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ILLINOIS COMMERCE COMMISSION

DOCKET NOS. 06-0070, 06-0071 and 06-0072

REBUTTAL TESTIMONY

OF

LEE R. NICKLOY

Submitted On Behalf

Of

**CENTRAL ILLINOIS LIGHT COMPANY d/b/a AMERENCILCO,
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY d/b/a AMERENCIPS and
ILLINOIS POWER COMPANY, d/b/a AMERENIP**

May 26, 2006

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Q. Please state your name and business address.

A. My name is Lee R. Nickloy. My business address is 1901 Chouteau Avenue, St. Louis, Missouri 63103.

Q. Are you the same Lee R. Nickloy who previously submitted direct testimony in these proceedings?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to certain statements, analyses and/or contentions made by the following witnesses in their direct testimony submitted in these proceedings: Commission Staff witnesses Alan S. Pregozen and Janis Freetly, Illinois Industrial Energy Consumers witness Michael Gorman and Citizens Utility Board witness Edward C. Bodmer. My rebuttal testimony focuses on the following points: 1) the use of S&P's financial ratio guidelines, 2) the importance of credit quality and a utility's financial condition, and 3) commitments made by Ameren prior to its acquisition of AmerenIP with respect to the recapitalization of, and restoration of investment grade credit ratings for, AmerenIP, Ameren's actions related thereto and the results of those actions.

USE OF S&P'S FINANCIAL RATIO GUIDELINES

Q. What is the stated purpose of the financial ratio guidelines published by S&P?

A. In its 2004 publication providing revised financial guidelines for U.S. utilities (*New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised*, published June 1, 2004), S&P stated, that these financial guidelines represent three principal ratios that S&P uses as an "integral part" of evaluating the credit quality of U.S. utility and power companies.

Q. What is the significance of this statement?

A. Certainly these ratios are important; however it is also important that S&P is indicating that these measures are only a *part* of S&P's *evaluation*. So, clearly these measures do not constitute anything even close to the *entirety* of their analysis. Too, they are used as part of an *evaluation*, i.e. an analysis or assessment, of the credit quality of the subject entity. Taken together, this means the ratios are used in the context of an overall, comprehensive credit analysis including, as we know, both quantitative factors such as these and other ratios along with a variety of qualitative factors. This does not mean that simply by achieving one or more of these ratio guidelines (especially the leverage ratio as I discuss later) for a given rating level that any given rating will automatically be assigned. It also noteworthy that S&P has characterized these measures as "guidelines."

Q. Is it appropriate to use S&P's published financial ratio guidelines as the sole basis for the reasonableness of a recommendation for a given cost of equity, weighted average cost of capital, capital structure (including any hypothetical capital structure) and/or revenue requirement?

A. No, it is not, for a number of reasons which would include the following.

1) Although financial ratios are important in any evaluation of an entity's credit quality, ratios alone do not define the analysis, especially if only considering a single ratio such as leverage (debt to capital). In the S&P publication referenced above, S&P includes the following language immediately before and immediately after the table listing their ratio guidelines:

> "It is important to emphasize that these metrics are *only guidelines* associated with *expectations* for various rating levels. Although credit ratio analysis is an important part of the ratings process, these three statistics [FFO interest coverage, FFO/total debt, and debt/capital] are by no means the only critical financial measures that [S&P] uses in its analytical process." (Emphasis added.)
>
> And,
>
> "Again, *rating analysis is not driven solely by these financial ratios*, nor has it ever been. In fact, [these revised financial guidelines] reinforce the analytical framework whereby other factors can outweigh the achievement of otherwise acceptable financial ratios." (Emphasis added.)

In my direct testimony, I also provide other statements made by the ratings agencies regarding the use of financial ratios as part of their analyses (see lines 241-245). We simply cannot ignore what the rating agencies have said here – the ratio guidelines are not definitive in terms of the assignment of ratings. My direct testimony also addresses the relative importance of leverage or an entity's equity ratio in the determination of credit ratings (see lines 228-250).

2) The ratio guidelines at issue here are only those published by S&P. The S&P guidelines would not be instructive or helpful in attempting to presuppose any ratings assigned by Moody's based on a similar analysis.

3) The rating agencies are the arbiters of credit ratings. Any analysis performed by others in an attempt to support or assume a given rating can be dangerously misleading. This would be especially true given the qualitative factors which are important to the rating agencies at the time they are reviewing or assigning ratings. The specific factors, and the relative importance or weighting those factors receive in the rating agencies' analyses are known with certainty only by the agencies.

