Ameren Exhibit 52.0

ILLINOIS COMMERCE COMMISSION

DOCKET Nos. 09-0306 - 09-0311 (Cons.)

SURREBUTTAL TESTIMONY

OF

KATHLEEN C. McSHANE

SUBMITTED ON BEHALF OF

CENTRAL ILLINOIS LIGHT COMPANY
d/b/a AmerenCILCO

CENTRAL ILLINOIS PUBLIC SERVICE COMPANY
d/b/a AmerenCIPS

ILLINOIS POWER COMPANY
d/b/a AmerenIP

(The Ameren Illinois Utilities)

DECEMBER 2, 2009

TABLE OF CONTENTS

Page

ILLINOIS COMMERCE COMMISSION

DOCKET Nos. 09-0306 - 09-0311 (cons.)

SURREBUTTAL TESTIMONY

OF

KATHLEEN C. McSHANE

Submitted on Behalf of

The Ameren Illinois Utilities

I. INTRODUCTION

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 who previously filed direct and rebuttal testimonies in this proceeding?

A. Yes, I am.

Q. To assist the Illinois Commerce Commission in following your surrebuttal testimony, would you please summarize the conclusions reached in your rebuttal testimony?

A. In my rebuttal testimony, I concluded that:

1. The fair returns on equity for each of the Ameren Illinois Utilities ("AIUs")were, based on the updated the results of my cost of equity tests, as follows:

Table 1

	Gas	Electric
CILCO	11.2%	11.7%
CIPS	10.8%	11.3%
IP	11.2%	11.7%

2. Ms. Freetly's recommended ROEs, which ranged from 8.7% CILCO Gas to 10.1% for IP Electric, were too low and suffer from the following deficiencies:

   a. The failure to consider the results of the constant growth DCF model applied using analysts' growth forecasts;

   b. Reliance on spot rather than forecast interest rates in the application of the CAPM;

   c. Reliance on forward Treasury yields rather than direct estimates of GDP growth in her application of the multi-stage DCF model;

   d. Using an average of weekly and monthly betas in the application of the CAPM rather than solely weekly betas; and

   e. Making unwarranted reductions to the costs of equity estimated for the proxy samples of companies for a combination of financial strength, rate design and the proposed uncollectibles riders.

3. With my proposed revisions to Ms. Freetly's cost of equity tests, and excluding the downward adjustments to the proxy samples' cost of equity, Ms. Freetly's resulting ROEs would have been 10.35% for the gas utility operations and 10.95% for the electric utility operations.

4. Mr. Gorman's proposed ROE of 10.0% was too low due to:

a. The failure to consider the results of the constant growth DCF model using analysts' growth forecasts;

b. The failure to include a factor for external growth in the application of the sustainable growth version of the DCF model;

c. An underestimate of the market risk premium in the CAPM; and

d. Failure to take into account the difference in financial risk between the Ameren Utilities and the proxy utilities inherent in the difference between the formers' ratemaking and the latter's market value capital structures.

5. Mr. Thomas' proposed ROEs of 8.76% and 7.97% for the electric and gas utility operations, respectively, of the Ameren Utilities were:

a. Outside the range of reasonableness;

b. Based on flawed inputs to his multi-stage DCF model; and

c. Allegedly supported by a CAPM analysis which relied on unreasonably low betas and market equity risk premium estimates.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to address the key issues related to cost of equity raised in the rebuttal testimony of Illinois Commerce Commission Staff ("Staff") witness Ms. Janice Freetly; Illinois Industrial Energy Consumers ("IIEC") witness Mr. Michael Gorman; and Citizens Utility Board ("CUB") witness Mr. Christopher Thomas.

Q. Are you sponsoring any exhibits with your surrebuttal testimony?

A. Yes, I am sponsoring Ameren Exhibit 52.0 Attachment A and Schedules 1 – 3.

III. SUMMARY OF SURREBUTTAL TESTIMONY

Q. With that background, please summarize your surrebuttal testimony.

A. With respect to Staff witness Ms. Freetly's rebuttal testimony, my surrebuttal testimony concludes that:

1. Despite Ms. Freetly's arguments to the contrary, it is reasonable to give weight to both the constant growth and multi-stage DCF models;
2. Ms. Freetly's rationale for rejecting direct estimates of long-term economic growth in favor of forward Treasury bond yields as a proxy for long-term economic growth expectations in the multi-stage DCF model is unpersuasive;
3. The use of "spot" interest rates in Ms. Freetly's application of the CAPM understates the cost of equity because it fails to recognize the high probability that interest rates will increase;
4. Ms. Freetly has not made a convincing case for reliance on an average of weekly and monthly betas in the application of the CAPM;
5. The adjustments that Ms. Freetly makes to the proxy samples' cost of equity for the relative financial strength, rate design and proposed uncollectibles riders for the Ameren Utilities are unjustifiable;
6. Ms. Freetly has failed to refute the merit of recognizing in the cost of equity the differences in financial risk between the proxy companies and the Ameren Utilities inherent in the market value capital structures of the former and the ratemaking capital structures of the latter.

