

**ILLINOIS COMMERCE COMMISSION  
DOCKET NOS. 06-0070 / 06-0071 / 06-0072 (CONSOLIDATED)**

**SURREBUTTAL TESTIMONY  
OF  
KATHLEEN C. McSHANE**

**Submitted On Behalf  
Of  
AMEREN COMPANIES**

**JULY 14, 2006**

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23

**ILLINOIS COMMERCE COMMISSION**

**DOCKET NOS. 06-0070 / 06-0071 / 06-0072 (CONSOLIDATED)**

**SURREBUTTAL TESTIMONY**

**OF**

**KATHLEEN C. McSHANE**

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

A. My name is Kathleen C. McShane. My business address is 4550 Montgomery Avenue, Suite 350N, Bethesda, Maryland 20814.

**Q. Are you the same Kathleen C. McShane that provided direct and rebuttal testimony in this proceeding?**

A. Yes.

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

A. The purpose of my surrebuttal testimony is to respond to cost of capital issues raised by (1) Ms. Janice Freetly (ICC Staff); (2) Mr. Michael Gorman (Illinois Industrial Energy Consumers); (3) Richard Cuthbert (Cities of Champaign and Urbana, Illinois); and (4) Mr. Edward Bodmer (Citizens Utility Board) in their respective rebuttal testimonies.

**Response to Ms. Freetly**

**Q. Ms. Freetly takes issue with your conclusions that the recent forecasted three- to five-year growth rates for utilities are low relative to expected long-term growth in the economy as a whole and likely to understate the growth rates that investors expect into perpetuity (that is, the growth rate that is reflected in the stock price). In that regard, she states that past growth rates may be misleading, since**

24 **they may reflect changes in the fundamental variables that investors do not expect**  
 25 **to continue in the future, or fail to capture changes that investors do expect. Please**  
 26 **respond.**

27 A. I do not disagree with Ms. Freetly that historical actual growth rates may be  
 28 misleading as estimates of what investors expect going forward. My comments with  
 29 respect to the level of expected growth for the next three to five years was in reference to  
 30 the level of growth that analysts had forecast for similar periods during the past 13 years  
 31 (1993-2005). The point I was making was that, on average, the three- to five-year growth  
 32 rates had varied around a rate approximately equal to the expected growth in the  
 33 economy as a whole. Thus, while investors may expect growth for utilities in the  
 34 relatively short-term to be lower than growth in the economy, the observed pattern of  
 35 expected three- to five-year growth rates strongly suggests the expected growth rate in  
 36 perpetuity mirrors the rate of growth in the economy. Changes in variables such as  
 37 regulation may alter short-term growth expectations, but in the absence of a major shift in  
 38 economic fundamentals (e.g., inflation, productivity), the long-term inherent growth  
 39 potential for utilities should remain relatively stable.

40 **Q. Ms. Freetly contends that the long-term expected growth for utilities must be**  
 41 **lower than the growth in the economy as utilities are of lower than average risk,**  
 42 **earn lower than average returns, and have below average retention rates. Do you**  
 43 **believe she is correct?**

44 A. No. It is clear from Ms. Freetly's own evidence that, at the present time, the  
 45 expected growth rate for the average stock is well in excess of the rate of growth in the  
 46 economy. Ms. Freetly, at line 137 of ICC Staff Exhibit 15.0, states that the average

47 expected rate of growth for dividend paying stocks in the S&P 500 is 11.3%, or more  
 48 than twice the expected growth in the economy. If utilities were excluded from the S&P  
 49 500 index, the expected growth rate for the remaining dividend paying sectors would be  
 50 higher than 11.3%. That comparison simply confirms that utilities are expected to grow  
 51 more slowly than the average stock in the next three to five years, but provides no basis  
 52 for concluding that the expected growth for utilities in perpetuity should be less than the  
 53 rate of economic growth.