4) As part of their ratio analysis, the rating agencies typically make certain adjustments. For example, S&P and Moody's remove the debt related to AmerenIP's transitional funding trust notes ("TFNs") along with the cash flow dedicated to service that debt. S&P also imputes a debt equivalent for AmerenIP's power purchase agreement with Dynegy along with related imputed interest.

These adjustments can have a meaningful impact on the calculation of financial ratios. The cash flow adjustment to remove the effects of AmerenIP's TFNs results in a reduction of annual cash flow of at least $86 million. This cash flow adjustment has a meaningful negative impact on any metric that uses cash flow as an input (such as interest coverage and cash flow/debt). And, we know from our discussions with S&P that the imputed debt equivalent related to its purchased power arrangement with Dynegy (a 2.25-year arrangement at the time of the closing of Ameren's acquisition of AmerenIP) was around $600 million. S&P recognized that notwithstanding the relatively short tenor of this specific power supply agreement, AmerenIP's need to continue to obtain its power supply requirements from third parties would continue well beyond the maturity date of that agreement. Annual interest related to this debt imputation was based on an interest rate of 10%. Given the potential magnitude of these adjustments, any ratio analysis must reflect such adjustments in the same manner as performed by the rating agencies. The purchased power debt imputation issue could remain significant for AmerenIP and become a much bigger issue for AmerenCIPS and AmerenCILCO once new power supply arrangements are entered into for periods post 2006.

On balance, with respect to being consistent with a given rating, there certainly would be reason for concern if an entity's ratios were to decline or fall out of the S&P ratio guideline ranges for that rating. However, to reiterate, it would be unwarranted and inappropriate to assume that simply because that entity's metrics fall within the guideline ranges that the related rating will be the result.

Q. Are there other reasons not to use a hypothetical capital structure for the Ameren Illinois utilities?

A. Yes. The equity ratio for each of AmerenCIPS, AmerenCILCO and AmerenIP has been taken into account by the rating agencies as part of their assignment of the ratings for these companies. For example, as I stated in my direct testimony, AmerenIP's equity ratio is a result of Ameren's recapitalization efforts at this utility. Notwithstanding this equity ratio, AmerenIP's ratings are only marginally within the investment grade category. If we were to reduce the equity ratio at AmerenIP, e.g. replace equity capital with debt capital, AmerenIP's key cash flow ratios would deteriorate and thus place negative pressure on AmerenIP's already marginal ratings.

IMPORTANCE OF UTILITY CREDIT QUALITY

Q. Why is it important for a utility to maintain its creditworthiness?

A. Utilities are capital intensive businesses. Utilities have a fundamental responsibility to provide reliable utility services such as the provision of electricity or natural gas to their customers. Utilities must access capital to fund working capital requirements, to make continuing investment in their utility infrastructure, and replace existing capital as it matures. It naturally follows then that utilities must have reliable access to capital at reasonable cost. The credit quality of a utility is directly related to its ability to reliably access the credit and capital markets for the debt capital it requires and the cost of that capital.

Q. Mr. Bodmer recommends developing hypothetical capital structures for AmerenCIPS, AmerenCILCO and AmerenIP that would be consistent with BBB ratings based on his analysis. Is this reasonable?

A. No. First, his analysis uses an approach based on S&P's financial ratio guidelines. My testimony above addresses the problematic nature associated with that.

Second, he is effectively arguing that AmerenCIPS' and AmerenCILCO's "A" category ratings are too high and that a "BBB" is the "correct" or most reasonable rating category or level for a utility.

If the Commission were to accept his premise that AmerenCIPS and AmerenCILCO are too highly rated, and accordingly, make adjustments to their allowed cost of capital based on this, the Commission would effectively be punishing these two utilities for their history of prudently financing and capitalizing their business and assets, and would be calling into question the utility managements' strategy of and commitment to maintaining strong investment grade utilities. An electric and gas transmission and distribution utility with an "A" category rating is not unusual nor is it unreasonable. In S&P's Regulated Transmission and Distribution – Electric, Gas and Water U.S. utility segment, there are 33 electric, gas or combination utilities with corporate credit ratings of A- or higher and this number does not include utilities, such as AmerenCIPS and AmerenCILCO, with BBB+ corporate credit ratings and A- ratings for their senior secured/first mortgage debt.

At BBB, a utility is only two ratings notches away from having sub-investment grade, or junk, ratings - a ratings situation which plagued Illinois Power Company prior to its acquisition by Ameren and a ratings situation which plagued the prior parent companies of both AmerenCILCO and AmerenIP. Two notches is not a lot of "ratings cushion" to absorb factors or conditions which could apply negative pressure to the ratings. As we have seen, these factors can include a political environment which places risk around the expected ability of the utility to recover its costs of providing utility service. These factors could also include other situations such as periods of heavy capital investment, especially if such investment has a long lead time and the utility must debt fund capital expenditures (construction work in process) without receiving incremental cash flows during the construction period and/or until a future rate case to offset the additional debt. Adding debt without adding incremental cash flow has negative and harmful effects on the financial metrics discussed above. These are challenges that AmerenIP is facing today.