With respect to Mr. Gorman,

1. As with respect to Ms. Freetly, I have not changed my position that it is reasonable to give weight to both the constant growth and multi-stage DCF models;
2. I demonstrate that his proposed adjustment to the sustainable growth DCF model for external growth is incorrect and thus understates the cost of equity;
3. I conclude that his market risk premium for purposes of the CAPM is understated; and
4. He should have used forecast interest rates in his risk premium test (as he did in the CAPM) given the high probability that interest rates will rise.

With regards to Mr. Thomas, I:

1. Reject his characterization of my position on the inadequacy of his initial recommended returns on equity for the Ameren Utilities as “alarmist” and point out that his recommendations would be even lower given his position that Ms. Freetly’s downward adjustments for the uncollectibles riders are conservative;
2. Reject his contention that analysts’ forecast growth rates should not be relied upon in the application of the DCF model due to their optimism;
3. Establish that his rationale for using real rates of growth in the economy rather than nominal growth rates as the expected long-term rate of growth in the DCF model is flawed;

4. Show that the use of adjusted betas in the application of the CAPM is appropriate, in contrast to Ms. Thomas' claim to the contrary; and
5. Demonstrate that history bears out the conclusion that his estimated market risk premium of 5% is unreasonably low.

IV. RESPONSE TO STAFF WITNESS FREETLY

Q. Please summarize briefly the key issues that you will address with respect to the rebuttal testimony of Ms. Freetly.

A. Ms. Freetly:

1. Disagrees that it is appropriate to apply both a constant growth and multi-stage Discounted Cash Flow (DCF) model, on the grounds that, in her opinion, the growth rates forecast by analysts are not sustainable.
2. Does not accept that, in the application of the multi-stage DCF model, a direct estimate of economic growth is a better measure of longer-term growth expectations rather than forward Treasury bond yields.
3. Disagrees that, in the application of the Capital Asset Pricing Model, forecast interest rates are a better representation of investor expectations than "spot" interest rates.
4. Disagrees with my conclusion that weekly betas for the proxy samples as provided by *Value Line* are to be preferred over betas calculated using monthly interval data.
5. Rejects my conclusions regarding the need to adjust the market rate of return on equity to recognize the difference in financial risk between

market value capital structures and the ratemaking capital structure to which the cost of equity is applied.

Q. With respect to the application of the DCF test, Ms. Freetly rejects reliance on a constant growth model because, in her opinion, it is unlikely that the analysts' growth forecasts she uses for the proxy samples of gas and electric utilities are sustainable in the long-run. Do you disagree with her opinion that the analysts'' growth rates are unsustainable?

A. No, but it is not my opinion or her opinion which sets market prices. Analysts' forecasts are the most objective measure of investor expectations that are embedded in the stock prices and dividend yields used to estimate the DCF cost of equity. We can only surmise if or when investors expect the analysts' forecast growth rates to decline (or increase) to levels that more closely track the growth in the economy. Underestimating the period over which the analysts' forecast growth rates are expected to prevail will understate the cost of equity when the forecast growth rates exceed the expected long-term equilibrium growth rate and overstate the cost of equity when the converse is the case.

Further, the multi-stage model (in this case a three-stage model) can create inconsistencies in the DCF cost estimates for the individual companies. For example, New Jersey Resources and Wisconsin Energy have among the highest forecast analysts' earnings growth rates and the lowest dividend yields, the latter being consistent with their higher than their respective sample average forecast earnings growth rates. These companies should, all other things equal, be expected to have higher costs of equity than their respective sample averages because there is greater risk associated with higher

expected growth rates. However, when the three-stage model is applied, because these companies have relatively low dividend yields, their three-stage DCF costs of equity are lower than their respective sample averages. (Ameren Exhibit 36.0, Ameren Exhibit 12.0G.6 Updated and 12 E.6 Updated).

