

REBUTTAL TESTIMONY

OF

JANIS FREETLY

Finance Department

Financial Analysis Division

Illinois Commerce Commission

Illinois Power Company  
Proposed General Increase For Gas Rates

Docket No. 04-0476

December 28, 2004

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### Witness Identification

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

2 A. My name is Janis Freetly. My business address is 527 East Capitol Avenue,  
3 Springfield, Illinois 62701.

4 **Q. Are you the same Janis Freetly who previously testified in this proceeding?**

5 A. Yes, I am.

6 **Q. What is the purpose of your rebuttal testimony in this proceeding?**

7 A. The purpose of my rebuttal testimony is to present my revised overall cost of  
8 capital recommendation for the gas operations of Illinois Power (“IP”) in response  
9 to the rebuttal testimony of IP witness Daniel Mortland.<sup>1</sup> I will also respond to the  
10 rebuttal testimony of IP witness Kathleen McShane.<sup>2</sup>

### Response to Mr. Mortland

11 **Capital Structure**

12 **Q. What capital structure did IP propose for setting rates in its rebuttal**  
13 **testimony?**

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<sup>1</sup> Rebuttal Testimony of Daniel L. Mortland, IP Exhibit 3.8.

<sup>2</sup> Rebuttal Testimony of Kathleen C. McShane, IP Exhibit 4.4.

14 A. IP proposed using a March 30, 2005 capital structure, composed of 27.44% long-  
15 term debt, 14.35% Transitional Funding Trust Notes (“TFTNs”), 2.11% preferred  
16 stock, and 56.10% common equity.<sup>3</sup> In his rebuttal testimony, IP witness  
17 Mortland changed the capital structure measurement date from December 31,  
18 2003 to March 30, 2005 to incorporate the impacts of several specific actions  
19 related to the acquisition of IP by Ameren that have occurred or are contractually  
20 required to occur prior to March 30, 2005.<sup>4</sup>

21 **Q. Do you agree with the March 30, 2005 capital structure proposed by Mr.**  
22 **Mortland?**

23 A. No, I do not agree that the capital structure should be updated through March 30,  
24 2005. Although IP claims that the changes are contractually required to occur  
25 prior to March 30, 2005, IP did not provide the supporting documentation  
26 required to demonstrate how the transactions would be carried out. For  
27 example, in order to remove the \$70,000,000 of 6.75% new mortgage bonds  
28 maturing March 2005, IP would have to show that it had adequate cash to retire  
29 the debt or otherwise show where the funds would come from. Further, it is not  
30 appropriate to update the capital structure measurement date to a future point in  
31 time without providing forecasted financial statements as required in 83 Ill. Adm.  
32 Code 285.7075.

33 **Q. What capital structure do you recommend?**

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<sup>3</sup> Rebuttal Testimony of Daniel L. Mortland, IP Exhibit 3.10

34 A. I am willing to accept changes to reflect the recapitalization transactions that  
35 have occurred since the closing of Ameren's acquisition of Illinois Power and use  
36 November 30, 2004 as the capital structure measurement date.<sup>5</sup> Thus, I  
37 recommend adopting a November 30, 2004 capital structure composed of  
38 29.68% long-term debt, 15.23% TFTNs, 1.98% preferred stock, and 53.10%  
39 common equity, as shown on Schedule 14.01.

40 **Q. Please summarize the changes that you made to the capital structure that**  
41 **you recommended in direct testimony.**

42 A. I incorporated the changes to IP's capital structure due to the recapitalization by  
43 Ameren<sup>6</sup> and the effect of updating the balances and amortization through  
44 November 30, 2004.

45 **Q. Please explain the changes that you made to the balance of long-term**  
46 **debt?**

47 A. I made several adjustments to the balance of long-term debt presented in my  
48 direct testimony<sup>7</sup> to incorporate the recapitalization transactions that have been  
49 completed. First, I removed the 11.5% series bonds issued in December 2002  
50 and January 2003 to reflect the exercise of the equity claw back option and the

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<sup>4</sup> Rebuttal Testimony of Daniel L. Mortland, IP Exhibit 3.8.

<sup>5</sup> IP agreed to use November 30, 2004 as the capital structure measurement date and provided Staff with its estimate of the weighted average cost of capital as of November 30, 2004, including the redemption of the 7.5% new mortgage bonds due July 2025 and the 7.4% pollution control bonds series due December 2024, in its response to Staff Data Request JF-6.01.

<sup>6</sup> Rebuttal Testimony of Daniel L. Mortland, IP Exhibit 3.8, pp. 4-7.

<sup>7</sup> Direct Testimony of Janis Freetly, ICC Staff Exhibit 4.0, Schedule 4.02.

51 actual results of the tender offer completed on November 22, 2004. I did not  
52 include the remaining \$6.529 balance that IP used because the redeemed  
53 amount (\$543,471,000) exceeded the balance of \$525,500,000 that I included in  
54 my recommended balance of long-term debt in direct testimony

55 Next, I removed the \$65,630,000 of 7.5% New Mortgage Bonds due July 2025  
56 and the \$84,150,000 of 7.4% Pollution Control Bonds Series V due December  
57 2024 that were redeemed December 1, 2004. Finally, I updated the balances of  
58 Unamortized Debt Discount (Premium) and Unamortized Debt Expense to reflect  
59 eleven additional months of amortization for January through November 2004.  
60 Those debt retirements reduce the balance of long-term debt to \$684,908,607

61 **Q. Please describe the changes that you made to the balance of Transitional**  
62 **Funding Trust Notes (“TFTNs”).**

63 A. I reduced the face amount outstanding of the TFTNs to reflect the contractually  
64 mandated repayment schedule through November 30, 2004.<sup>8</sup> In addition, I  
65 updated the balances of Unamortized Debt Discount (Premium) and  
66 Unamortized Debt Expense to reflect eleven additional months of amortization for  
67 January through November 2004. Those changes reduce the balance of TFTNs  
68 to \$351,384,973.

