STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS POWER COMPANY	**)**	
AMEREN CORPORATION	**)**	**Docket No. 04-0476**
	)	
Proposed General Increase in	**)**	
Gas Rates	**)**	

REBUTTAL TESTIMONY OF CHRISTOPHER C. THOMAS ON BEHALF OF THE CITIZENS UTILITY BOARD

CUB Exhibit 2.0

December 23, 2004

ILLINOIS POWER COMPANY
ICC DOCKET NO. 04-0476
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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Christopher C. Thomas. My business address is 208 S. LaSalle Street, Suite 1760, Chicago, Illinois 60604-1003.

Q. ARE YOU THE SAME CHRISTOPHER C. THOMAS WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to issues raised in the direct testimony of Illinois Commerce Commission Staff (ICC Staff) witnesses Freetly and McNally, and in the rebuttal testimony of Illinois Power Company (IP) witnesses Mortland and McShane. Specifically, I will address the appropriate capital structure for rate making purposes, the appropriate return on outstanding long-term debt, and the appropriate return on equity for IP's gas distribution operations. Based upon a review of the issues raised in the Staff's direct testimony and in IP's rebuttal testimony, my cost of capital recommendation has been modified. My rebuttal testimony will explain these modifications and address the issues that the Commission needs to decide in order to ensure that IP earns an appropriate rate of return on invested capital.

My testimony demonstrates that the appropriate ratemaking capital structure for IP's gas distribution operations should reflect the retirement of both the intercompany note between IP and Dynegy and approximately $578 million in outstanding debt. This capital structure should also reflect $578 million of the common equity infused into IP by Ameren, as follows:

	Capital	Ratio
Long Term Debt	$746,985,378	36.87%
TFTNs*	$309,516,375	15.28%
Preferred Stock*	$45,430,145	2.24%
Common Stock Equity	$923,881,787	45.61%
	$2,025,813,685	100.00%

* As proposed by IP Witness Mortland (IP Exhibit 3.8)

- The appropriate cost of IP's outstanding long-term debt is 6.80%. This is an increase from my earlier recommendation and reflects the appropriate cost of outstanding debt after adjustments described in my testimony. (Schedule 1)
- The appropriate cost of equity for IP's gas distribution operation is 9.64%. This is a decrease from my earlier recommendation and reflects the update of both analysts' growth expectations and beta estimates to ensure that the three cost of equity proposals before the Commission are performed over a consistent time period. (Schedules 2 & 3)
- Overall, the changes I am making from my direct testimony result in a decrease in my initial recommendation (of 8.16%) to 7.93%. (Schedules 4 & 5)

	Capital	Ratio	Cost	Weighted cost
Long Term Debt	$746,985,378	36.87%	6.80%	2.51%
TFTNs*	$309,516,375	15.28%	5.98%	0.91%
Preferred Stock*	$45,430,145	2.24%	5.05%	0.11%
Common Stock Equity	$923,881,787	45.61%	9.64%	4.40%
	$2,025,813,685			7.93%

* As proposed by IP Witness Mortland (IP Exhibit 3.8)

AG/CUB witness David Effron will quantify the impact of the capital structure changes on IP's revenue requirement in his Rebuttal Testimony.

The calculation of the Company's rate of return is based on issues that I discuss in this testimony. Since Staff and other intervenors have yet to file rebuttal testimony, I have not reviewed their responses to my initial analysis in preparation of my testimony. Therefore, at this time, I cannot take a position on issues that may be addressed in their testimony.

II. COST OF DEBT AND CAPITAL STRUCTURE

Q. HAVE YOU REVIEWED THE CAPITAL STRUCTURE AND COST OF DEBT PROPOSED IN THE DIRECT TESTIMONY OF STAFF WITNESSES JANIS FREETLY AND MICHAEL MCNALLY (STAFF EXHIBITS 4.0 AND 5.0) AND IP'S RESPONSES TO STAFF AND CUB'S DIRECT TESTIMONY AS IDENTIFIED IN THE REBUTTAL TESTIMONY OF IP WITNESS DANIEL L. MORTLAND (IP EXHIBIT 3.8)?