These outcomes make no logical sense. They arise because of the inconsistency between the relatively low dividend yield and the assumption in the three-stage model that investors expect a much lower growth rate (the long-term GDP growth rate) than the company-specific forecast earnings growth rate to "kick in", albeit with a transitional period.

The use of the average of the constant growth and the three-stage DCF models, rather than the results of the three-stage model alone, recognizes the imprecision of the period during which investors might expect analysts' forecast growth rates to persist and avoids results that are potentially internally inconsistent. As a result, a reasonable approach is to give equal weight to the results of both the constant growth and multi-stage models.

Q. Do you accept Ms. Freetly's arguments in support of the use of the forward yield on the 20-year Treasury bond as a proxy for long-term GDP growth in the final stage of her three-stage DCF model rather than a consensus forecast of GDP growth?

A. No. Ms. Freetly makes two points in support of the use of forward yields on the 20-year Treasury bond rather than a direct forecast of GDP growth rates. First, she states that the consensus GDP forecasts as produced by Blue Chip *Economic Indicators* are for a ten-year period which does not overlap with the period represented by the "long-term"

in the three-stage DCF test. Second, she states that the GDP growth forecasts have been static (that is, they have not changed materially over time), while the forward 20-year Treasury yields reflect changing investor expectations. Related to the second point, she states that the GDP forecasts are sometimes only updated infrequently, which might explain their alleged stability.

Ms. Freetly is correct that the Blue Chip long-term consensus forecast of GDP growth only extends 10 years. She is also correct that some long-term GDP forecasts are only updated infrequently, e.g., annually. Neither of these points supports using forward interest rates as a proxy for long-term GDP growth. Barring a material structural shift in inflationary pressures or output potential in the underlying economy, forecasters (and investors) would reasonably anticipate that, while there will always be cyclical deviations from the trend rate of growth, nominal economic growth over the longer-term will revert to trend. In this context, there is no basis for concluding that investors would not rely on forecasts of GDP over the next ten years as the best available estimate for the very long term growth estimates required in a multi-stage DCF model.

While Ms. Freetly speculates that the stability of the 10-year consensus forecasts of GDP growth issued by Blue Chip may be due to infrequent updating, it is more likely that their stability represents the expected reversion of growth to trend levels. If investors required more frequently updated long-term growth estimates because they were constantly changing, such estimates would be provided. The observation that forecast long-term growth rates are not updated more frequently is basically a rebuttable presumption that the long-term, steady state growth expectations do not change very frequently.

As I indicated in my rebuttal evidence (page 4), Ms. Freetly's proposition that in the long-run the long-term risk-free rate of interest and GDP growth should be approximately similar is theoretically correct, there are simply too many influences on interest rates at any given time to conclude that the forward 20-year Treasury yield is a good proxy for investor expectations of the long-term growth in the U.S. economy – especially in a period marked by extensive monetary intervention by governments. Furthermore, an additional key factor has been high global demand for U.S. securities because they are viewed as default-free, they are highly liquid, and the U.S. dollar remains the world's reserve currency. Foreign investors currently own approximately 30% of the outstanding federal debt.[1] When those factors are combined with what has been described as a global savings glut, downward pressure has been maintained on U.S. Treasury bond yields. With the extent of global influences on U.S. Treasury bond yields, forward yields are an unreliable proxy for investors' expectations of long-term growth in the U.S. economy at this time and thus for the long-term growth rate to be used in a multi-stage DCF model.

Q. Ms. Freetly takes issue with your conclusion that forecast interest rates rather than "spot" interest rates should be used in the application of the Capital Asset Pricing Model. She states that if investors viewed forecasts as valuable, the forecasts would be reflected in current market interest rates. She recommends that the Commission continue to use current interest rates rather than forecast interest rates. Please respond.

[1] Foreign investors are not subject to U.S. taxation, which in isolation, would place downward pressure on Treasury yields relative to where they would be if only U.S. investors held Treasury bonds.