69 **Q. Please describe the adjustments that you made to the balance of preferred**  
70 **stock.**

71 A. I removed the unamortized expense associated with preferred stock. IP  
72 eliminated its unamortized expense on preferred stock as part of the accounting  
73 adjustments IP recorded to reflect Ameren's purchase of IP. The new balance of  
74 preferred stock is \$45,786,945.<sup>9</sup>

75 **Q. Please describe the changes that you made to the balance of common**  
76 **equity.**

77 A. At the closing of the Ameren acquisition, the intercompany note between Illinova  
78 Corporation and IP was eliminated, which resulted in the elimination of IP's  
79 balance of retained earnings and an overall reduction of over \$1.2 billion in IP's  
80 balance of common equity.<sup>10</sup> Further, Ameren has infused \$865,000,000 of new  
81 common equity into IP. Those changes were reflected in the November 30, 2004  
82 balance of common equity the Company provided in response to Staff Data  
83 Request JF-6.01, which I accept as the appropriate common equity balance for  
84 use in this proceeding. The revised balance of common equity is  
85 \$1,225,360,028. The pension liability adjustment that I proposed in my direct  
86 testimony<sup>11</sup> and the Company did not accept<sup>12</sup> is no longer an issue due to the  
87 resetting of IP's common equity balance as described above.

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<sup>8</sup> IP Response to Staff Data Request JF-6.01, p. 5 of 16.

<sup>9</sup> IP Response to Staff Data Request JF-6.01, p.15b of 16.

<sup>10</sup> Rebuttal Testimony of Daniel L. Mortland, IP Exhibit 3.8, p. 4.

<sup>11</sup> Direct Testimony of Janis Freetly, ICC Staff Exhibit 4.0, p. 5.

<sup>12</sup> Rebuttal Testimony of Peggy E. Carter, IP Exhibit 2.35, pp. 51-52.

88 **Cost of Long-Term Debt**

89 **Q. What is the embedded cost of long-term debt for IP?**

90 A. As of November 30, 2004, incorporating the changes to the balance of long-term  
91 debt discussed previously, the embedded cost of long-term debt was 6.27%, as  
92 shown on Schedule 14.02.

93 **Q. Please describe the adjustments you made to Schedule 4.02 presented with**  
94 **your direct testimony.**

95 A. In addition to removing the 11.5% series bonds, the 7.5% New Mortgage Bonds  
96 due July 2025 and the 7.4% Pollution Control Bonds Series V due December  
97 2024 since these issues are no longer outstanding, I added the insurance  
98 premium costs to the Pollution Control Bonds Series S, T, W, and X, which I  
99 verified through IP's response to Staff Data Request JF-5.03. Next, I removed  
100 the amortization of debt expense associated with the 11.5% series bonds.  
101 Finally, I eliminated the balances of loss on reacquired debt that IP had written  
102 off due to the deregulation of its generation assets in 1997.

103 **Q. Why did you eliminate the balances of loss on reacquired debt that IP had**  
104 **written off due to the deregulation of its generation assets in 1997?**

105 A. As explained in my direct testimony, IP sold its generation assets to an affiliate in  
106 exchange for a \$2.8 billion note receivable from Illinova. Illinova repaid roughly  
107 \$500 million of the principal outstanding on the note shortly thereafter. In my

108 direct testimony, I eliminated an equivalent proportion of the previously written-off  
109 loss on reacquired debt in order to maintain the same ratio of loss on reacquired  
110 debt to debt outstanding.<sup>13</sup>

111 At the closing of the Ameren acquisition of IP, the intercompany note between  
112 Illinova and IP was eliminated. Hence, the entire balance of loss on reacquired  
113 debt associated with the generation assets should be eliminated. IP should not  
114 recover these costs from ratepayers; if those written-off losses on reacquired  
115 debt were included in the cost of capital for rate-regulated, utility service, then  
116 retail utility customers would be subsidizing IP's former investment in non-utility  
117 assets. Consequently, the written-off losses on reacquired debt should be  
118 excluded from the calculation of IP's embedded cost of long-term debt.

119 The deregulation of a portion a utility's assets, including their eventual  
120 disposition, should not result in the shifting of debt costs to or from the utility's  
121 remaining retail rate-regulated operations. That is, a change in the status of a  
122 portion of a utility's assets from rate-regulated to non-rate regulated should not  
123 affect the amount or proportion of capital costs each utility operation should be  
124 expected to recover. Further, just as the non-rate regulated assets should be  
125 expected to generate sufficient cash flows to recover associated (i.e.,  
126 proportional) capital costs, the sale of those non-rate regulated assets should be  
127 sufficient to recover associated (i.e., proportional) capital costs. Specifically, the  
128 Commission should assume that IP recovered the written-off loss on reacquired

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<sup>13</sup> Direct Testimony of Janis Freetly, ICC Staff Exhibit 4.0, pp. 4-5.

129 debt through the proceeds it received through the sale of its power plants. The  
130 scenarios that I present in Schedule 14.03 demonstrate that if the loss on  
131 reacquired debt associated with the Company's investment in generating plant is  
132 included in its cost of debt, those costs will be improperly shifted to gas utility  
133 customers.

134 **Q. Please explain each scenario contained in Schedule 14.03.**

135 A. Schedule 14.03 demonstrates how unamortized debt costs affect the cost of debt  
136 under five scenarios. **Scenario one** represents traditional rate making before the  
137 restructuring of electric service in Illinois in December 1997, in which both the  
138 delivery services and generation operations were rate-regulated. In this  
139 scenario, debt costs would be recovered from a particular investment in  
140 proportion to total investment. Since delivery services operations comprise 40%  
141 of total investment in scenario one, 40% of debt costs (i.e., \$25,280) would be  
142 recovered from delivery services operations and 60% of debt costs (i.e., \$37,920)  
143 would be recovered from generation operations.

