Ameren Ex. 23.0

ILLINOIS COMMERCE COMMISSION

ICC DOCKET NO. 07-0585 (CONS.)

REBUTTAL TESTIMONY

OF

MICHAEL G. O'BRYAN

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

(The Ameren Illinois Utilities)

April 14, 2008

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I. INTRODUCTION

A. Witness Identification

Q. Please state your name.

A. My name is Michael G. O'Bryan.

Q. Are you the same Michael G. O'Bryan who submitted prefiled direct testimony on behalf of the Ameren Illinois Utilities?

A. Yes, I am.

B. Purpose and Scope

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

A. The purpose of my rebuttal testimony is to respond to certain portions of the direct testimony of Staff witnesses Rochelle Phipps and Janis Freetly as well as Illinois Industrial Energy Consumers' ("IIEC") witness Michael Gorman. Ms. Phipps makes significant changes to the capital structures I proposed in my direct

testimony and exhibits. The main effect of Ms. Phipps' changes is to significantly understate the Ameren Illinois Utilities' ("AIU") cost of capital by including extraordinary levels of short-term debt in the capital structures. In addition, Ms. Phipps made changes to the AIU cost components that I oppose and will detail in this rebuttal testimony. Ms. Freetly and Mr. Gorman used rating agency benchmark ratio analyses to develop their own credit ratings for the AIUs that differ greatly from the actual credit ratings. I will explain in this rebuttal testimony how this exercise is misguided.

C. Identification of Exhibits

Q. Will you be sponsoring any exhibits with your rebuttal testimony?

A. Yes, I am attaching and sponsoring the following exhibits:

- **Ameren Ex 23.1 – AmerenCILCO, AmerenCIPS and AmerenIP Cost of Capital Summary**
- **Ameren Ex 23.2 – AmerenCILCO Cost of Short-Term Debt**
- **Ameren Ex 23.3 – AmerenCIPS Cost of Short-Term Debt**
- **Ameren Ex 23.4 – AmerenCIPS Embedded Cost of Long-Term Debt**
- **Ameren Ex 23.5 – AmerenIP Embedded Cost of Long-Term Debt**

These exhibits represent updates and amendments to cost of capital schedules included in my direct testimony. I will explain in this rebuttal testimony the reasoning behind such changes.

II. <u>ISSUES ACCEPTED AND/OR SETTLED</u>

Q. Are you accepting any of Ms. Phipps' adjustments to capital structure?

A. Yes, I am accepting Ms. Phipps' miscellaneous adjustments to the AIU's common equity balances, including the removal of the unappropriated undistributed subsidiary earnings balance from each AIU's common equity balance, the removal of Ameren Energy Resources Generating's Accumulated Other Comprehensive Income ("OCI") from AmerenCILCO's common equity balance as well as the removal of the preferred stock premiums from AmerenIP's common equity balance.

I have updated each of the AIU's common equity balances to account for such changes in Ameren Exhibit 23.1.

For purposes of this case, I am accepting Ms. Phipps' reversal of the adjustment I made to reduce AmerenCIPS' month-end short-term debt balances from December 2006 through April 2007 by $36,610,667, to reflect the May 1, 2007 payment received by Ameren Energy Generating Company. I have updated AmerenCIPS' cost of short-term debt schedule (see Ameren Exhibit 23.3) to reflect these changes.

Q. Are you accepting any of Ms. Phipps' adjustments to the AIUs cost of debt?

A. I updated the AIU's cost of short-term debt to conform with Staff, and for purposes of this case, I am accepting Ms. Phipps' weighting methodology used to calculate the cost of short-term debt for the AIUs. This weighting methodology determined a spread over the LIBOR index to calculate the AIUs cost of short-term debt. The updated cost of short-term debt for each AIU are reflected in Ameren Exhibit 23.1.

Further, I accept Ms. Phipps' interest rates for AmerenCILCO and

AmerenCIPS Series 2004 auction rate pollution control bonds. She used interest rates from the last auctions prior to the December 2007 rating agency actions that affected the bond insurers that insured these pollution control bonds ("PCBs"). This, in turn, had a negative effect on the interest rates of the PCBs. Although this is a reasonable approach to treat the cost of these bonds, this approach should not be used with respect to the AmerenIP auction rate PCBs. I will explain my reasoning later in this testimony.

III. <u>SHORT-TERM DEBT</u>

Q. Ms. Phipps argues that cash should not be netted against short-term debt to obtain the proper net short-term debt balance. Please respond.