Another result of having lower ratings would be an increase in borrowing costs. Investors/lenders will demand higher interest rates for providing debt capital to a lower rated credit.

Q. At lines 2624 and 2625 of his direct testimony, Mr. Bodmer states, "In my opinion the ICC should encourage distribution companies to take advantage of high debt capacity given their very low business risk." What is problematic about that recommendation?

A. In the case of Ameren's three Illinois distribution utilities, I question the claim of these utilities having high debt capacity. The senior secured debt ratings of AmerenCIPS, AmerenCILCO and AmerenIP are currently (S&P/Moody's) A3/A-

, A3/A- and Baa2/BBB+, respectively: basically low "A" and mid to high BBB (which, as I demonstrate above, are not abnormally high). These ratings are either under negative creditwatch or under review for possible downgrade which indicates the rating agencies are poised to move the ratings lower. Adding debt without adding incremental cash flow would only negatively pressure these ratings further. I would characterize this situation as being indicative of these utilities having an *absence* of high debt capacity.

Also, Ameren's credit agreements have leverage covenants which limit the amount of debt that can be incurred by Ameren's Illinois utilities. Violation of this covenant would result in an event of default and would prevent these borrowers from utilizing the facility – a very important resource for external short-term liquidity.

Also, I wouldn't characterize these utilities of having "very low" business risk. S&P assigns a business profile score of "4" to each of AmerenCIPS and AmerenIP. This is a numerical score on a scale of "1" (excellent) to "10" (vulnerable) representing S&P's assessment of utilities' qualitative business or operating characteristics and risk including such factors as markets and service area economy, competitive position, fuel and power supply, operations, regulation and management. A business profile score of "1" represents an entity of lower risk than one with a business profile score of "10". Of the 33 transmission and distribution utilities I referenced above, all have business profile score of "1", "2" or "3". None is rated as "4". Apparently, S&P does not believe that AmerenCIPS and AmerenIP have "very low" business risk. AmerenCILCO's S&P business profile score is "6".

By this statement, and his arguments that AmerenCIPS, AmerenCILCO and AmerenIP should have debt ratios of 60% or 63% (again, please refer to my comments above on the appropriate use of S&P's financial ratio guidelines), Mr. Bodmer is essentially saying that Ameren's Illinois utilities should have much more debt in their capital structures and Ameren should just "lever up" these utilities. Not only would this be inconsistent with Ameren's commitment to maintaining the credit quality of these utilities, this would in fact be a credit hostile action. The rating agencies' reaction to this would go well beyond a simple reassessment of the resulting impact on the utilities' financial measures. This would also have a major negative impact on qualitative factors which are just as important in the ratings process. Management's credibility and commitment to credit quality would be seriously questioned.

The fallout from this would be significant. Ratings almost certainly would decline, borrowing costs would increase, reliable access to capital would be diminished, the ability to reliably and cost-effectively fund utility infrastructure would be harmed, the risk of financial default would increase, and investor confidence would be impaired. These consequences would be incompatible with the utilities' commitment to reliably provide utility service over the long-term.

AMERENIP COMMITMENTS

Q. Why would Mr. Bodmer's recommendation to lever up Ameren's Illinois utilities and maintain debt ratios of at least 60% be especially inappropriate for AmerenIP?

A. In my direct testimony, I discuss the commitments Ameren made with respect to restoring the financial health of Illinois Power Company and achieving investment grade credit ratings, and Ameren's fulfillment of those commitments. I also discuss the positive results of those actions. Following Mr. Bodmer's recommendation would effectively "undo" and render moot all of those efforts and represent possibly an unprecedented (especially if the time parameter is considered) unwinding of a recapitalization strategy, raising and deployment of equity capital, and shift in wealth between classes of investors. Ameren infused $865 million of equity (which Ameren raised specifically for that purpose) in the form of cash into AmerenIP which was used to reduce debt. Premiums of about $100 million paid to bondholders were necessary to reduce that debt. These actions were consistent with achieving the conditions imposed on the Commission's approval of Ameren's acquisition of Illinois Power Company in Docket No. 04-0428. It is not appropriate that Ameren and AmerenIP should be punished for complying with the Commission's Order in that Docket in this regard, especially given Ameren's actions led to the achievement of the positive results that Ameren contemplated: the restoration of investment grade ratings, improved access to capital (including regaining access to short-term working capital) and a resulting equity ratio in the range of 50-60%.