144 **Scenario two** depicts the retail deregulation of generation operations and the  
145 resulting write down of debt expense. In this scenario, the utility retains  
146 ownership of generation plant. Further, the written-down debt costs are not  
147 restored for the purpose of determining the cost of capital for delivery services.  
148 Since the utility's capital structure still supports both the delivery services  
149 operations and generation operations, the remaining \$8,000 in debt expense is

150 spread over the same amount of debt outstanding, or \$1,020,000, thus reducing  
151 the calculated cost of debt. As such, the embedded cost of debt declines from  
152 6.32% to 6.13% and the proportion of debt costs recovered from delivery service  
153 customers would decline from 40% to 39.24%. In summary, when a utility retains  
154 ownership of deregulated assets, any debt costs that were written down as a  
155 result of that deregulation must be restored for the purpose of setting utility rates  
156 so that the utility continues to recover the same proportion of debt costs from the  
157 regulated service that it had recovered before deregulation. This is shown in  
158 **scenario three**, which is identical to scenario two except that the \$12,000 in  
159 written-off debt costs are restored for the purpose of determining the cost of  
160 capital for delivery services. The dollar amount (i.e., \$25,280) and proportion  
161 (i.e., 40%) of debt costs recovered from delivery services is identical to that  
162 before restructuring. The remaining 60% of debt costs would have to be  
163 recovered from the deregulated generation business just as it was when  
164 generation was rate-regulated.

165 **Scenario four** corresponds to the position that IP has taken in this case with  
166 regard to the written-off losses on reacquired debt. In contrast to scenarios two  
167 and three, under which the utility retains ownership of the deregulated generation  
168 plant, the deregulated generation plant is sold for \$1,212,000, the proceeds from  
169 which are used to retire 60% of the principal amount of debt outstanding and to  
170 fund dividends or stock repurchases equal to 60% of the common equity  
171 balance. Further, the utility is allowed to restore \$12,000 in debt costs that had  
172 been written-off due to deregulation. As a result of the reduction in the amount of

173 debt outstanding, the embedded cost of debt increases since debt expense has  
174 increased from almost 2% of debt outstanding (i.e., \$20,000 of debt expense ÷  
175 \$1,020,000 of debt outstanding) to almost 5% of debt outstanding (i.e., \$20,000  
176 of debt expense ÷ \$408,000 of debt outstanding). In consequence, delivery  
177 service customers would become responsible for reimbursing the utility for  
178 42.54% of debt costs rather than the 40% of debt costs for which they were  
179 responsible before deregulation or the sale of the generation plant. This shifting  
180 of additional debt costs to the utility delivery services customer is not appropriate  
181 and would be a form of subsidy of deregulated operations by regulated  
182 operations.

183 To prevent shifting a portion of debt costs to delivery service customers, when a  
184 utility disposes of non-utility assets, it should be assumed that it recovered an  
185 equitable proportion of debt costs. This principal is illustrated in **scenario five**,  
186 which corresponds to my position that written-off losses to reacquired debt  
187 should be excluded from the calculation of IP's embedded cost of debt. Although  
188 the written-off debt costs are not included in the embedded cost of debt, the utility  
189 would still recover the same dollar amount (i.e., \$25,280) and proportion (i.e.,  
190 40%) of debt costs from delivery service customers that it did before generation  
191 was deregulated. In summary, when a utility disposes of its non-utility assets, as  
192 IP did when it was sold to Ameren, debt costs such as losses on reacquired debt  
193 that were associated with the proportion of debt capital that supported those non-

194 utility assets should not be included in the embedded cost of debt for the purpose  
195 of setting utility rates.<sup>14</sup>

196 **Q. IP witness Mortland notes that Staff did not recommend excluding any of**  
197 **the written-off losses on reacquired debt in IP's last delivery services rate**  
198 **case (Docket No, 01-0432) even though the principal payments on the**  
199 **intercompany note were made prior to that case.<sup>15</sup> How do you respond?**

200 A. The proper treatment of the written-off losses on reacquired debt was not an  
201 issue in Docket No. 01-0432. The parties in that case reached an agreement on  
202 the rate of return, including the components thereof, for the purposes of setting  
203 rates for delivery services in that proceeding. Staff did not put forward an official  
204 position in testimony on how those losses on reacquired debt should be treated  
205 for ratemaking purposes. I am taking the position in this case that the written-off  
206 losses on reacquired debt should be excluded from the calculation of IP's  
207 embedded cost of long-term debt, as explained previously.

208 **Cost of Transitional Funding Trust Notes**

209 **Q. What is the embedded cost of IP's TFTNs?**

210 A. The embedded cost of IP's TFTNs is 5.95%, as shown on Schedule 14.04

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<sup>14</sup> The cancellation of the \$2.3 billion note that IP held from Illinova represents a disposition of a non-utility asset.

<sup>15</sup> Rebuttal Testimony of Daniel L. Mortland, IP Exhibit 3.8, pp. 8-9.

211 **Q. Please explain how you determined the embedded cost of IP's TFTNs.**

212 A. To determine the annual interest cost, I applied the 5.72% internal rate of return  
213 ("IRR") that I developed in direct testimony<sup>16,17</sup> to the face amount outstanding as  
214 of November 30, 2004. I then added the amortization of debt discount and debt  
215 expense to calculate the total expense associated with the TFTNs. Finally, I  
216 divided the total expense by the carrying value to derive the embedded cost of  
217 TFTNs of 5.95%, as shown on Schedule 14.04.

218 **Cost of Preferred Stock**

219 **Q. What is the embedded cost of preferred stock for IP?**

220 A. IP's embedded cost of preferred stock is 5.01%.<sup>18</sup> The elimination of the  
221 unamortized expense that I described earlier lowered that cost slightly.

222 **Cost of Common Equity**

223 **Q. What is IP's cost of common equity?**

224 A. My analysis indicates that the cost of common equity for IP's gas operations is  
225 10.14%.

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<sup>16</sup> Direct Testimony of Janis Freetly, ICC Staff Exhibit 4.0, p. 10 & Schedule 4.03.

<sup>17</sup> IP accepted the 5.72% IRR as the appropriate interest rate for the TFTNs in the Rebuttal Testimony of Daniel Mortland, IP Exhibit 3.8, pp.10-11.

<sup>18</sup> IP Response to Staff Data Request JF-6.01, p. 15b of 16.

