

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

CENTRAL ILLINOIS LIGHT COMPANY d/b/a AmerenCILCO)	Docket Nos. 07-0585, 07-0588
)	
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY d/b/a AmerenCIPS)	Docket Nos. 07-0586, 07-0589
)	
ILLINOIS POWER COMPANY d/b/a AmerenIP)	Docket Nos. 07-0587, 07-0590
)	
Proposed general increase in electric delivery service rates.)	(Consolidated)
)	

Rebuttal Testimony and Exhibit of

Michael Gorman

On behalf of

Illinois Industrial Energy Consumers

May 14, 2008
Project 8899



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Rebuttal Testimony of Michael Gorman

1 Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway,
3 Suite 208, St. Louis, MO 63141-2000.

4 Q ARE YOU THE SAME MICHAEL GORMAN WHO FILED DIRECT TESTIMONY IN
5 THIS PROCEEDING?

6 A Yes.

7 Q WHAT IS THE SUBJECT OF YOUR REBUTTAL TESTIMONY?

8 A I will respond to Staff witness Ms. Janis Freetly and a witness of Illinois Power
9 Company (AmerenIP), Central Illinois Light Company (AmerenCILCO) and Central
10 Illinois Public Service Company (AmerenCIPS), Ms. Kathleen C. McShane. For

11 purposes of this testimony, these three utilities will be referred to collectively as
12 Ameren Illinois Utilities (AIU or Company).

13 **Q PLEASE SUMMARIZE YOUR VIEW OF MS. FREETLY'S RECOMMENDED**
14 **RETURN ON EQUITY.**

15 A Ms. Freetly's recommended return on equity is overstated because of a Utility Risk
16 Premium study that incorporates a return on the market that is not reasonable.
17 Correcting Ms. Freetly's Utility Risk Premium estimate would reduce her estimated
18 return on equity for AIU down to approximately 10%, which supports my
19 recommended return on equity for AIU.

20 **Q PLEASE SUMMARIZE YOUR REBUTTAL TO AIU WITNESS MS. MCSHANE.**

21 A I also respond to AIU witness Ms. McShane's proposal to reject my return on equity
22 recommendation of 10%. Ms. McShane argues that consideration should be given to
23 both constant growth and two-stage growth DCF analyses in the formation of a final
24 return estimate. I explain why this recommendation is unsound and should not be
25 adopted.

26 I also respond to Ms. McShane's proposed adjustment to my risk premium
27 estimate to reflect an inverse relationship between interest rates and equity risk
28 premiums. As outlined below, this simplistic inverse relationship is not a sound
29 method of estimating a fair risk premium in today's marketplace. Rather, the risk
30 premium should be tied to risk differentials between equity and debt securities, not
31 simply nominal interest rate variations.

32 I also respond to Ms. McShane's criticisms of my CAPM return estimate, and
33 show that the risk premium I relied on is reasonable and does produce accurate

34 CAPM return estimates. Finally, I summarize my conclusions and show that my
35 recommended return on equity for AIU of 10% is reasonable, and that Ms. McShane's
36 criticisms are not sound.

37 **Response to Staff Witness Ms. Janis Freetly**

38 **Q PLEASE SUMMARIZE STAFF WITNESS MS. FREETLY'S RETURN ON EQUITY**
39 **RECOMMENDATIONS.**

40 A Ms. Freetly recommends a return on equity of 10.72% for AIU's gas operations. She
41 recommends a return on equity of 10.73% for AmerenCILCO's electric operations,
42 and 10.68% for AmerenCIPS and AmerenIP's electric operations.

43 In support of her return on equity recommendation for the gas operations,
44 Ms. Freetly took the simple average of her DCF derived result of 9.41% and a Utility
45 Risk Premium result of 12.04% $((9.41 + 12.04)/2 = 10.73\%)$.

46 In support of a return on equity recommendation for the electric operations,
47 Ms. Freetly started with the simple average of her DCF result of 10.01% and Utility
48 Risk Premium result of 11.94% $((10.01 + 11.94)/2 = 10.98\%)$. From this midpoint
49 estimate, she then subtracted (i) 25 basis points for AmerenCILCO, yielding a
50 10.73% recommendation for that utility, and (ii) 30 basis points for AmerenCIPS and
51 AmerenIP, yielding a 10.68% recommendation for those two utilities. The reduction
52 was made to reflect AIU's lower risk in comparison to her sample group. (ICC Staff
53 Ex. 5.0 at 23 and 24).