A. Yes, I have. I have organized my response by issue, although there is some overlap among the issues.

II. A. 11.5% SERIES BONDS

Q. STAFF HAS PROPOSED TO REDUCE THE ALLOWABLE DEBT EXPENSE AND PRINCIPLE OUTSTANDING OF IP'S 11.5% SERIES BONDS. DO YOU AGREE THAT THESE MODIFICATIONS SHOULD BE MADE?

A. Yes. Although I did not make similar adjustments in my Direct Testimony, both adjustments are reasonable adjustments to make and are reflected in Schedule 1, attached to this testimony. These adjustments reflect the benefits that the company receives from the issuance of lower cost debt and should be incorporated to ensure that regulated ratepayers benefit from repricing the 11.5% series bonds at a reasonable level.

Q. **MR. McNALLY PROPOSES AN ALLOWABLE YIELD OF 5.70% FOR THE OUTSTANDING 11.5% SERIES MORTGAGE BONDS. THIS IS IN CONTRAST WITH YOUR ORIGINAL RECOMMENDATION OF 6.44%. ARE YOU CHANGING YOUR ORIGNIAL RECOMMENDATION?**

A. Yes, I am. While I believe that my analysis is certainly a reasonable approach for determining the allowable yield on BBB rated bonds issued by IP, the bond yield spread analysis performed by Mr. McNally should more closely track BBB rated utility bonds. As I explained in my direct testimony, the sample of utility bonds that I utilized was rather small, and given this fact, Mr. McNally's approach should better approximate the yield of BBB rated utility bonds. Ergo, I utilized Staff's proposed 5.7% allowable yield in my analysis (Schedule 1). This is one of several factors affecting my original recommendation and individually has the effect of reducing the cost of debt below the level it would have been under my original recommendation.

II. B. LOSS OF RE-ACQUIRED DEBT

Q. STAFF WITNESS FREETLY PROPOSES TO ADJUST THE BALANCE OF LONG TERM DEBT OUTSTANDING TO REFLECT THE REMOVAL OF THE PORTION OF LOSS ON RE-ACQUIRED DEBT

ASSOCIATED WITH REPAID PRINCIPLE ON IP's INTERCOMPANY NOTE WITH ILLINOVA. IS THIS ADJUSTMENT REASONABLE?

A. Yes, it is. Staff's reasoning is correct, and the deregulation of an asset should not be allowed to impact regulated customers. In this instance, the losses on reacquired debt associated with the deregulation of IP's generation assets should be excluded from the calculation of both IP's cost of debt and capital structure for ratemaking purposes, and Staff's adjustments are reflected in my analysis (Schedule 1).

II. C. CAPITAL STRUCTURE CHANGES PURSUANT TO THE MERGER

Q. IN HIS REBUTTAL TESTIMONY (IP EXHIBIT 3.8), IP WITNESS MORTLAND PRESENTS THE CAPITAL STRUCTURE CHANGES THAT HAVE OCCURRED (OR ARE SCHEDULED TO OCCUR PRIOR TO THE ORDER DATE IN THIS PROCEEDING) AS A RESULT OF AMEREN'S ACQUISITION OF IP. ARE THESE CHANGES APPROPRIATE FOR RATEMAKING PURPOSES?