226 **Q. Please summarize how you determined the 10.14% estimate of the investor-**  
227 **required rate of return on common equity for IP's gas operations.**

228 A. I reviewed the results of the DCF and risk premium analyses presented in my  
229 direct testimony.<sup>19</sup> Due to the increase in IP's common equity ratio resulting from  
230 the recapitalization by Ameren, the financial risk of IP has decreased. Although  
231 the credit rating agencies have not taken further action to reflect the  
232 recapitalization transactions that have transpired, an adjustment to my estimate  
233 of IP's cost of common equity is necessary to reflect that decrease in financial  
234 risk. When IP's common equity ratio is compared to the average common equity  
235 ratios for my gas and utility samples, it becomes apparent that a change to my  
236 cost of equity recommendation is necessary. For the four quarters ended June  
237 30, 2004, the mean common equity ratio of my gas sample was 46.63%, with a  
238 standard deviation of 3.90%. The mean common equity ratio of my utility sample  
239 was 38.52%, with a standard deviation of 4.30% for the four quarters ended June  
240 30, 2004. The November 30, 2004, common equity ratio of 53.18% is much  
241 closer to that of the gas sample. Hence, in my judgment, the weighting applied  
242 to the cost of equity estimates for the gas and utility samples should be reversed.  
243 Therefore, I applied two-thirds weight to the gas sample average investor-  
244 required rate of return on common equity (9.92%) and one-third weight to the  
245 utility sample average investor-required rate of return on common equity  
246 (10.59%). My recommended cost of equity for IP, 10.14%, is the result of that  
247 calculation.

248 To verify the reasonableness of the revised cost of common equity estimate, I  
249 compared the interest coverage ratio implied in my recommended overall cost of  
250 capital for IP to the average interest coverage ratio for my sample companies.  
251 My recommended overall cost of capital for IP implies an interest coverage ratio  
252 of 4.30. For 2003, the interest coverage ratio for my gas sample was 4.03 with a  
253 standard deviation of 0.83, and 2.53 with a standard deviation of 0.90 for my  
254 utility sample. The three-year average interest coverage ratio for the 2001  
255 through 2003 period was 3.49 for my gas sample and 2.16 for my utility sample.  
256 This further illustrates that the financial risk of IP following its acquisition by  
257 Ameren is closer to that of my gas sample than my utility sample and justifies the  
258 weighting reversal.

259 **Overall Cost of Capital Recommendation**

260 **Q. What is the overall cost of capital for the gas operations of IP?**

261 A. As shown on Schedule 14.01, the overall cost of capital for the gas operations of  
262 IP is 8.25%. The recommended estimate incorporates a cost of common equity  
263 of 10.14%.

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<sup>19</sup> Direct Testimony of Janis Freetly, ICC Staff Exhibit 4.0, pp. 10-31.

**Response to Ms. McShane**

264 **Q. Ms. McShane disagrees with your use of a spot dividend yield in the**  
265 **application of the DCF and claims that use of an average stock price will**  
266 **smooth out aberrations in stock prices. Please respond.**

267 A. Ms. McShane claims that she used historical data to estimate the dividend yield  
268 because it “will smooth out daily aberrations in stock prices and provide a  
269 sounder basis for setting an allowed return that will be in place for an extended  
270 period of time”<sup>20</sup> I agree that measurement error is a problem inherent in cost of  
271 common equity analysis and should be reduced whenever possible, but  
272 introducing old stock prices into an analysis simply substitutes one alleged  
273 source of measurement error, volatile stock prices, for another, irrelevant stock  
274 prices. Stock prices can be influenced by temporary imbalances in supply and  
275 demand; however, any distortions such imbalances might have on the measured  
276 cost of common equity can be reduced through the use of samples, a technique  
277 which Ms. McShane already applies.<sup>21</sup>

278 The use of historical stock data in DCF analysis is problematic. First, historical  
279 stock data improperly favors outdated information that the market no longer  
280 considers relevant over the most-recently available information. Second,  
281 historical stock data reflects conditions that may not continue in the future. In  
282 other words, use of average historical data wrongly implies that securities data

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<sup>20</sup> Rebuttal Testimony of Kathleen C. McShane, IP Exhibit 4.4, pp. 5-6, lines 105-107.

<sup>21</sup> Direct Testimony of Kathleen C. McShane, IP Exhibit 4.1, pp. 4-7.

283 will revert to a mean. To the contrary, security return movements approximate a  
284 random walk, which suggests no tendency of mean reversion.<sup>22</sup> That is, in a  
285 random walk, the “future steps or directions cannot be predicted on the basis of  
286 past actions.”<sup>23</sup> Finally, even if securities data were mean reverting, there is no  
287 method for determining the true value of that mean. Consequently, sample  
288 means, which depend upon the measurement period used, are substituted.  
289 Thus, any measurement period chosen is arbitrary, rendering the results  
290 uninformative.

291 Ms. McShane used historical data to calculate the dividend yield (i.e., dividend ÷  
292 stock price) in her DCF model. Since stock prices reflect all current information,  
293 only the most recent stock price can reflect the most recently available  
294 information. Historical stock prices necessarily include observations that cannot  
295 reflect the most current information available to the market. For example, if the  
296 actual earnings for a company were much higher than anticipated, the market  
297 would react to that news and bid up its stock price. Consequently, the pre-  
298 earnings announcement stock prices would reflect obsolete information and  
299 understate the value of that company’s stock.

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<sup>22</sup> Burton G. Malkiel, *A Random Walk Down Wall Street*, Fourth Edition, Norton, 1985, pp. 132 and 146.

<sup>23</sup> *Id.*, at 16, *emphasis added*.

300 **Q. Ms. McShane claims that forecasts of the risk free rate indicate that**  
301 **expectations are approximately 6.0%. She concludes that a 6.0% risk-free**  
302 **rate should be used. Do you agree?**

303 A. No. Obviously, a discrepancy exists between the real risk-free rate and inflation  
304 expectations embedded in the long-term forecasts Ms. McShane cited and those  
305 embedded in the T-bond yield. That is, those long-term forecasts are not in line  
306 with expectations of the investing public (as reflected in T-bond yields), or  
307 investors are willing to accept a lower return than the forecasts suggest.

308 It is important to note that T-bond yields reflect market forces, while forecasts do  
309 not. The true risk-free rate is reflected in the return investors are willing to accept  
310 in the market. As of October 14, 2004, investors were willing to accept a 4.87%  
311 return on T-bonds, despite the T-bonds' inclusion of a maturity premium. That  
312 the T-bond yield includes a maturity premium indicates that the true long-term  
313 risk-free rate is actually below 4.87%.