54 **Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH MS. FREETLY'S PROPOSED**
55 **RETURN ON EQUITY FOR AIU.**

56 A My concern with Ms. Freetly's proposed return on equity rests primarily with the
57 development of her Utility Risk Premium return estimates. For her gas sample, she
58 estimates a Utility Risk Premium return of 12.04%, and for her electric sample, she
59 derives a Utility Risk Premium return of 11.94%. Ms. Freetly's Utility Risk Premium
60 model develops an estimated Utility Risk Premium return from the sum of a risk-free
61 rate plus the product of a utility risk factor (beta) times the "Market Risk Premium"
62 (MRP). I believe Ms. Freetly's Utility Risk Premium return is overstated because she
63 overstated the MRP estimate.

64 In developing her Utility Risk Premium return estimate, Ms. Freetly derived an
65 MRP using a DCF derived return on the market (as proxied by the S&P 500 Index) of
66 13.75% less a risk-free rate of 4.72%.¹ Her workpapers indicate that this market
67 return DCF estimate reflects an S&P 500 Index dividend yield of approximately 2%
68 and a growth rate of over 11.5%. This DCF derived market return of 13.75% yielded
69 an MRP of 9.03%, and this MRP was used in both the gas and electric Utility Risk
70 Premium return estimates. Again, this MRP is not reasonable and resulted in an
71 inflated Utility Risk Premium return estimate.

¹ ICC Staff Exhibit 5.0, Schedule 5.07, Electric and Gas Risk Premium (13.75% - 4.72%) = 9.03%.

72 **Q WHY DO YOU BELIEVE MS. FREETLY'S MRP IS NOT REASONABLE?**

73 A This MRP is unreasonable for several reasons. First, the DCF derived return of
74 13.75% is not a reasonable and accurate estimate of a DCF return on the market.
75 This return estimate reflects a growth rate of over 11%, which is more than twice the
76 expected long-term growth rate of the U.S. GDP. By relying on an unreasonable
77 growth rate, her constant growth DCF model is inflated and not reliable. Ms. Freetly
78 recognized the need for a sustainable long-term growth rate in applying the DCF
79 model to her utility proxy groups.² However, she does not support the
80 reasonableness of the market DCF used in her Utility Risk Premium study. Because
81 her market DCF return of 13.75% is overstated and flawed, her MRP estimate of
82 9.03% is overstated and flawed.

83 Second, a wealth of market evidence indicates that the MRP of 9.03% derived
84 from her flawed market DCF return estimate is excessive. Morningstar, a
85 well-recognized and utilized source of historical security returns, capital costs, and
86 risk premiums, has studied long-term historical returns in the stock market relative to
87 Treasury bond investments. While Morningstar measures this MRP in many different
88 ways, and with different methodologies, its data and findings indicate a reasonable
89 estimate of the MRP is significantly lower than the 9.03% risk premium estimated by
90 Ms. Freetly.

91 For example, Morningstar estimates an MRP from the total return on stocks,
92 less an income return on Treasury bonds, to be in the range of 6.35% to 7.05%. The
93 7.05% represents the unadjusted long-term risk return on the S&P 500. The 6.35%³
94 is based on a subgroup of the New York Stock Exchange Index.

² ICC Staff Exhibit 5.0 at 6-7.

³ Morningstar, Ibbotson SBBI 2008 Valuation Yearbook at 72.

95 Further, Morningstar found the calculated 7.05% S&P 500 MRP is overstated,
96 because price-earnings ratios in the S&P 500 have been abnormally high relative to
97 earnings and dividend growth during the period 1980 through 2001. Morningstar
98 adjusted for this abnormal trend in price-to-earnings ratios and found that its MRP
99 estimate would decline from 7.05% down to 6.23%.⁴ Finally, Morningstar's data
100 would produce a risk premium of 6.5%⁵ relying on the total return of the stock market
101 less the total return on Treasury bonds during this same historical study period. Ms.
102 Freetly's use of a market risk of 9.03% is significantly in excess of the actual realized
103 MRPs over long historical periods as measured by Morningstar.