A. The changes Mr. Mortland proposes result in an unnecessarily equity-heavy capital structure that should not be accepted by the Commission. CUB has raised this issue before. Witness James A. Rothschild cautioned the Commission in Docket No. 04-0294 (*In Re: ILLINOIS POWER AND AMEREN CORPORATION: Application For Authority To Engage In A Reorganization, And To Enter Into Various Agreements In Connection Therewith, Including Agreements With Affiliated Interests, And For Such Other Approvals As May Be Required Under The Illinois Public Utilities Act To Effectuate The Reorganization* that:

> As long as there remains a chance that the Illinois Power capital structure might be used for regulatory purposes, the Company has an incentive to keep the common equity ratio of the regulated subsidiary as high as it dares. There is no extra cost to Ameren or Illinois Power to keep surplus equity in Illinois Power because the surplus equity at Illinois Power allows Ameren to use less equity somewhere else. This allows Ameren to collect more money from Illinois Power ratepayers to offset equity deficiencies elsewhere and represents a subsidy from ratepayers to unregulated operations of the parent. (ICC Docket No. 04-0294, Direct Testimony of James A Rothschild at 14).

As CUB anticipated, Ameren has attempted to recover excessive equity infused into IP's operations that provides no benefit for IP's ratepayers. The impact of the capital structure proposed in Mr. Mortland's Rebuttal Testimony is a rate increase that serves no benefit for IP's ratepayers, only to Ameren's shareholders. The Commission should not allow regulated ratepayers to be used as a windfall to help support the unregulated activities of IP's parent company.

Q. HOW IS IP'S PROPOSED CAPITAL STRUCTURE DEFICIENT FOR RATEMAKING PURPOSES?

A. The capital structure proposed by IP results in more equity than is necessary to attract capital on reasonable terms and conditions and therefore should not be utilized for ratemaking purposes. The proposed capital structure results in a lower debt to equity ratio than the debt to equity ratio of Ameren and a higher EBIT coverage ratio than is necessary to achieve an appropriate credit rating (Schedule 6).

Q. WHY IS IT SIGNIFICANT THAT THE DEBT TO EQUITY RATIO OF IP WOULD BE LOWER THAN THE DEBT TO EQUITY RATIO OF

AMEREN IF IP'S PROPOSED CAPITAL STRUCTURE WERE ACCEPTED?

A. A debt to equity ratio higher than Ameren's will not necessarily improve IP's bond rating. Page 43 of S&P's "CORPORATE RATINGS CRITERIA 2000" which is publicly available on the S&P website, contains the following:

> Utilities are often owned by companies that own other, riskier businesses or that are saddled with an additional layer of debt at the parent level. **Corporate rating criteria would rarely view the default risk of an unregulated subsidiary as being substantially different from the credit quality of the consolidated economic entity** (which would fully take into account parent-company obligations). Regulated subsidiaries can be treated as exceptions to this rule –if the specific regulators involved are expected to create barriers that insulate a subsidiary from its parent. [Bold emphasis added.]

Q. WHY IS THE EBIT COVERAGE RATIO SIGNIFICANT?

A. The EBIT coverage ratio is the ratio of earnings from continuing operations (before interest and taxes) to the gross interest incurred before subtracting capitalized interest and interest income. Essentially, the EBIT coverage ratio is a measure of a firm's ability to cover interest on its outstanding debt from earnings. The median 2003 coverage ratio for A-rated utilities was 3.2 (available publicly on S&P's website). As demonstrated in Schedule 6, IP's proposed capital structure would provide the company with an EBIT Coverage ratio in the range of 4.1-4.8. This ratio is 25-50% higher than the median utility with a long-term credit rating of A, which is a reasonable target for the management of IP and Ameren, and should be more than sufficient to allow IP to attract capital on reasonable terms.

Q. HOW SHOULD THE COMMISSION DETERMINE THE APPROPRIATE CAPITAL STRUCTURE FOR RATE MAKING PURPOSES?

A. The Commission should not include excessive equity (infused into IP by Ameren) in the capital structure of IP for ratemaking purposes. Excessive equity provides no benefit for regulated customers and increases the rate of return the company receives on its capital investments. As I've alluded to before, Ameren has an incentive to infuse additional equity into IP in order to increase its return on secure regulated investments, which provides no benefit to ratepayers. Because this creates no benefit to ratepayers, the Commission should not include such excessive equity in setting the rate of return for a regulated entity.