54 **Q. Ms. Freetly also states that the market efficiently reflects growth**  
 55 **expectations in the stock price and that those expectations need to be reflected in the**  
 56 **DCF model whether they are irrationally exuberant or irrationally pessimistic. Do**  
 57 **you agree?**

58 A. Yes. The question is whether the irrational exuberance or pessimism is for the  
 59 near-term or the long-term. Since we cannot read investors' minds, we cannot state with  
 60 any degree of certainty whether the stock price today incorporates the expectation that the  
 61 three- to five-year growth rate forecasts will continue forever, or the expectation that  
 62 growth will trend over time to a long-run value. Consequently, estimating the utility cost  
 63 of equity using both assumptions is a reasonable means of approximating long-term  
 64 growth expectations.

65 **Q. Ms. Freetly claims that your comparison of her DCF estimate to utility bond**  
 66 **yields as a means of testing its reasonableness is misleading on two counts; first**  
 67 **because she is not recommending a return equal to the 9.11% DCF cost, and second,**  
 68 **because a comparison with Baa rated utility bond yields is not appropriate since she**

69 **is recommending returns that, in her view, are compatible with the achievement of**  
70 **debt ratings higher than Baa. What is your response?**

71 A. My conclusions in this regard were in specific reference to the results of her DCF  
72 test, given the growth rates she had used, and to whether the results of that specific test  
73 were reasonable in light of historic relationships between allowed returns and yields on  
74 utility bonds in the same rating category as her sample (median S&P debt rating of  
75 BBB+). In this context, the allowed returns were used as a proxy for the DCF cost, on  
76 the grounds that the DCF test has historically been the principal test used by state  
77 regulators in setting allowed ROEs.

78 **Q. In her rebuttal testimony, Ms. Freetly claims that there is nothing inherently**  
79 **superior about the *Value Line* betas as compared to her regression betas, and states**  
80 **that, in contrast to earlier time periods, when her raw regression beta was unusually**  
81 **low, her current raw beta is more typical. Do you have any concerns with that**  
82 **conclusion?**

83 A. Yes, the term “typical” assumes that the “true” beta is static. Exhibit 33.0,  
84 Schedule 1 demonstrates that the *Value Line* betas for Ms. Freetly’s sample have been  
85 rising over time.<sup>1</sup> The betas are considerably higher for the most recent period available  
86 (median of 0.90) than the 0.75 level observed prior to the anomalous market bubble and  
87 bust period (1998-2002) during which utility betas were unusually low. The rising betas  
88 of these utilities demonstrate that the accuracy of Ms. Freetly’s regression betas cannot be  
89 tested against what has been “typical”. The fact remains that calculating betas using

---

<sup>1</sup> Exhibit 33.0, Schedule 1 provides a history of the *Value Line* betas of Ms. Freetly’s sample.

90 more observations (i.e., *Value Line*'s weekly observations versus Ms. Freetly's monthly  
91 observations) will improve the fit of the regression line.

92 **Q. In your rebuttal testimony, you concluded that Ms. Freetly's downward**  
93 **adjustment to her DCF results to take account of her claim that Staff's**  
94 **recommendations would result in financial parameters consistent with a higher debt**  
95 **rating than her proxy sample was unjustified. Has Ms. Freetly subsequently**  
96 **justified the downward adjustment?**

97 A. No. I agree with Ms. Freetly that, in principle, there is a direct relationship  
98 between risk and required return. However, Ms. Freetly has not demonstrated that, in  
99 practice, the DCF test is accurate enough to distinguish between samples of somewhat  
100 different levels of investment risk. Ms. Freetly made the unwarranted assumption that  
101 the DCF cost of equity that she estimated for her sample is a completely accurate  
102 measure of the cost of equity for that risk level. The implication of that assumption is  
103 that, had she actually measured the DCF cost of equity for a lower risk utility sample, e.g.  
104 a sample whose average debt rating was AA, the DCF estimates would have been lower  
105 than those of her sample by approximately 40 basis points. My comparison of the DCF  
106 costs of Mr. Gorman's two samples demonstrated that is not necessarily the case, as the  
107 estimated DCF cost for his gas sample was 30 basis points higher than the DCF cost for  
108 his electric sample. The electric utility sample is at least as risky, and potentially more  
109 risky, than his gas sample.