104 **Q IS THERE ANY WAY TO CORRECT MS. FREETLY'S UTILITY RISK PREMIUM**
105 **STUDY TO PRODUCE A REASONABLE RESULT IN THIS PROCEEDING?**

106 A Yes. Adjusting her Utility Risk Premium study to reflect a more reasonable MRP
107 estimate would produce a more reasonable Utility Risk Premium return estimate for
108 AIU in this proceeding. Using the midpoint of the three MRP estimates using
109 Morningstar data discussed above -- 7.05%, 6.23%, and 6.5% -- would produce an
110 MRP of about 6.6%.

111 Using an MRP of 6.6% and the other data Ms. Freetly showed on her ICC
112 Staff Exhibit 5.0, Schedule 5.07, would indicate a Utility Risk Premium return estimate
113 of 10.07% for her gas sample and 10.0% for her electric sample.

⁴ *Id.* at 92-98.

⁵ *Id.* at 28.

114 **Q HOW WOULD THIS ADJUSTED UTILITY RISK PREMIUM RETURN ESTIMATE**
115 **CHANGE MS. FREETLY'S RETURN ON EQUITY ESTIMATE?**

116 A Applying the same averaging she used to develop her recommendation from DCF
117 and Utility Risk Premium estimates, with the adjusted Utility Risk Premium, would
118 lower her recommended point estimate. For her electric sample, her DCF result of
119 10.01% and her adjusted Utility Risk Premium result of 10%, would indicate a fair
120 return on equity for electric operations of 10.0%. Reflecting her risk adjustment (for
121 AIU being less risky than her proxy group) would indicate a return of 9.75% (10.0%
122 less 0.25%) for AmerenCILCO's electric operations and 9.7% (10.0% less 0.30%) for
123 the electric operations of AmerenCIPS and AmerenIP.

124 Adjusting the development of her range for her gas sample, using this updated
125 Utility Risk Premium estimate, would reduce the high end of her estimated range from
126 12.04% down to 10.1%. Thus, for her gas group, the range would be 9.41% to
127 10.1%, with a midpoint estimate of 9.80%.

128 **Q DOES THIS ONE ADJUSTMENT TO MS. FREETLY'S ANALYSIS SHOW THAT**
129 **YOUR RECOMMENDED RETURN ON EQUITY FOR AIU'S OPERATIONS IS**
130 **REASONABLE?**

131 A Yes. As discussed above, my recommended return on equity for AIU of 10.0% would
132 be shown to be reasonable with this one adjustment to Ms. Freetly's return on equity
133 methodologies.

134 Q IN YOUR TESTIMONY YOU DEMONSTRATED THAT A 10% RETURN ON EQUITY
135 WOULD SUPPORT AIU'S FINANCIAL INTEGRITY. WOULD A 10% RETURN ON
136 EQUITY STILL BE SUPPORTIVE USING THE FINANCIAL METRIC
137 CALCULATIONS SHOWN IN MS. FREETLY'S TESTIMONY?

138 A Yes. I have adjusted her financial metrics shown on page 27 of her testimony to use
139 a 10% return on equity. As shown on my IIEC Exhibit 7.1, a 10% return on equity
140 would produce credit metrics that would correspond to an investment grade bond
141 rating of "AA" and "A" relative to the Moody's guideline ratios she illustrates on that
142 schedule.

143 **Response to AIU Witness Ms. Kathleen C. McShane**

144 Q DO YOU HAVE ANY RESPONSE TO THE REBUTTAL TESTIMONY OF AIU
145 WITNESS MS. KATHLEEN C. MCSHANE?

146 A Yes. Ms. McShane, at page 11 of her rebuttal testimony, argues that she would
147 recommend placing equal weight on the results of a constant growth DCF model and
148 a two-stage growth DCF model. While Ms. McShane agrees that the growth rates
149 used in these models must reflect long-term sustainable growth, and that current
150 short-term growth rates may be too high to be reasonable estimates of long-term
151 sustainable growth, she is concerned that the DCF model should properly reflect the
152 uncertain expectations of investors. To reflect this uncertainty, Ms. McShane
153 believes it appropriate to give equal weight to the two-stage and constant growth DCF
154 models.