A. Ms. Phipps argues that netting cash against short-term debt as part of the calculation of the proper amount of short-term debt 'is improper because cash is not a part of short-term indebtedness'[1]. The proper analysis is whether the capital structure accurately reflects the mix of debt supporting utility assets. The principal flaw with Ms. Phipps' approach is that, by failing to net cash against short-term debt, she treats cash as a rate base asset, ,but then does not include the cash in rate base. This produces a mismatch between the cost of funds supporting assets and the returns those assets earn.

The Ameren Illinois Utilities are holding relatively high cash balances due to their credit standing in the aftermath of the legislative crisis involving the 2007 retail electric rate changes. The Ameren Illinois Utilities require these cash

[1] Lines 137-138 of Ms. Phipps direct testimony.

balances for operating purposes. The cash balances sit in money market accounts, earning standard money market returns, to assure immediate access to the funds. Were their credit position better, the Ameren Illinois Utilities would not hold cash balances at these levels.

There are two ways to treat the cash balances being held for utility purposes. One is to maintain them entirely outside of the ratemaking process by deducting them from the short-term debt balances, as we did. This produces a return on the cash (the money market interest rate) comparable to its cost (the short-term debt rate). Alternatively, the cash could be included in rate base, and the short-term debt would be fully reflected in the capital structure. This approach could produce an excess return, however, because the cash would be earning both the overall cost of capital in rates, plus the money market return. The Ameren Illinois Utilities did not pursue this approach, because of this mismatch of cost and return.

Staff has elected a third method, which produces a significant mismatch between the cost of financing and the return on the assets being financed . Staff includes the full amount of short term debt (other than money pool lendings and CWIP) in the utility capital structure, while simultaneously treating the cash as a non-utility asset. This means the Staff assumes that the cash is supported by a mix of capital equal to that supporting assets in rate base. This means, in turn, that Staff believes the Ameren Illinois Utilities would raise cash at a cost of roughly 8% and invest it in money market accounts earning roughly 3%. This is obviously a significant and unreasonable mismatch between the cost of funds and

the return those funds can earn when invested, in this case, in money market funds.

No utility would do what Staff is assuming. The utility would take the cash and pay down the short term debt if they could. The point is that the Ameren Illinois Utilities cannot – because they require the cash for operating purposes. This fact mandates that the Ameren Illinois Utilities have an opportunity to earn a proper return on all the funds raised for utility purposes, not one that requires them to lose approximately 5% on the funds supporting the cash balances , as would be the case if Staff's approach is adopted.

I note that, by differentiating between (1) cash on hand funding loans to sister utilities and (2) cash invested in liquid money market funds, Ms. Phipps is suggesting that there is a fundamental difference between the two scenarios. But in reality only a cash management decision differentiates the two. In both instances, the cash is earning a return elsewhere, and the cost of capital supporting the cash should be consistent with the return.

This same reasoning is consistent with that used in discerning that short-term debt related to CWIP and loans to the money pool should not be included in the capital structure. The same short-term debt funds cannot be used simultaneously support rate base and fund CWIP or be loaned to sister utilities. This is consistent with Staff's long-standing practice and Commission precedent. Again, the exact same logic applies to cash balances.

Q. At lines 91–133, Ms. Phipps, in her calculation of the twelve-month average of short-term debt, aligns the midpoint of the twelve months with the

measurement date of the long-term capital structure components. Do you agree with Ms. Phipps' adjustment

A. No. Whatever perceived merits her approach might have are outweighed by its shortcomings. My calculation of the twelve-month average of short-term debt incorporates data that does not go beyond the date of measurement of the capital structure components. Conversely, Ms. Phipps uses data that goes beyond this measurement date by up to six months. Short-term debt balances are the result of costs during the test year/measurement period. The use of measurement balances beyond this period results in a measurement mismatch between short-term debt and the other capital structure balances. These balances tend to be inversely related in such cases as issuances, accumulation, repurchases, redemptions or maturities of equity or debt—a relationship which is lost with this measurement mismatch. Ms. Phipps must provide more compelling evidence that use of data within the boundaries of the test year/measurement period is not proper. Although the Commission ultimately sided with Staff and this approach in the most recent case[2], the language of the ruling was hardly a mandate[3].