314 **Q. Ms. McShane notes that betas calculated by Value Line for your Gas**  
315 **Sample are significantly higher than your regression beta, and suggests**  
316 **your regression beta should be disregarded. Do you agree?**

317 A. No. The methodology I used to calculate the betas for my samples, which Staff  
318 has regularly used and the Commission has consistently approved,<sup>24</sup> employs

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<sup>24</sup> Order, Docket No. 02-0837, October 17, 2003, pp. 37-38; Order, Docket Nos. 02-0798/03-0008/03-0009 Cons., October 22, 2003, p. 85; Order, Docket No. 00-0340, February 15, 2001, p. 25; and Order, Docket No. 03-0403, April 13, 2004, p. 42.

319 the same monthly frequency of stock price data as Merrill Lynch and is widely  
320 accepted. The Value Line methodology is not inherently superior to Staff's  
321 methodology. Different beta estimation methodologies can produce different  
322 betas when those methodologies employ different samples of stock return data.  
323 In the past, Staff had little need to include Value Line beta estimates in its  
324 analyses, since the Staff regression and Value Line methodologies produced  
325 very similar results. However, the difference that currently exists between the  
326 Value Line results and my regression analysis results led me to include the Value  
327 Line beta with the regression beta Staff regularly uses.

328 **Q. Do the Value Line and the Bloomberg betas presented by CUB witness**  
329 **Thomas indicate your regression betas are too low?**

330 A. No. Value Line, Bloomberg and regression betas are estimates of the  
331 unobservable true beta, which measures investors' expectations of the quantity  
332 of non-diversifiable risk inherent in a security. Consequently, which beta  
333 estimates are more accurate is unknown. Further, other sources publish beta  
334 estimates for the companies in my gas and utility samples that are even lower  
335 than the regression beta estimates. For example, the published betas for my  
336 gas sample from Zacks and Yahoo! Finance average 0.43 after adjustment,  
337 which is lower than the adjusted regression beta of 0.58.<sup>25,26</sup> The published  
338 betas for my utility sample from Zacks and Yahoo! Finance average 0.55 after

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<sup>25</sup> Using the same upward adjustment applied to the raw regression betas.

<sup>26</sup> Zacks Research Wizard, December 7, 2004; Yahoo Finance Key Statistics,  
<http://finance.yahoo.com/q/ks?s...>, December 7, 2004.

339 adjustment, which is lower than the adjusted regression beta of 0.72.<sup>27</sup> The beta  
340 estimates from the various sources I reviewed are shown in the table below. The  
341 disparity in beta estimates does not indicate which beta estimates are superior.

<b>Beta Estimates</b>	Value Line	Regression	Zacks	Yahoo
Gas Sample Average	0.75	0.58	0.43	0.43
Utility Sample Average	0.79	0.72	0.54	0.56

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343 **Q. Ms. McShane claims that the Value Line beta estimates are superior to the**  
344 **regression beta because the average R-square statistic is higher when**  
345 **using weekly data rather than monthly data.<sup>28</sup> Is she correct?**

346 A. No. In the context of beta estimation through regression analysis, the R-square  
347 statistic measures the proportion of a security's risk that cannot be eliminated  
348 through portfolio diversification (i.e., "systematic risk" or "market risk"). However,  
349 Value Line and regression betas are proxies for investors' expectations of the  
350 non-diversifiable risk inherent in a security. Thus, the R-square statistic  
351 represents an estimate of the true proportion of a security's risk that is  
352 systematic. Like any estimate, the R-square for a beta regression contains  
353 measurement error, which can be either too high or too low. If the R-square  
354 statistic for a security equals 0.20, which means that the model estimates that

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<sup>27</sup> Zacks Research Wizard, December 7, 2004; Yahoo Finance Key Statistics,  
<http://finance.yahoo.com/q/ks?s...>, December 7, 2004.

<sup>28</sup> Rebuttal Testimony of Kathleen C. McShane, IP Exhibit 4.4, pp. 8-10.

355 20% of the security's risk is systematic, but the true proportion of systematic risk  
356 in a security is actually 15%, then the model has over-estimated the extent to  
357 which that security's return is systematic.

358 **Q. Ms. McShane provides testimony in response to your criticism of the**  
359 **comparable earnings model and the market to book adjustment that she**  
360 **proposed in her direct testimony. Did her rebuttal testimony change your**  
361 **position with regard to those issues?**

362 A. No. I have not changed the position that I put forward in direct testimony  
363 regarding the comparable earnings model and market to book adjustment  
364 proposed by Ms. McShane. My direct testimony cites many Commission Orders  
365 that previously rejected these approaches and explains why the Commission  
366 should once again reject them in this proceeding.<sup>29</sup> Ms. McShane herself  
367 acknowledged that the comparable earnings test does not measure the investor-  
368 required rate of return on equity.<sup>30</sup>

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

370 A. Yes.

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<sup>29</sup> Direct Testimony of Janis Freetly, ICC Staff Exhibit 4.0, pp. 32-42.

<sup>30</sup> Rebuttal Testimony of Kathleen C. McShane, IP Exhibit 4.4, p. 12.

**Illinois Power Company**

Weighted Average Cost of Capital  
November 30, 2004

**Staff Proposal**

	<u>Amount</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Weighted Cost</u>
Long-term Debt	\$684,908,607	29.68%	6.27%	1.86%
TFTN	\$351,384,973	15.23%	5.95%	0.91%
Preferred Stock	\$45,786,945	1.98%	5.01%	0.10%
Common Equity	<u>\$1,225,360,028</u>	<u>53.10%</u>	<u>10.14%</u>	<u>5.38%</u>
Total Capital	\$2,307,440,553	100.00%		
<b>Weighted Average Cost of Capital</b>				<b>8.25%</b>