155 Q DO YOU AGREE WITH MS. MCSHANE ON PLACING EQUAL WEIGHT ON THE
156 TWO-STAGE AND CONSTANT GROWTH DCF MODELS IN THIS PROCEEDING?

157 A No. I agree with much of Ms. McShane's assessment of evaluating the growth
158 outlooks in a DCF model. However, there is no dispute that short-term growth rates
159 in the market today are too high to be sustainable over the long term. As I outlined in
160 my direct testimony at pages 19-22, short-term growth rate outlooks reflect significant
161 capital expenditures by utilities, which are significantly increasing rate base, and
162 causing a dramatic increase in short-term earnings growth outlooks. It is simply not
163 rational to expect that those 3-5 year short-term growth rates will continue indefinitely.
164 Therefore, Ms. McShane's proposal to equal weight the two-stage and constant
165 growth DCF models would unrealistically suggest that the perpetual continuation of
166 the anomalous short-term growth projections (a forecast she rejects) is just as likely
167 as the leveling and decline in growth rates that I incorporated in my two-stage growth
168 DCF analysis. This suggestion is not reasonable, and does not produce a reliable
169 DCF return estimate.

170 Since the constant growth DCF model is based on the assumption that the
171 short-term growth rates will be maintained indefinitely, which is not a rational
172 expectation at this time, those inflated 3-5 year growth rates produce unreasonably
173 high constant growth DCF returns at this time.

174 Under most market conditions, analysts' 3-5 year growth rate estimates do
175 reflect reasonable estimates of long-term sustainable growth. Therefore, in most
176 instances, I would agree that consideration should be given to constant growth DCF
177 results. However, circumstances and market outlooks change, which requires an
178 informed analyst's development of a DCF estimate that reasonably reflects rational
179 expectations, which will properly reflect an efficient market and produce a reasonable

180 estimate of a utility's cost of equity. Those circumstances and investigations at this
181 point in time indicate that the constant growth DCF model is not reliable at this time
182 and no weight should be given to this model in this case.

183 **Q DO YOU HAVE ANY RESPONSE TO MS. MCSHANE'S REVIEW OF YOUR RISK**
184 **PREMIUM STUDIES?**

185 A Yes. Ms. McShane first argues that a risk premium study based on Commission-
186 authorized returns does not constitute an independent assessment of a utility's cost
187 of equity. Second, Ms. McShane argues that the use of an average risk premium
188 over the historical study period is inappropriate because it does not reflect an inverse
189 relationship between interest rates and equity risk premiums. Ms. McShane
190 concludes that reflecting an inverse relationship would increase the results of my risk
191 premium study by over a half a percentage point, to 10.7% from 10.2%.

192 **Q DO YOU AGREE WITH MS. MCSHANE'S CONCLUSIONS?**

193 A No. First, Commission-authorized returns are typically based on expert witnesses'
194 estimates of the prevailing market required return on equity. Since this is normally a
195 highly controversial issue in a rate proceeding, Commission-authorized returns reflect
196 an independent assessment of the prevailing contemporary return on equity cost. As
197 such, it is a much more independent assessment of an MRP than would be produced
198 from a market return estimate of required equity returns less prevailing utility yields
199 performed by an individual expert.

200 Second, Ms. McShane's contention that the equity risk premium should be
201 adjusted for the simplistic assumption of an inverse relationship between interest
202 rates and equity risk premiums is without merit. Academic research on this issue

203 indicates that the relationship between interest rates and equity risk premiums
204 changes over time and can be positive or negative, but it cannot be predicted with
205 any degree of certainty.

206 Moreover, academic research generally finds that this relationship is based on
207 the changes and perceptions of risk in equity investment versus bond investments.
208 This relative risk of equity versus bond investments and the prevailing equity risk
209 premium can be estimated by reviewing the relative bond yield spread between
210 Treasury bonds and utility bonds. In my analysis, I relied on the prevailing utility bond
211 to Treasury bond yield spread to gauge whether or not the equity risk premium used
212 in my study in this case should be higher or lower than the average equity risk
213 premium estimated over the historical time period. That analysis, as discussed at
214 pages 26-27 of my direct testimony, indicated that the equity risk premiums now
215 should be about average because utility bond yields and Treasury bond yields used
216 in my study represent about an average risk spread.