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[2] Docket Nos. 06-0070/06-0071/06-0072 (consolidated)

[3] Excerpts from Final Order, November 21, 2006: 'Neither Ameren's nor Staff's approach could be considered totally unreasonable…The Commission observes that in a relatively recent rate case the Commission adopted the approach advocated by Staff. (Docket Nos. 03-0676/03-0677 (Cons.), October 6, 2004 Order at 20-21) Thus, the Commission adopts Staff's methodology for calculating short-term debt balances in this proceeding'.

IV. AMERENCIPS INTERCOMPANY NOTE

Q. Do you agree with Ms. Phipps' removal from AmerenCIPS' embedded cost of long-term debt the incremental cost due to its decision to refinance the 4.70% intercompany note with 6.7% bonds?

A. No, I do not. AmerenCIPS was justified in refinancing the 4.70% note. First, the refinancing extended the date of final maturity from 2010 to 2036. Because of annual amortization requirements, the 4.70% note had an average remaining life of just over three years. This extension greatly reduced CIPS' refinancing risk which could only come with a cost. This 26.7-year extension of the remaining life naturally comes at a cost by virtue of an upward sloping yield curve and credit curve. Further, the more permanent capital achieved by extending the tenor corresponded with the permanent transmission and distribution assets which it financed. In addition, the new structure relieved AmerenCIPS from having to fund annual amortization payments. The principal payments that remained at the time the note was refinanced were $5.6 million in May 2007, $5.9 million in May 2008, and $6.2 million in May 2009, and would have been made in addition to quarterly interest payments. The 6.70% bond, on the other hand, was a non-amortizing bullet structure (*i.e.*, full principal paid at maturity) that paid interest semi-annually. Therefore, the structure of the "new" bonds afforded AmerenCIPS valuable flexibility through the extension of maturity and freedom from the burden of annual amortization payments.

Finally, Ms. Phipps' argument that AmerenCIPS should have received a discount on the repurchase price of the promissory note due to the fact that

interest rates had risen since the inception of the note is erroneous. I am not aware of any financial instrument in either the capital or credit markets which can be redeemed prior to final maturity at a discount. Make whole provisions for early redemption always have a floor price no less than principal amount. Ms. Phipps is expecting the original intercompany note to have terms which do not exist anywhere in the financial markets and which never could have been made available to AmerenCIPS. This reasoning would be akin to asking the bank holding my mortgage to write down the principal I owe on my home because interest rates have risen since the time I originally financed the purchase.

V. <u>TRANSITIONAL FUNDING TRUST NOTES</u>

Q. Ms. Phipps suggests that the AmerenIP Transitional Funding Trust Notes ("TFTN") coupon rate should not be calculated using an internal rate of return ("IRR") monthly compounded methodology. Please respond.

A. Ms. Phipps argues that AmerenIP overstates the cost of its TFTNs by using an IRR approach that involves monthly compounding. Ms. Phipps' argument to annualize the monthly discount rate by multiplying the rate by twelve assumes that the IFC (Instrument Funding Charges) collections are remitted by AmerenIP to the indenture trustee on a monthly basis, which is not true in this case. In fact, AmerenIP remits funds to the trustee on a *daily* basis, and those funds are unavailable to the company once remitted. Although the trustee makes interest and principal payments to bondholders quarterly, this is irrelevant to AmerenIP's cost of debt. Thus, Ms. Phipps' means of calculating the TFTN cost understates the true cost to the Company. The use of the IRR method to determine the cost of

TFTNs was approved by the Commission in AmerenIP's 1999 DST case and 2001 DST case[4].

Q. Please respond to the other adjustments Ms. Phipps made to the cost of TFTN calculations.

A. Ms. Phipps pointed out two "errors" in my cost of TFTN IRR analysis that were not, in fact, errors. First, she claims that I incorrectly included an additional year of cash flows in my IRR analysis. However, these cash flows must be included in the IRR analysis, as they make up the test year cost calculations. Unlike the balance of TFTNs, which is a capital structure component and must be measured as of the end of the test year, the IRR calculates the true cost of the TFTNs and must incorporate the full test year cash flows. Second, Ms. Phipps adjusted the amount of "Net Proceeds Used to Retire Principal" to reflect a $100,000 subtraction to the capital subaccount, stating that I incorrectly did not include this in my calculations. Conversely, I did include this subtraction in the last line of the "Collection Amount" column in my IRR spreadsheet. Therefore, this amount is embedded in my IRR calculation.