Instead, the Commission should limit the amount of equity in IP's capital structure for ratemaking purposes to no more than $923,881,787 in determining what is excessive. When combined with the other modifications I recommend, this amount would establish an EBIT coverage ratio of 3.21 and a debt to equity ratio in the range of Ameren's, as reflected in Schedule 6.

Q. HOW WOULD THE COMMISSION GO ABOUT INCORPORATING YOUR RECOMMENDED AMOUNT OF EQUITY INTO IP's RATEMAKING CAPITAL STRUCTURE?

A. The Commission should incorporate the following transactions into its calculation of IP's capital structure and cost of debt:

- Eliminate the intercompany note between Illinova and IP, reduce the overall balance of common equity to $345,226,787 and eliminate the balance of retained earnings (IP Exhibit 3.8 page 4)

- Incorporate the redemption of both $65,630,000 of the 7.5% New Mortgage Bonds due July 2025 and $84,150,000 of the 7.4% Pollution Control Bonds Series V due December 2024, and remove a total of $149,780,000 from the capital structure (IP Exhibit 3.8 page 6).
- Incorporate the redemption of $70,000,000 of the 6.75% New Mortgage bond maturing March 2005 from the capital structure (IP Exhibit 3.8 page 6)
- Reduce the Initial principle amount of the 11.5% series mortgage bonds to $525,250,000 and the yield to 5.70% (Staff Exhibit 4.0).
- Incorporate the October 14, 2004 equity clawback redemption exercise of 35% of the 11.5% series mortgage bonds removing $192,500,000 from the capital structure. (IP Exhibit 3.8 page 5).
- Incorporate redemption of 50% of outstanding balance of the 11.5% series bonds and remove $166,375,000 from the capital structure.
- Incorporate an infusion of $578,655,000 by Ameren into IP's capital structure. (Schedule 4).

The resulting changes to IP's capital structure and cost of debt are:

- A cost of debt of 6.80% (Schedule 1).
- A capital structure (Schedule 5) of:

	Capital	**Ratio**
Long Term Debt	$746,985,378	36.87%
TFTNs*	$309,516,375	15.28%
Preferred Stock*	$45,430,145	2.24%
Common Stock Equity	$923,881,787	45.61%
	$2,025,813,685	100.00%

- As proposed by IP Witness Mortland (IP Exhibit 3.8)

Q. IS THE RESULTING CAPITAL STRUCTURE REASONABLE?

A. Yes, it allows Ameren to maintain an EBIT coverage ratio in the range of A-rated utilities, without placing any undue burden on the company's ratepayers, and allows IP a debt-to-equity ratio in the same range as its parent company.

III. COST OF EQUITY

Q. HAVE YOU UPDATED YOU ANALYSIS SINCE YOUR INITIAL FILING?

A. Yes, as Ms. McShane indicated on page 2 of her rebuttal testimony, it is important for the Commission to evaluate differences in analysis due to methodology and not to variance in the input data used. To that end, I have updated my analysis to reflect both the updated I/B/E/S growth rates and Valueline betas presented in Ms. McShane's Rebuttal Testimony (IP Exhibit 4.5, Schedules 5 and 6). Schedules 2 and 3 incorporate these updates and result in a cost of equity of 9.642%, using the methodology I laid out in my direct testimony. Schedule 7 compares these results with the Staff and Company proposals. It is important to note that IP has only provided two criticisms of the methodology I utilized, as addressed below.

III. A. USE OF SPOT YIELDS VS. AVERAGE OR FORECASTED YIELDS

Q. IP WITNESS McSHANE CRITICIZES YOUR USAGE OF SPOT PRICES, FOR THE RISK FREE RATE, IN PERFORMING YOUR CAPM ANALYSIS. IS THERE ANY VALIDITY TO HER CRITICISM?