**Illinois Power Company**  
**Embedded Cost of Long-Term Debt**  
**November 30, 2004**

Debt Issue Type Coupon Rate (A)	Date Issued (B)	Maturity Date (C)	Original Principal Amount (D)	Face Amount Outstanding (E)	Unamortized		Carrying Value (H)	Coupon Interest Expense (I)	Amortization		Total Expense (L)
					Debt Discount or (Premium) (F)	Unamortized Debt Expense (G)			of Debt Discount or (Premium) (J)	Amortization of Debt Expense (K)	
6.75% New Mortgage Bond	3/15/93	3/15/05	70,000,000	70,000,000	15,129	2,903	69,981,968	4,725,000	52,385	10,052	4,787,437
7.50% New Mortgage Bond	7/22/93	7/15/25	200,000,000	0	624,510	57,660	(682,170)	0	30,262	2,794	33,056
5.40% PCB Series S	3/6/98	3/1/28	18,700,000	18,700,000		453,894	18,246,106	1,033,800		19,495	1,053,295
5.40% PCB Series T	3/6/98	3/1/28	33,755,000	33,755,000		458,160	33,296,840	1,866,770		19,692	1,886,462
7.50% New Mortgage Bond	6/29/99	6/15/09	250,000,000	250,000,000	167,049	1,068,208	248,764,743	18,750,000	36,766	235,101	19,021,867
5.70% PCB Series U	2/1/94	2/1/24	35,615,000	35,615,000	4,263,946	1,169,486	30,181,568	2,030,055	222,258	60,959	2,313,272
7.40% PCB Series V	12/1/94	12/1/24	84,150,000	0	562,461	2,591,535	(3,153,996)	0	28,098	129,463	157,561
1.77% PCB Series P,Q,R Adjustable Auction Agent & Broker Fees	4/10/97	4/1/32	150,000,000	150,000,000		3,311,070	146,688,930	2,655,000		121,043	2,776,043
1.80% PCB Series W Adjustable Auction Agent & Broker Fees	4/10/97	4/1/32	150,000,000					398,625			398,625
1.80% PCB Series W Adjustable	5/1/01	11/1/28	111,770,000	111,770,000		3,257,487	108,512,513	2,145,984		136,079	2,282,063
1.75% PCB Series X Adjustable Auction Agent & Broker Fees	5/1/01	11/1/28	111,770,000					298,985			298,985
1.75% PCB Series X Adjustable	5/1/01	3/1/17	75,000,000	75,000,000		1,577,401	73,422,599	1,402,500		128,676	1,531,176
1.75% PCB Series X Adjustable Auction Agent & Broker Fees	5/1/01	3/1/17	75,000,000					200,625			200,625
5.70% Mortgage Bond	12/20/02	12/15/10	525,250,000	0		0	0	0		0	0
14.5,12 Loss on Reacquired Debt	9/1/86	9/1/16	158,520,000			2,610,427	-2,610,427			221,923	221,923
10.5 Loss on Reacquired Debt	5/1/91	9/1/04	50,000,000			0	0			0	0
8.625 Loss on Reacquired Debt	4/1/93	3/1/05	100,000,000			32,750	(32,750)			130,761	130,761
10.75 Loss on Reacquired Debt	12/1/93	11/1/28	111,770,000			1,771,853	(1,771,853)			74,018	74,018
11.625 Loss on Reacquired Debt	5/1/94	2/1/24	35,615,000			485,895	(485,895)			25,327	25,327
10.75 Loss on Reacquired Debt	3/1/95	12/1/24	84,150,000			806,312	(806,312)			40,280	40,280
9.9,12.6 Loss on Reacquired Debt	11/1/90	7/1/16	63,500,000			76,857	(76,857)			6,630	6,630
9.375 Loss on Reacquired Debt	3/1/93	2/1/23	125,000,000			2,438,457	(2,438,457)			134,094	134,094
8.875 Loss on Reacquired Debt	3/1/93	2/1/23	100,000,000			1,229,506	(1,229,506)			67,612	67,612
7.625 Loss on Reacquired Debt	6/1/97	4/1/32	150,000,000			1,892,115	(1,892,115)			69,170	69,170
series E Loss on Reacquired Debt	7/1/87	4/1/17	33,755,000			985,156	(985,156)			79,811	79,811
12 Loss on Reacquired Debt	1/1/88	11/1/12	6,827,000			77,863	(77,863)			9,822	9,822
8.3,6 Loss on Reacquired Debt	3/1/98	3/1/28	52,455,000			415,886	(415,886)			17,875	17,875
8.25,10 Loss on Reacquired Debt	8/1/93	7/1/25	150,000,000			586,658	(586,658)			28,481	28,481
8.75 Loss on Reacquired Debt	1/1/99	12/1/08	57,061,000			2,851,212	(2,851,212)			711,625	711,625

**Illinois Power Company**  
**Embedded Cost of Long-Term Debt**  
 November 30, 2004

Debt Issue Type Coupon Rate (A)	Date Issued (B)	Maturity Date (C)	Original Principal Amount (D)	Face Amount Outstanding (E)	Unamortized Debt Discount or (Premium) (F)	Unamortized Debt Expense (G)	Carrying Value (H)	Coupon Interest Expense (I)	Amortization of Debt Discount or (Premium) (J)	Amortization of Debt Expense (K)	Total Expense (L)	
7.95	Loss on Reacquired Debt	1/1/99	12/1/08	72,000,000		5,666,309	(5,666,309)			1,414,236	1,414,236	
7.375	Loss on Reacquired Debt	7/20/99	12/1/08	84,710,000		3,023,133	(3,023,133)			754,534	754,534	
var	Loss on Reacquired Debt	5/1/01	11/1/28	111,770,000		1,225,306	(1,225,306)			51,186	51,186	
var	Loss on Reacquired Debt	5/1/01	3/1/17	75,000,000		423,897	(423,897)			34,579	34,579	
MIPS	Loss on Reacquired Debt	8/1/01	12/1/43	93,000,000		2,570,300	(2,570,300)			65,857	65,857	
TOPRS	Loss on Reacquired Debt	9/1/01	1/1/45	100,000,000		2,699,150	(2,699,150)			67,283	67,283	
7.5	Loss on Reacquired Debt	4/1/96	7/1/25	23,000,000		(273,561)	273,561			(13,281)	(13,281)	
8	Loss on Reacquired Debt	1/1/99	12/1/08	229,000,000		6,077,057	(6,077,057)			1,516,754	1,516,754	
9.45	Loss on Reacquired Debt	3/1/99	12/1/08	3,872,500		84,675	(84,675)			21,134	21,134	
6.5	Loss on Reacquired Debt	2/1/99	12/1/08	72,000,000		268,411	(268,411)			66,992	66,992	
7.5	Loss on Reacquired Debt	1/1/99	12/1/08	68,370,000		3,012,862	(3,012,862)			751,971	751,971	
6	Loss on Reacquired Debt	8/1/99	12/1/08	10,000,000		(239,531)	239,531			(59,784)	(59,784)	
7.5	Loss on Reacquired Debt	10/1/99	12/1/08	11,000,000		(298,992)	298,992			(74,625)	(74,625)	
6.25	Loss on Reacquired Debt	10/1/99	12/1/08	4,325,000		(51,805)	51,805			(12,930)	(12,930)	
7.5	Loss on Reacquired Debt	1/1/00	12/1/08	32,000,000		(97,665)	97,665			(24,376)	(24,376)	
<b>TOTAL ENDING BALANCE</b>					744,840,000	5,633,095	54,298,297	684,908,607	35,507,344	369,769	7,646,998	42,917,427

