on long-term debt") to record push-down adjustments to
306 long-term debt and Accounts 207 ("Unamortized premium on preferred stock")
307 and 213 ("Unamortized discount on preferred stock") to record push-down
308 adjustments to preferred stock. Those accounts are used to record the
309 difference between the face or stated amount outstanding and the actual cash
310 proceeds the utility received from the issuance of long-term debt and preferred
311 stock.

²¹ ICC Staff Exhibit 19.0, p. 3.

312 **Q. Do you have any further suggestions for making it easier for the**
313 **Commission to track the amounts recorded in those accounts that would**
314 **be recoverable through rates?**

315 A. Yes. Regardless of which accounts are ultimately selected, the Commission
316 should mandate that any purchase accounting adjustments included in debt and
317 preferred stock accounts be reported separately in the appropriate supporting
318 schedule in Form 21 ILCC. For example, pages 26-27 of Form 21 ILCC, which
319 present debt premium (Account 225) and debt discount (Account 226) by debt
320 series, should present amounts related to push-down accounting separately from
321 those amounts related to the premium or discount associated with the original
322 issuance of IP's debt. Also, pages 45 and 46 of Form 21 ILCC, which present
323 capital stock premium (Account 207) and capital stock discount (Account 213) by
324 stock series, respectively, should present amounts related to push-down
325 accounting separately from those amounts related to the premium or discount
326 associated with the original issuance of IP's preferred stock. Further, I
327 recommend that IP include separate subtotals for amounts resulting from push-
328 down accounting and those unrelated to push-down accounting. Further,
329 because Accounts 207, 213, 225, and 226, are subject to amortization, I
330 recommend that IP segregate amortization related to push-down accounting from
331 amortization unrelated to push-down accounting on pages 26-27 for Accounts
332 225 and 226 (debt premium and discount) and page 45 for Account 206 (capital
333 stock premium) and page 46 for Account 213 (capital stock discount). Again, IP
334 should also provide separate subtotals for amortization related to push-down
335 accounting and amortization unrelated to push-down accounting.

336 **Q. Does this conclude your direct testimony?**

337 A. Yes, it does.