A. No, because my analysis relied on a weekly average, not an individual daily "spot" price as Ms. McShane's rebuttal suggests. Ms. McShane's criticism seems to be that the weekly average I utilized as an estimate of the future risk-free rate isn't as high as the risk-free rate that she has proposed. Regardless, I'm confident that the use of a weekly average is reflective of what investors perceive the appropriate forward-looking risk-free rate to be at the time the information is published.

Using longer averages tends to smooth the variability in prices, but is not an inherently better predictor of the future risk-free interest rate. Generally, variability is simply due to the availability of new information. At any given moment, the current prices (or yields) will reflect this information, to the degree that investors value it. Although investors may occasionally overreact, there is no basis to conclude that longer averages will better predict what prices (and the risk-free) rate will be on a forward-looking basis. There is an inherent bias towards the past in both methods, and neither reflects information that might become available to investors in the future. There is no way to effectively capture that information and using longer-term averages does not correct for it.

III. B. T-BILLS

Q. IP WITNESS McSHANE CRITICIZED THE USAGE OF 90-DAY T-BILLS IN YOUR CAPM ANALYSIS AS INAPPROPRIATE. HOW DO YOU RESPOND TO HER CRITICISMS?

A. IP contends that the yield on 90-day T-bills "...does not does not approach providing full compensation for inflation and the real cost of capital…" (IP Exhibit 4.4, line 225). My analysis does not rely solely on T-bills. Rather, ninety

(90) day T-bills are one of the investment instruments that investors looking for a risk free investment can choose and my analysis treats them as such. Clearly T-bills are not the only instrument, but one of several risk-free investments that can be made and are therefore appropriately considered as part of my analysis. While Ms. McShane criticizes T-bills as underestimating the risk-free rate (IP Exhibit 4.4, page 11), Staff witness Freetly notes that US T-Bond yields are upwardly biased due to their long term to maturity (ICC Staff Exhibit 4.0, page 24). My analysis addresses this incongruity by using a balanced set of the available risk-free instruments.

III. C. MARKET TO BOOK VALUE ADJUSTMENTS

Q. HAVE YOU REVIEWED IP WITNESS McSHANE'S RESPONSES TO THE CRITICISMS OF MARKET TO BOOK VALUE ADJUSTMENTS RAISED IN YOUR DIRECT TESTIMONY?

A. I have. Thus far, the company has not even attempted to rebut my findings that investors are aware of the longstanding regulatory practice of applying the rate of return to book value assets and consider it in their investment decisions. My Direct testimony clearly demonstrates that information concerning the regulatory practice of applying market-derived returns to book value assets is readily available to investors and yet they still value assets above book value. Apparently, the company realizes there is no rational rebuttal to this fact. As I've testified to previously, this clearly establishes that Ms. McShane's market-to-book value adjustments are baseless and without merit. The Commission should summarily dismiss IP's flawed market-to-book value adjustments.

Q. MS. MCSHANE DISCUSSES THE HAMADA EQUATION, USED TO DERIVE THE ASSET BETA OF THE FIRM, TO REBUT YOUR STATEMENTS CONCERNING THE DIFFICULTY IN DISTINGUISHING BETWEEN INVESTORS' EXPECTATIONS OF BUSINESS AND FINANCIAL RISK. DOES THE HAMADA EQUATION SUPPORT IP's CONCLUSION?

A. It does not. I'm aware of the Hamada Equation and the derivation of the asset beta, or unlevered beta. Contrary to IP's suggestion, the Hamada Equation does not justify using relative equity betas to adjust returns. After arguing that the asset beta can be derived from the equity beta, Ms. McShane uses the equity beta in her calculation. The Hamada equation does not justify using equity betas to adjust returns; it merely derives the business risk, or asset beta, component of the common equity beta estimate.