**Embedded cost of long-term debt = 6.27%**

**Scenario 1** illustrates how unamortized debt costs affect the cost of debt when the utility is a fully rate-regulated, integrated company. The first table presents the embedded cost of debt. The second table presents the overall cost of capital including the weighted cost of debt. The last table presents the rate base and the amount and proportion of debt expense that would be recovered from rate regulated services (i.e., the product of rate base and the weighted cost of debt.)

**Embedded Cost of Debt**

Interest Rate (A)	Face Amount Outstanding (B)	Unamort. Debt Exp. (C)	Net Proceeds (D)=(B)-(C)	Coupon Interest (E)=(A)x(B)	Amort. Debt Exp. (F)	Interest Expense (G)=(E)+(F)	Embedded Cost of Debt (H)=(G)/(D)
6.00%	\$ 1,020,000	\$ 20,000	\$ 1,000,000	\$ 61,200	\$ 2,000	\$ 63,200	6.32%

**Cost of Capital (CoC)**

Component (I)	Amount (J)	Percentage (K)	Cost (L)	Wt Cost (M)=(K)x(L)
Equity	\$ 1,000,000	50.00%	10.00%	5.00%
Debt	1,000,000	50.00%	6.32%	3.16%
<b>Total (CoC)</b>	<b>\$ 2,000,000</b>	<b>100.00%</b>		<b>8.16%</b>

**Rate Base and Operating Income**

Component (N)	Rate Base (O)	Debt Cost Component of Operating Inc. (P)	Percentage of Total Interest Expense (Q)
Delivery Services Plant	\$ 800,000	\$ 25,280	40.00%
Generation Plant	1,200,000	37,920	60.00%
<b>Total</b>	<b>\$ 2,000,000</b>	<b>\$ 63,200</b>	

**(P) = Weighted Cost of Debt x Rate Base**

**Scenario 2** illustrates how unamortized debt costs affect the cost of debt when the utility retains ownership of its electric generation plant, which is deregulated, and a proportion of unamortized debt costs are **written-off and not restored** for the purpose of determining the cost of debt for the regulated delivery service portion of the company.

The first table presents the embedded cost of debt. The second table presents the overall cost of capital including the weighted cost of debt. The last table presents the rate base and the amount and proportion of debt expense that would be recovered from rate regulated services (i.e., the product of rate base and the weighted cost of debt.)

**Embedded Cost of Debt**

Interest Rate (A)	Face Amount Outstanding (B)	Unamort. Debt Exp. (C)	Net Proceeds (D)=(B)-(C)	Coupon Interest (E)=(A)x(B)	Amort. Debt Exp. (F)	Interest Expense (G)=(E)+(F)	Embedded Cost of Debt (H)=(G)/(D)
6.00%	\$ 1,020,000	\$ 8,000	\$ 1,012,000	\$ 61,200	\$ 800	\$ 62,000	6.13%

60% of debt expense is written-off (i.e., \$12,000) since deregulated generation plant is 60% of total plant.

**Cost of Capital (CoC)**

Component (I)	Amount (J)	Percentage (K)	Cost (L)	Wt Cost (M)=(K)x(L)
Equity	\$ 988,000	49.40%	10.00%	4.94%
Debt	1,012,000	50.60%	6.13%	3.10%
Total (CoC)	\$ 2,000,000	100.00%		8.04%

Write-off of debt expense reduces common equity by the same amount.

**Rate Base and Operating Income**

Component (N)	Rate Base (O)	Debt Cost Component of Operating Inc. (P)	Percentage of Original Interest Expense (Q)
Delivery Services Plant	\$ 800,000	\$ 24,800	39.24%
Generation Plant	0	-	
Total	\$ 800,000	\$ 24,800	

(Q) = (P) / \$63,200

(P) = Weighted Cost of Debt x Rate Base

**Scenario 3** illustrates how unamortized debt costs affect the cost of debt when the utility retains ownership of its electric generation plant, which is deregulated, and a proportion of unamortized debt costs are **written-off and restored** for the purpose of determining the cost of debt for the regulated delivery service portion of the company. The first table presents the embedded cost of debt. The second table presents the overall cost of capital including the weighted cost of debt. The last table presents the rate base and the amount and proportion of debt expense that would be recovered from rate regulated services (i.e., the product of rate base and the weighted cost of debt.)