110 To further illustrate this point, I took all the utilities that were in the utility  
111 samples of the five direct cost of capital testimonies filed in this proceeding, and  
112 calculated their DCF cost using the annual constant growth DCF model, the stock price

113 as of April 4, 2006 (the same date used by Ms. Freetly in her DCF test), the most recent  
114 dividend paid prior to that date, and the I/B/E/S consensus forecast of earnings growth for  
115 each utility at the end of March 2006. I then sorted the utilities by their April 7, 2006  
116 S&P bond rating. Next, I calculated the mean and median DCF costs for all of the  
117 utilities with a debt rating of BBB-, BBB, and BBB+, and the mean and median debt  
118 costs of all of the utilities with a debt rating of A-, A, or A+. The mean and median DCF  
119 costs for the utilities rated in the BBB category were 9.5% and 8.7% respectively; the  
120 mean and median DCF costs for the utilities with ratings in the A category were 9.7%  
121 and 9.1% respectively (See Exhibit 33.0, Schedule 2). In other words, the estimated DCF  
122 costs were higher for the less risky companies. Thus Ms. Freetly's deduction from her  
123 sample's DCF cost of equity for the alleged relatively lower risk of the Ameren utilities  
124 cannot be empirically justified.

125 **Response to Mr. Gorman**

126 **Q. Mr. Gorman makes a similar argument to that of Ms. Freetly as regards the**  
127 **growth prospects of utilities relative to the S&P 500. Has he made a more**  
128 **compelling argument that the long-term growth of utilities cannot be equivalent to**  
129 **the nominal growth in the economy?**

130 A. No. He simply shows that the growth for companies that pay out more in  
131 dividends than those that do not would be expected to achieve lower growth rates in the  
132 near future than those that retain more. I have no disagreement with this basic  
133 proposition. I do not claim, as Mr. Gorman suggests, that utilities can grow as fast the  
134 growth rates currently anticipated for the S&P 500. Over the next three to five years, the  
135 expected growth rates for the companies in the S&P 500, who are currently paying out

136 about 30% of earnings, are much higher than the expected growth in the economy, as  
137 indicated in Ms. Freetly's testimony. Consistent with the higher expected growth is a  
138 much lower dividend yield for the S&P 500 than for utilities. When the growth prospects  
139 for the companies that currently make up the S&P 500 decline (and gradually trend  
140 toward the growth in the economy and potentially lower when they reach the stage of  
141 decline), they will begin to pay out a higher proportion of their earnings in dividends and  
142 exhibit higher dividend yields. There is no inconsistency between that proposition and  
143 the expectation that long-run growth prospects of the mature utility industries mirror the  
144 long-run growth potential in the economy as a whole.

145 **Q. Mr. Gorman takes issue with your critique of his risk premium test in which**  
146 **he estimates the annual average differential between allowed returns and bond**  
147 **yields over the period 1986-2005 rather than a more recent period, on the grounds**  
148 **that inflation impacts both stock and bond yields and valuations. How do you**  
149 **respond?**

150 A. I agree that inflation impacts both. The issue is whether the fear of inflation  
151 impacts both equally. If inflation rises above expected levels, bond investors will be  
152 impacted more negatively, since they are locked-in at the rate at which they invested. If  
153 there is a strong fear of unanticipated inflation, bond investors will require an additional  
154 premium above the expected rate of inflation (a lock-in premium). Since equities are a  
155 better hedge against unanticipated inflation, equity investors will not demand a lock-in  
156 premium of the same magnitude. During periods when the fear of unanticipated inflation  
157 is high, and the lock-premium in bond yields is also high, the equity risk premium will be

158 lower. When the fear of unanticipated inflation dissipates, the equity risk premium will  
159 expand.