217 **Q DID MS. MCSHANE TAKE ISSUE WITH YOUR CAPM ANALYSIS?**

218 A Yes. Ms. McShane believes that my CAPM analysis was inappropriate because she
219 disagrees with my estimate of an MRP. She proposes instead to use Morningstar's
220 estimate of the MRP of 7.1%, which is derived from a total return on utility stocks
221 relative to the income return on Treasury bonds. (Ameren Ex. 22 at 17).

222 **Q DO YOU AGREE WITH MS. MCSHANE'S CRITICISMS OF YOUR CAPM**
223 **ANALYSIS?**

224 A No. I derived my equity risk premiums through the relationship of a risk premium
225 return estimate on the marketplace to projected Treasury bonds. The risk premium

226 estimate was based on the principle that historical investments in the market have
227 yielded real returns, or returns above inflation. Those real returns are reasonable
228 expectations of forward-looking real returns on the market. I created a nominal
229 expected return on the market, based on the real return experienced over the period
230 1926-2006 using Morningstar data, and a projected inflation rate expected over the
231 next 3-5 years. This produces an expected risk premium market return.

232 It is not necessary, as Ms. McShane contends, to demonstrate that the real
233 return is correlated in any way with historical stock returns. Indeed, Ms. McShane
234 does not claim that it is necessary to show that a DCF-derived return on the market
235 should be somehow correlated with historical market returns. Therefore, it is not
236 appropriate to create this restriction on the use of a risk premium method for
237 forecasting an expected return.

238 **Q DO YOU AGREE WITH MS. MCSHANE THAT THE MRP SHOULD BE 7.1%?**

239 **A** No. Ms. McShane argues that an appropriate risk premium is around 7.1% using
240 Morningstar data. Importantly, as discussed above in response to Ms. Freetly's
241 testimony, Morningstar publishes significant data concerning an estimate of an MRP.
242 Morningstar finds that the MRP can range anywhere from 6.2% up to 7.1%,
243 depending on the market index used, and on whether adjustments are necessary to
244 reflect price growth in the marketplace that significantly exceeds earnings and
245 dividend growth in the market. Importantly, all of Morningstar's risk premiums are
246 measured using the Treasury bond income returns.

247 As discussed above, using Morningstar's methodology of taking the total
248 return on the market less the income return on Treasury bonds, creates a risk
249 premium in the range of 6.2% up to 7.1%. Ms. McShane proposes to use

250 Morningstar's highest market return estimate of 7.1%. However, the midpoint of
251 Morningstar's estimated MRPs is 6.6%, which is nearly the same as my MRP
252 estimate of 6.5%. Using the 6.6% MRP midpoint in my CAPM instead of 6.5%, would
253 not change my CAPM analysis end result.

254 **Q DO YOU BELIEVE MS. MCSHANE'S PROPOSED REVISIONS TO YOUR**
255 **CONSTANT GROWTH, NON-CONSTANT GROWTH, RISK PREMIUM AND CAPM**
256 **RETURN ESTIMATES WOULD INCREASE YOUR AUTHORIZED RETURN ON**
257 **EQUITY TO 10.7% FROM 10%, AS SHE SUGGESTS AT PAGE 18 OF HER**
258 **REBUTTAL TESTIMONY?**

259 A No. As described above, Ms. McShane's proposed use of the constant growth DCF
260 model in this proceeding is inappropriate, without merit and flawed. Second,
261 Ms. McShane's proposed adjustments to my risk premium study are without merit,
262 and do not reflect a current assessment of investment risk differentials between
263 equity and bond investments. Therefore, she is not reasonably estimating an equity
264 risk premium appropriate for estimating AIU's cost of equity in this proceeding. Third,
265 Ms. McShane is relying on Morningstar data for its highest risk premium for
266 adjustments to my CAPM analysis. That assessment is unjust and unreasonable. As
267 such, Ms. McShane's criticisms are without merit, and my recommended return for
268 AIU of 10% is reasonable and should be adopted.

269 **Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

270 A Yes.