**Embedded Cost of Debt**

Interest Rate (A)	Face Amount Outstanding (B)	Unamort. Debt Exp. (C)	Net Proceeds (D)=(B)-(C)	Coupon Interest (E)=(A)x(B)	Amort. Debt Exp. (F)	Interest Expense (G)=(E)+(F)	Embedded Cost of Debt (H)=(G)/(D)
6.00%	\$ 1,020,000	\$ 8,000	\$ 1,012,000	\$ 61,200	\$ 800	\$ 62,000	
Written-Off Debt Expense		\$ 12,000	\$ (12,000)		\$ 1,200	\$ 1,200	
<b>Total</b>	<b>\$ 1,020,000</b>	<b>\$ 20,000</b>	<b>\$ 1,000,000</b>	<b>\$ 61,200</b>	<b>\$ 2,000</b>	<b>\$ 63,200</b>	<b>6.32%</b>

**Cost of Capital (CoC)**

Component (I)	Amount (J)	Percentage (K)	Cost (L)	Wt Cost (M)=(K)x(L)
Equity	\$ 1,000,000	50.00%	10.00%	5.00%
Debt	1,000,000	50.00%	6.32%	3.16%
<b>Total (CoC)</b>	<b>\$ 2,000,000</b>	<b>100.00%</b>		<b>8.16%</b>

**Rate Base and Operating Income**

Component (N)	Rate Base (O)	Debt Cost Component of Operating Inc. (P)	Percentage of Original Interest Expense (Q)
Delivery Services Plant	\$ 800,000	\$ 25,280	40.00%
Generation Plant	0	-	
<b>Total</b>	<b>\$ 800,000</b>	<b>\$ 25,280</b>	

$(Q) = (P) / \$63,200$

$(P) = \text{Weighted Cost of Debt} \times \text{Rate Base}$

**Scenario 4** illustrates how unamortized debt costs affect the cost of debt when the utility sells its electric generation plant, which is deregulated, and a proportion of unamortized debt costs are **written-off and restored** for the purpose of determining the cost of debt for the regulated delivery service portion of the company. Sale Price = \$1,212,000  
 The first table presents the embedded cost of debt. The second table presents the overall cost of capital including the weighted cost of debt. The last table presents the rate base and the amount and proportion of debt expense that would be recovered from rate regulated services (i.e., the product of rate base and the weighted cost of debt.)

**Embedded Cost of Debt**

Interest Rate (A)	Face Amount Outstanding (B)	Unamort. Debt Exp. (C)	Net Proceeds (D)=(B)-(C)	Coupon Interest (E)=(A)x(B)	Amort. Debt Exp. (F)	Interest Expense (G)=(E)+(F)	Embedded Cost of Debt (H)=(G)/(D)
6.00%	\$ 408,000	\$ 8,000	\$ 400,000	\$ 24,480	\$ 800	\$ 25,280	
Written-Off Debt Expense		\$ 12,000	\$ (12,000)		\$ 1,200	\$ 1,200	
<b>Total</b>	<b>\$ 408,000</b>	<b>\$ 20,000</b>	<b>\$ 388,000</b>	<b>\$ 24,480</b>	<b>\$ 2,000</b>	<b>\$ 26,480</b>	<b>6.82%</b>

**Cost of Capital (CoC)**

Component (I)	Amount (J)	Percentage (K)	Cost (L)	Wt Cost (M)=(K)x(L)
Equity	\$ 400,000	50.76%	10.00%	5.08%
Debt	388,000	49.24%	6.82%	3.36%
<b>Total (CoC)</b>	<b>\$ 788,000</b>	<b>100.00%</b>		<b>8.44%</b>

Proceeds from sale applied as follows: \$600,000 for common dividends and \$612,000 for debt retirement.

**Rate Base and Operating Income**

Component (N)	Rate Base (O)	Debt Cost Component of Operating Inc. (P)	Percentage of Original Interest Expense (Q)
Delivery Services Plant	\$ 800,000	\$ 26,883	42.54%
Generation Plant	0	-	
<b>Total</b>	<b>\$ 800,000</b>	<b>\$ 26,883</b>	

$(Q) = (P) / \$63,200$

$(P) = \text{Weighted Cost of Debt} \times \text{Rate Base}$

**Scenario 5** illustrates how unamortized debt costs affect the cost of debt when the utility sells its electric generation plant, which is deregulated, and a proportion of unamortized debt costs are **written-off and not restored** for the purpose of determining the cost of debt for the regulated delivery service portion of the company. Sale Price = \$1,212,000  
 The first table presents the embedded cost of debt. The second table presents the overall cost of capital including the weighted cost of debt. The last table presents the rate base and the amount and proportion of debt expense that would be recovered from rate regulated services (i.e., the product of rate base and the weighted cost of debt.)

**Embedded Cost of Debt**

Interest Rate (A)	Face Amount Outstanding (B)	Unamort. Debt Exp. (C)	Net Proceeds (D)=(B)-(C)	Coupon Interest (E)=(A)x(B)	Amort. Debt Exp. (F)	Interest Expense (G)=(E)+(F)	Embedded Cost of Debt (H)=(G)/(D)
6.00%	\$ 408,000	\$ 8,000	\$ 400,000	\$ 24,480	\$ 800	\$ 25,280	6.32%

60% of debt expense is written-off (i.e., \$12,000) since deregulated generation plant is 60% of total plant.

**Cost of Capital (CoC)**

Component (I)	Amount (J)	Percentage (K)	Cost (L)	Wt Cost (M)=(K)x(L)
Equity	\$ 400,000	50.00%	10.00%	5.00%
Debt	400,000	50.00%	6.32%	3.16%
<b>Total (CoC)</b>	<b>\$ 800,000</b>	<b>100.00%</b>		<b>8.16%</b>

Proceeds from sale applied as follows: \$600,000 for common dividends and \$612,000 for debt retirement.

**Rate Base and Operating Income**

Component (N)	Rate Base (O)	Debt Cost Component of Operating Inc. (P)	Percentage of Original Interest Expense (Q)
Delivery Services Plant	\$ 800,000	\$ 25,280	40.00%
Generation Plant	0	-	
<b>Total</b>	<b>\$ 800,000</b>	<b>\$ 25,280</b>	

(Q) = (P) / \$63,200

(P) = Weighted Cost of Debt x Rate Base

**Illinois Power Company**  
 Embedded Cost of Long-Term Debt  
 November 30, 2004

Debt Issue Type	Date Issued	Maturity Date	Original Principal Amount	Face Amount Outstanding	Unamortized Debt Discount or (Premium)	Unamortized Debt Expense	Carrying Value	Coupon Interest Expense	Amortization of Debt Discount or (Premium)	Amortization of Debt Expense	Total Expense
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)	(L)
5.72% TFTNs	12/22/98	12/25/08	\$864,000,000	\$354,036,905	\$33,506	\$2,618,426	\$351,384,973	\$20,250,911	\$8,228	\$642,973	\$20,902,111

**Embedded Cost of TFTNs = 5.95%**