160           The existence of a higher lock-in premium during the earlier years of Mr.  
161 Gorman's analysis can be discerned by comparing real dividend yields and real bond  
162 yields from 1986-1995 and from 1996-2005. During 1986-1995, the average real utility  
163 dividend yield was 3.1% compared to the real Treasury bond yield of 4.0%, where the  
164 real yield was estimated as the nominal yield in each year minus the forecast long-term  
165 rate of CPI inflation.<sup>2</sup> By comparison, during 1996-2005, the real utility dividend yield  
166 had not declined at all from its average 1986-1995 level, while the real Treasury bond  
167 yield had declined by .9% to 3.1% (Exhibit 33.0, Schedule 3). The larger decline in the  
168 real bond yield is a strong indicator of a reduction in the relative risk of Treasury bonds  
169 and an increase in the equity risk premium. Using the longer 1986-2005 period to  
170 measure the differential between allowed returns and bond yields masks the change in the  
171 equity risk premium that occurred as bond investors became increasingly comfortable  
172 that inflation would not reignite to levels that had been experienced in the 1970s and  
173 early to mid-1980s

---

<sup>2</sup> From *Blue Chip Economic Indicators'* bi-annual long-term forecasts during the year that corresponds to the actual bond and utility dividend yields as presented in MPG-R1. See Exhibit 33.0, Schedule 3.

174 **Q. With respect to his equity risk premium study in which he adds the achieved**  
175 **real market return to the expected rate of inflation to estimate the forward-looking**  
176 **expected market return, Mr. Gorman believes you misunderstood his approach.**

177 **Did you misunderstand?**

178 A. Not at all. My point was that there is no evidence based on history that the  
179 expected market return has risen and fallen with inflation, and thus it is more appropriate  
180 to base the expected equity market return on nominal, rather than inflation-adjusted,  
181 achieved values.

182 **Q. Mr. Gorman rejects the methodology supported by Ibbotson Associates<sup>3</sup> for**  
183 **the estimation of the market equity risk premium using historic returns for the**  
184 **market and the historic income returns for Treasury bonds. He claims the**  
185 **methodology is unreasonable because it results in a mismatch of periods and**  
186 **because it unreasonably assumes that investors in bonds do not expect changes in**  
187 **bond prices from year to year. What are your comments?**

188 A. First, there is no mismatch in periods. Both the equity and income returns on  
189 bonds cover the same historic period. Second, the CAPM is based on a risk-free rate.  
190 While Treasury bonds are viewed as free of default, they are not without risk. Using the  
191 income return component of the Treasury bond return to measure the market risk  
192 premium is consistent with the basic CAPM formula which holds that the market risk  
193 premium is equal to the expected return on the market less the risk-free rate. When the

---

<sup>3</sup> The main source of data on the U.S. market risk premium comes from the seminal work of Ibbotson and Sinquefeld, who calculated holding period return data from December 1925 for common equities, long term government bonds, treasury bills, and the consumer price index.

194 total return on Treasury bonds is used, the result is a premium over a security that has  
195 interest rate risk.

196 **Q. Mr. Gorman claims that your evidence with regard to the capital structure of**  
197 **AmerenIP is flawed and inconsistent with Ameren witness Nickloy's evidence. Is he**  
198 **correct?**

199 A. Absolutely not. Inclusion of the TFNs in the capital structure for regulatory  
200 purposes, as AmerenIP proposes, is consistent with ICC precedent. Including the TFNs  
201 in the AmerenIP's capital structure results in a common equity ratio for ratemaking  
202 purposes of 53.1% for AmerenIP (as updated in the rebuttal testimony of Ameren witness  
203 Mr. Michael O'Bryan). That common equity ratio is within the range of common equity  
204 ratios maintained by the companies in Mr. Gorman's sample. Mr. Nickloy's direct and  
205 rebuttal testimony state that S&P ignores the TFN indebtedness and related revenues in  
206 assessing AmerenIP's financial risk; S&P's analysis is a different exercise than  
207 determining appropriate capital structure for ratemaking purposes. Mr. Nickloy also  
208 explains that the debt rating agencies do not measure financial risk by capital structure  
209 alone. That conclusion is borne out by the statements of S&P regarding AmerenIP's  
210 financial risk. With exclusion of the TFNs, and associated revenues, AmerenIP is judged  
211 by S&P to have a stand-alone financial profile that is much weaker than Ameren's  
212 consolidated financial profile (S&P, "Illinois Power: Credit Ratings", June 16, 2006). If  
213 the Commission were to accept Mr. Gorman's recommendation to impute a hypothetical  
214 capital structure containing 42.3% equity (inclusive of the TFNs), AmerenIP's financial  
215 risk profile would weaken further relative to the consolidated Ameren financial profile.