Q. Do you have any other comments about AmerenIP's equity ratio?

A. Yes. As I stated in my direct testimony, AmerenIP's equity ratio is a result of Ameren's recapitalization efforts for this utility. Notwithstanding this equity ratio, AmerenIP's ratings are only marginally above the minimum investment grade rating level (the rating agencies would have course considered AmerenIP's equity ratio as part of their overall assessment and assignment of ratings). Reducing this equity ratio would imply a trade of debt capital for equity capital resulting in a net increase of debt. An increase in debt would also translate into an increase in total interest obligations. All leading to negative pressure on ratings given the decline in key financial metrics. Unless it can be demonstrated that AmerenIP's ratings are unreasonably high, it would be inappropriate to argue that its equity ratio is too high.

Q. In his direct testimony Mr. Gorman states that because S&P views the credit risk of, and rates AmerenIP based on the consolidated credit risk of Ameren and its subsidiaries, the capital structure of AmerenIP should be reasonably consistent with the capital structures of Ameren's other utilities. Do you agree with this statement?

A. No, I don't for a number of reasons. First I would point out that S&P is unique in its consolidated ratings approach. Neither Moody's nor Fitch utilizes this approach, instead relying on a more conventional stand-alone, legal entity-based approach. Moody's and Fitch recognize that Ameren's utilities are separate legal entities, are capitalized independently of one another (and in fact, are affiliated only because of Ameren's merger and acquisition efforts), do not share or jointly participate in the issuance and investment of permanent capital, and importantly, are not obligated for the obligations of one another. The fact that they are affiliated does not directly influence their capital structures. In fact, AmerenIP has only been affiliated with Ameren's other utilities since September 30, 2004. Second, "consolidated" does not mean "the same or similar." It means "added together." Ameren could have utilities engaged in interstate natural gas transportation, water, telephone, etc. and still be subject to S&P's consolidated rating approach.

Third, although I would acknowledge that Ameren's Illinois utilities are exposed to a number of similar business risks, they are and remain separate legal entities with separate operations, separate cash flow profiles and separate debt and preferred stock obligations. Their respective capital structures reflect these factors and related ratings effects. AmerenIP's permanent capital cannot finance the operations of its affiliates and vice versa. The Cities of Champaign and Urbana, Illinois witness Richard W. Cuthbert acknowledges this in his direct testimony at page 7, lines 11-14 where he states, "Each Ameren subsidiary has separate operations and financial structures, with separate debt, preferred equity, and common equity of each company's capitalization." Too, AmerenIP's capital structure is in part a result of certain adjustments made by S&P including imputed indebtedness and interest obligations associated with AmerenIP's purchased power obligations.

Fourth, Mr. Gorman's recommendation is at odds with a fundamental cost of service ratemaking principal of ignoring the costs and effects of affiliates as part of setting rates for a given utility.

Q. Given the post-2006 risks faced by Ameren's Illinois utilities, what likely would have happened at AmerenIP if Ameren had not acquired and recapitalized it?

A. Of course this question is only academic, but it is interesting for the sake of discussion and to reinforce the positive benefits of Ameren's recapitalization of the utility and the resulting ratings result. Prior to its acquisition by Ameren, Illinois Power Company's ratings were as low as B/B3 (S&P/Moody's).

Assuming the ratings downgrades experienced by Ameren's Illinois utilities in the 4th quarter of 2005 would have similarly occurred at Illinois Power, its ratings would have declined to B-/Caa. Moody's characterizes "Caa" level ratings as representing securities which may be in default or indicating the presence of elements of danger with respect to the payment of principal or interest. Clearly, a company with ratings indicative of a default situation will have marked shortcomings with respect to obtaining capital in any form or tenor, and will be so challenged in managing the capital and liquidity needs of its business that its ability to prudently manage the operational aspects of its business will be severely undermined.

Any recommendation to "re-lever" AmerenIP could lead to a decline in ratings and return the company to its weak financial state prior to acquisition and recapitalization by Ameren. For example, during this period Illinois Power Company did not have access to critical short-term funding and working capital; it had to rely on prepayments of interest under a note with a sub-investment grade affiliate. It had a very large amount ($550 million) of high coupon (11.5%) debt outstanding which alone required interest obligations of about $175,000 *per day*. This situation has been remedied, but only after a very significant effort was undertaken to achieve this. It would be foolhardy to take any action which could put AmerenIP right back to where it started.

Q. Does this conclude your rebuttal testimony?

A. Yes.

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