Perhaps IP misunderstood my criticism. Although the existence of an asset beta is useful, it does not support adjustments based upon the equity beta, which is the adjustment Ms. McShane made in her Direct Testimony. Ms. McShane's argument is a red herring in that it discusses the derivation of the asset beta estimate from the equity beta estimate without addressing my criticism that there is no basis for adjusting returns based upon relative levered, or equity, beta estimates. The equity beta is an estimate of both business and financial risk. The existence of a business risk component does not justify adjustment based upon relative total risk.

III. D. STAFF COST OF EQUITY

Q. HAVE YOU REVIEWED THE COST OF EQUITY TESTIMONY FILED BY STAFF WITNESS JANIS FREETLY (ICC STAFF EXHIBIT 4.0)?

A. Yes, I have. As I mentioned before, Schedule 7 compares the three (3) different proposals before the Commission. I have two criticisms of Staff's methodology. The first is Ms. Freetly's comparison of IP's gas operations to a sample of utility companies. The second is Ms. Freetly's calculation of the market rate of return.

Q. WHAT IS YOUR CONCERN WITH COMPARING A GROUP OF UTILITY COMPANIES TO THE GAS OPERATIONS OF ILLINOIS POWER?

A. For the purposes of determining the appropriate return on equity for IP's gas distribution operations, I don't believe that entities operating primarily in businesses other than the distribution of natural gas should be considered. While I admire the Staff's factor analysis as a sincere attempt at quantifying the risks that investments in each company would entail, there is still information about the nature of the business that is not fully represented in the data.

There is no purely mathematical way to quantify all of the risks that are specific to each utility's business. The risks specific to a regulated LDC are different than the risks faced by a diversified energy company. In my opinion, it is appropriate to limit any sample of companies with comparable operations to those in similar lines of business to isolate industry-specific risks, and to minimize the impact that those risks could have on variability between the firm being analyzed and comparable companies. For example, a diversified energy company faces risks on all fuels employed in its energy portfolio, rather than solely natural gas price fluctuations. This approach was utilized in the analysis of both Ms. McShane and myself.

Q. WHAT CONCERNS DO YOU HAVE WITH THE MARKET RATE OF RETURN UTILIZED IN MS. FREETLY'S CAPM ANALYSIS?

A. I'm concerned that Ms. Freetly's market rate of return is limited to a portion of the S&P 500 (although it is a substantial majority). The market return utilized in a CAPM analysis is intended to represent the average return available on all of the alternative investments an investor can choose. It is my belief that returns for the entire S&P 500 need to be examined in order to accurately estimate the value of the alternatives available when establishing a market rate of return for CAPM purposes. Once again, both Ms. McShane and I utilized this approach.

IV. SUMMARY

Q. PLEASE SUMMARIZE YOUR RECOMMENDATION TO THE COMMISSION.

A. My testimony demonstrates the following:

- The appropriate capital structure for IP's gas distribution operations is:

	Capital	Ratio
Long Term Debt	$746,985,378	36.87%
TFTNs *	$309,516,375	15.28%
Preferred Stock*	$45,430,145	2.24%
Common Stock Equity	$923,881,787	45.61%
	$2,025,813,685	100.00%

* As proposed by IP Witness Mortland (IP Exhibit 3.8)

- The appropriate cost of equity for IP's gas distribution operation is 9.64%.
- The appropriate cost of IP's outstanding long-term debt is 6.80%.

- Overall, IP should be allowed the opportunity to earn a 7.93% rate of return on its gas distribution operations.

	Capital	Ratio	Cost	Weighted cost
Long Term Debt	$746,985,378	36.87%	6.80%	2.51%
TFTNs*	$309,516,375	15.28%	5.98%	0.91%
Preferred Stock*	$45,430,145	2.24%	5.05%	0.11%
Common Stock Equity	$923,881,787	45.61%	9.64%	4.40%
	$2,025,813,685			7.93%

*** As proposed by IP Witness Mortland (IP Exhibit 3.8)**

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.