216 **Response to Mr. Cuthbert**

217 **Q. Mr. Cuthbert appears astounded that you do not estimate a DCF cost for**  
 218 **Ameren only. What is your response?**

219 A. As I indicated in both Exhibits 3.0 and 13.0, such an exercise is fraught with both  
 220 circularity and potential measurement error. Further, it does not meet a basic standard for  
 221 the fair return, that is, the return should be “commensurate with returns on investments in  
 222 other enterprises having corresponding risks.”<sup>4</sup> I note that neither Ms. Freetly nor Mr.  
 223 Gorman perform an Ameren-only DCF test. In fact, Ms. Freetly also concludes that  
 224 applying the DCF test solely to Ameren is inappropriate. (ICC Staff Exhibit 15.0, lines  
 225 382-389).

226 **Q. Mr. Cuthbert continues to claim that your sample of gas distribution utilities**  
 227 **is of higher risk than a sample of electric utilities. Please address his claims.**

228 A. To support his view that gas utilities are more risky than electric utilities, Mr.  
 229 Cuthbert cites a *Value Line* article (RWC-7) which refers to the impact of rising gas  
 230 prices on gas utilities. Mr. Cuthbert implies that the article concludes gas utilities are  
 231 more risky than electric utilities, which it does not. One risk factor cannot be used to  
 232 conclude that gas utilities are more risky than electric utilities. The various risk statistics  
 233 of Mr. Cuthbert's and my samples demonstrate objectively and quantitatively that the gas  
 234 utilities I have relied upon are less risky than his sample of electric utilities (Exhibit 13.0,  
 235 Table 4). Mr. Gorman also uses a sample of gas utilities; there is no objective evidence  
 236 that his sample of gas distributors is riskier than his electric utility sample. Ms. Freetly  
 237 includes gas utilities in her sample; there is no objective evidence that the gas distributors  
 238 in the sample are riskier than the electric utilities in the sample.

---

<sup>4</sup> *Federal Power Commission v. Hope Natural Gas Company* (320 U.S. 591 (1944)).

239 **Q. In his rebuttal evidence, Mr. Cuthbert refers to clerical and methodological**  
240 **errors in your alternative approach to his equity risk premium analysis in which he**  
241 **compares actual electric utility returns to bond yields. Is he correct?**

242 A. He is correct that, unfortunately, there were some input errors in developing the  
243 alternative approach. Correcting for the input errors has a minimal impact on the results  
244 of the alternative approach to Mr. Cuthbert's equity risk premium analysis, resulting in a  
245 return on equity of 10.8% rather than the 10.9% initially reported. I disagree, however,  
246 that there are any methodological errors.

247 **Q. With respect to methodology, Mr. Cuthbert contends that the return from**  
248 **the alternative analysis is overstated because it only includes electric utilities that**  
249 **exist today, and that many of the companies that have disappeared due to mergers**  
250 **and consolidations "likely had returns that were lower than the 'surviving'**  
251 **companies. Is there any reason to believe that is true?**

252 A. No. There is no reason to believe that the acquired firms were relatively low  
253 earners. To illustrate, *Value Line* reported a return on equity for the industry in 2000 of  
254 7.2%. The median return for the electric utilities existing today, as reported by *Value*  
255 *Line*, was 11.9%. At the end of 2001, when *Value Line* first reported the 7.2% industry  
256 return, it was covering 65 utilities. The median 2000 ROE for all the utilities that existed  
257 at the end of 2001 was 12.1%, close to the 12.5% median for the still existing utilities.

258 **Q. Mr. Cuthbert also claims that you made a methodological error by not**  
259 **counting the returns on equity designated as "NMF" by *Value Line*. He then**  
260 **"corrected" your results by assuming that each of those returns was below the**  
261 **median. Do you agree with this change?**

262 A. No. The *Value Line* glossary defines NMF as follows: “*NMF*—not meaningful.  
263 Used when a number or ratio is so **large or small** that it is not meaningful (emphasis  
264 added)”.