VI. MISCELLANEOUS UPDATES AND ADJUSTMENTS

Q. Describe any updates or adjustments you made to any capital structure components or costs.

A. I updated AmerenIP's long-term debt schedule to reflect the recent refinancing of the entirety of their auction rate PCBs. On April 8, 2008, AmerenIP issued $337

[4] Direct testimony of Daniel L. Mortland, lines 168-170, Docket 04-0476.

million of senior secured notes for the purpose of redeeming AmerenIP's outstanding PCBs that were in auction rate mode. As Ms. Phipps pointed out in her testimony, negative credit rating actions against the bond insurers starting in December 2007 caused rates to spike in the auction rate market. Rates on these securities, which averaged in the range of 1.54% - 3.93%[5] over the period 2004-2007, saw rates climb to as high as 18%. Due to the extremely high rates on these securities as of late, Ms. Phipps measured these rates 'using the interest rates from the last rates from the last auctions prior to the December 2007 rating actions by Moody's and S&P on the companies that insure the Ameren utilities auction rate PCBs'[6]. Ms. Phipps also reasoned that a possible outcome was the refinancing of these securities[7] due to the recent Commission authority granted to do so[8]. Her reasoning was indeed correct—therefore I conclude that her proxy rates should be updated for actual rates that reflect AmerenIP's true amount and cost of long-term debt for the foreseeable future. I have updated AmerenIP's cost of long-term debt schedule (see Exhibit 23.5) to reflect this adjustment.

In addition, I have included a cost of short-term debt schedule for AmerenCILCO (see Exhibit 23.2) which reflects adjustments from my schedule included in direct testimony. These adjustments correct net short-term debt balances for March and April 2007 and cost of short-term debt for the months of April – June 2007.

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[5] Ameren Corporation's 2005 annual report (page 126) and 2007 annual report (page 126). Each PCB series average annual rates are listed. I used the highest and lowest average annual rates over the four year period.
[6] Lines 264-267 of Ms. Phipps direct testimony
[7] Line 261 of Ms. Phipps direct testimony
[8] Docket Nos. 08-0143 through 08-0148, March 12, 2008

VII. USE OF RATINGS METRICS AS SUBSTITUTE FOR ACTUAL RATINGS

Q. Please respond to Staff witness Freetly and IIEC witness Gorman's use of ratings metrics analyses to develop AIUs credit ratings which are different than the actual credit ratings of the Companies.

A. Ms. Freetly and Mr. Gorman's use of rating agency benchmark ratio analyses to form their own credit ratings in support of their return on equity recommendations falls short in many ways. First, this approach is based on the theory that selective quantitative analyses, such as the result of a few benchmark ratios at a point in time, is the only means of determining an issuer's credit ratings. This not true, as the rating agencies use qualitative factors such as operations, management and political and regulatory environment that play a key role in the final determination of an issuer's credit ratings.

Also, it cannot be overstated that the rating agencies are the final arbiters of credit ratings. This fact is apparent when the same analyses of Ms. Freetly and Mr. Gorman in the last AIU DST case[9] is evaluated. Ms. Freetly concluded that her revenue requirement recommendations were commensurate with an AA- credit rating for AmerenCILCO, AA credit rating for AmerenCIPS and A+ credit rating for AmerenIP[10]. Similarly, Mr. Gorman saw his capital structure and rate of return analyses supportive of ratings of a "strong A" at both AmerenCILCO and AmerenIP and within an "A" rating at AmerenCIPS[11]. However, it can be concluded that since AmerenCILCO, AmerenCIPS and AmerenIP's current issuer

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[9] Docket Nos. 06-0070/06-0071/06-0072 (Consolidated).
[10] Direct testimony of Janis Freetly dated April 26, 2006 lines 407-410.
[11] Direct testimony of Michael Gorman dated April 26, 2006 lines 679-718.

ratings of Ba1 at Moody's Investor Services that the predictive quality of these witnesses' ratings metrics analyses falls woefully short. Since we now have the benefit of 20/20 hindsight, we know that their previous conjectures were not just wrong, but far, far off the mark. We have no reason to expect their current conjectures to be any more accurate. In addition, it can be safely concluded that despite similar analyses put forth time after time in rate case proceedings, that there are plenty of factors—factors that can override simple benchmark ratio analyses—that rating agencies consider in assigning ratings.

VIII. CONCLUSION

Q. Does this conclude your testimony?

A. Yes, it does.