265 **Q. Do you have any final comments regarding Mr. Cuthbert’s equity risk  
266 premium analysis?**

267 A. Yes, while I continue to believe the results would be more meaningful if the  
268 ROEs were expressed by individual company, in the end, as I suggested in Exhibit 13.0,  
269 this type of analysis suffers from a degree of circularity that renders the results, however  
270 calculated, of minimal, if any, value in arriving at a fair return for the Ameren utilities.

271 **Q. With respect to your revision of his CAPM results, Mr. Cuthbert states that  
272 he was unable to replicate the interest rates that you used. Please clarify.**

273 A. The interest rates used to revise the CAPM results (and cited in lines 322-324 of  
274 Exhibit 13.0) are the yields of May 10, 2006, consistent with the yields shown in Table 2  
275 of Exhibit 13.0. The support for the yields is provided as a workpaper to this surrebuttal  
276 testimony.

277 **Q. Mr. Cuthbert states at page 11 of his rebuttal testimony, “Equally important  
278 is McShane’s incorrect re-estimation of market rate premiums to account for the  
279 more recent Ibbotson data.” Please respond.**

280 A. In revising Mr. Cuthbert’s CAPM results to reflect more recent bond yields and  
281 the use of income returns for bonds rather than total returns, I used the same Ibbotson  
282 data that he did, that is, data through 2004, as well as the same betas he used. If I had  
283 actually updated the historic market risk premium data to include 2005, the revised  
284 CAPM results would have been slightly lower (by 9 to 10 basis points depending on the

285 term of the risk-free rate he had used) than those based on the historic risk premium data  
286 through 2004 that Mr. Cuthbert had actually used (See Exhibit 33.0, Schedule 4). The  
287 significantly lower results that Mr. Cuthbert reports, compared to my revisions of his  
288 CAPM, are not a function of adding the 2005 data, but rather because my revisions to the  
289 market risk premium component of his CAPM were based on Treasury bond income  
290 returns, not the total bond returns that Mr. Cuthbert used.

291           However, while Mr. Cuthbert updated his interest rates and market risk premium  
292 in his rebuttal testimony, he did not update the betas for his sample. As indicated in  
293 Exhibit 33.0, Schedule 4, the median beta of his sample is now 0.85, compared to 0.80 in  
294 his direct testimony.

295 **Q. Mr. Cuthbert also disagrees with your use of a single day's interest rate (May**  
296 **10, 2006) in your revisions of his CAPM, and continues to use a six-month average**  
297 **in applying the CAPM. Does he have a point?**

298 A. Yes, I would agree that there is some risk in perfunctorily using a single day's  
299 yield, inasmuch as it can reflect anomalous behavior on a given day. Nevertheless, one  
300 would not pick a single day's yield in a vacuum. To minimize the risk of picking an  
301 anomalous yield, an analyst would compare a specific day's yield to those preceding it  
302 and to forecasts of yields for subsequent periods. However, using a six-month average is  
303 completely unwarranted, particularly when it is clear that interest rates six months earlier  
304 were totally out of line with the observed recent trends in rates and the forecasts of future  
305 rates.

306           When Mr. Cuthbert prepared his initial evidence, he used a six-month average of  
307 20-year Treasury bond yields for the period ending March 31, 2006 of 4.77%. On April

308 26, 2006, the date Mr. Cuthbert's direct testimony was filed, 20-year Treasury bonds  
309 were yielding 5.34%. Mr. Cuthbert has updated his interest rates to the six-month period  
310 ending May 31, 2006 to 4.93%. On May 31, 2006, 20-year bond yields were 5.35%; on  
311 June 27, 2006, the date his rebuttal evidence was filed, the yield was 5.38%. On average  
312 over the past three months (April 1-June 30, 2006), the 20-year bond yields have  
313 averaged 5.29%. Clearly, the 5.3% 20-year Treasury bond yield of May 10, 2006 that I  
314 used in revising Mr. Cuthbert's CAPM is a representative rate. However, to be  
315 conservative I have updated my revisions to Mr. Cuthbert's CAPM results using the  
316 three-month average yields ending June 30, 2006, the Ibbotson data ending 2005 and the  
317 most recent *Value Line* betas. The results, as shown in Exhibit 33.0, Schedule 4, support  
318 a range of CAPM results of 11.3-12.0%, compared to Mr. Cuthbert's updated results of  
319 9.9% to 11.2%.

320 **Q. Mr. Cuthbert continues to argue that your results are overstated because you**  
321 **did not conduct any risk premium analyses relative to corporate bond yields. Do**  
322 **you have any further response to that opinion?**

323 A. Yes. Mr. Cuthbert conducted one test using corporate bond yields. The result  
324 was higher than his DCF results and lower than his CAPM results. The simple average  
325 of his DCF, equity risk premium and CAPM results for his comparable sample as  
326 summarized on RWC-6 is 9.7%. Excluding the risk premium test using corporate bond  
327 yields, the simple average of the DCF and CAPM tests is lower, at 9.65%. Based on Mr.  
328 Cuthbert's own tests, ignoring any problems with their application, there is no basis to  
329 conclude that including a test using corporate bond yields would produce a lower  
330 recommended return.

331 **Response to Mr. Bodmer**

332 **Q. Mr. Bodmer claims that your real argument is that this Commission should**  
333 **grant the Ameren utilities a similar return to that which has been allowed by other**  
334 **state commissions. Is that what you are recommending?**

335 A. No. It goes without saying that the estimation of the cost of equity and a fair  
336 return should be independent of what other regulators allow. Nevertheless, the national  
337 average can be interpreted as a consensus assessment of the expert testimony that has  
338 been proffered by a wide range of stakeholders under capital market conditions that are  
339 similar to those prevailing. As one regulatory commission correctly observed in a recent  
340 decision approving an 11.0% ROE, a return on equity finding should not mindlessly  
341 mirror the national average. However, the regulatory commission also pointed out that  
342 the national average is an indicator of the capital market in which the utility will have to  
343 compete for necessary capital. Similarly, the national average is an indicator of the  
344 reasonableness of the return recommended. It is not necessary to address each aspect of  
345 Mr. Bodmer's testimony to conclude that his recommended return of "no greater than  
346 8%" simply is not indicative of the capital market in which the Ameren utilities will have  
347 to compete for capital.

348 **Q. Mr. Bodmer claims that the high market/book ratios of utilities are an**  
349 **indication that the allowed returns should be lower than they are. What is your**  
350 **response to this claim?**

351 A. Mr. Bodmer believes that the market/book ratio of utilities should be 1.0. There  
352 are multiple reasons this would not be the case even if such an outcome were fair and

353 reasonable.<sup>5</sup> These reasons include the fact that market price reflects future earnings  
354 expectations, expected earnings from unregulated operations, the fact that the reported  
355 assets are an imperfect measure of the base upon which utilities are allowed to earn a  
356 return, and the value that investors place on the stability of dividends. Moreover, the  
357 level of the market/book ratios of utilities is a relative concept, and should be judged  
358 relative to the tenor of the market as a whole. Over the past 10 years (1996-2005), the  
359 market/book ratio of the S&P 500 has averaged 3.6 times; it is currently 3.0 times  
360 (*Barron's*, June 26, 2006). Over the same decade, the market/book ratio of all the  
361 utilities that are included in the proxy samples of Ms. Freetly, Mr. Gorman, Mr. Cuthbert  
362 and myself averaged 1.6 times, less than half the level of the equity market composite  
363 (which includes utilities); the current median market/book ratio for these same utilities is  
364 also 1.6 times; See Exhibit 33.0, Schedule 5. Relative to the market as a whole, the  
365 market/book ratios of the utilities are quite modest and provide no basis for concluding  
366 that allowed returns have been too high.

367 **Q. Does this conclude your surrebuttal testimony?**

368 A. Yes

369 CHI-1543764v1

---

<sup>5</sup> See Exhibit 3.0, lines 538-545 for discussion of why a market/book ratio of 1.0 for a utility is inconsistent in principle with the competitive model that regulation is intended to emulate.