A. "Spot" Treasury yields remain at relatively low levels as a result of a confluence of factors, including (1) the commitment of the Federal Reserve to interest rates at low levels by maintaining the target Fed Funds rate in a range of 0 to ¼ percent; (2) the expected purchase by the Federal Reserve of over a $1 trillion dollars of agency mortgage-backed securities and $175 billion of agency debt; (3) the global demand for U.S. Treasury debt and (4) relatively weak economic conditions. A number of market participants have referred to the prevailing conditions as the "Treasury bubble", that is, Treasury bond yields are abnormally low. With the U.S. federal budget deficit for 2009 topping $1.4 trillion, the most likely trajectory for U.S. Treasury bond yields as the U.S. and global economies strengthen is an upward one, as is reflected in the consensus of economists' forecasts. The application of the CAPM, which in principle is a forward-looking estimate of the cost of equity, should recognize the high probability that U.S Treasury yields will increase.

Q. Ms. Freetly disagrees with your conclusion that the weekly *Value Line* betas are superior to monthly betas (which include Staff's regression betas). Please describe Ms. Freetly's concerns .

A. Ms. Freetly recommends equal weighting of weekly and monthly betas in determining a cost of common equity with the CAPM because neither is superior to the other. She acknowledges that weekly betas have a lower standard error and are "usually more reliable…than monthly betas". However, she justifies the inclusion of monthly betas in the determination of the estimated beta because:

a. Monthly betas are less susceptible to non-synchronous trading than weekly betas; and

b. Monthly returns have lower coefficients of variation than weekly betas indicating that the variation of weekly returns to the sample mean is subject to increased random error.

Q. Ms. Freetly comments that your regression analysis is flawed due to problems with the data. Please respond.

A. Ms. Freetly notes that the gas utility prices do not always match the prices on the Yahoo website and the NYSE index prices data do not match the data on the nyse.com website. With respect to the former, the weekly beta analysis was conducted using the adjusted close prices reported by Yahoo.com.[2] With respect to the latter, the monthly beta analysis for the gas utilities inadvertently relied on the monthly high prices, rather than the closing prices. Schedule 1 attached revises the weekly analysis to utilize the close prices for the gas utilities in place of the adjusted close prices and the monthly analysis to utilize the close prices of the NYSE index. The revised analysis does not change the conclusions, namely that much greater confidence can be placed in the weekly betas.

Q. Ms. Freetly claims that the difference in the beta estimates as between weekly and monthly calculations may be due to the effect of non-synchronous trading. Do you agree?

A. No. The non-synchronous trading effect arises when stock prices respond with a lag to economic events. As a result, the returns on a stock at a particular point in time are not "in synch" with those of the market. This effect is of particular concern when

[2] The historic adjusted prices are adjusted both for stock splits and dividend payments.

analyzing daily data collected on thinly traded stocks, i.e., stocks that are not traded daily or very heavily. The companies in the gas distribution sample are not thinly traded, but rather trade on a consistent basis. Yahoo.com reports significant daily trading volume for each of the companies in the gas and electric utility samples, typically in the hundreds of thousands of shares.

Q. Doesn't Ms. Freetly conduct an analysis which shows that there is a statistically significant negative relationship between the lagged returns on the gas utilities and the returns on the equity market composite, which she attributes to non-synchronous trading?

A. Yes, using returns generated during the financial crisis. However, the same analysis conducted for periods ending 2005 and 2006, i.e., periods not incorporating the financial crisis, produces different results. The coefficients on 1, 2 and 3 week lags in regressions for the periods ending 2005 and 2006 are insignificant.[3] The differing results suggest that Ms. Freetly's analysis may relate to the market conditions during the financial crisis rather than to non-synchronous trading issues.

Q. Ms. Freetly calculates the coefficient of variation for the monthly and weekly series of returns and concludes that, as it is higher for the weekly series than for the monthly series, there is increased random error in the weekly series relative to the monthly series. Does this provide evidence in support of using the monthly betas?

A. No. The coefficient of variation is the ratio of the standard deviation of returns to the average return. It measures the unit of risk per unit of return. The higher the

[3] Analysis provided in workpapers.

coefficient of variation, the greater is the risk. The higher coefficients of variation associated with the weekly betas are consistent with the higher weekly (than monthly) betas.

Q. Ms. Freetly argues that reference to the superiority of the statistics associated with the weekly regressions as compared to those of the monthly regressions does not support the conclusion that weekly betas are to be preferred to monthly betas. Please respond.

A. Ms. Freetly focuses on my reporting of the R^2 and t-statistic and downplays the comments made with respect to the standard error. As was stated in my Rebuttal testimony at lines 162 to 183 and in the AIUs' response to Staff data request JF 6.03 (Ameren Exhibit 52.1), the quality of the regression is measured by the R^2 while the statistical reliability is measured by the standard error. As stated in Brealey, Myers and Allen, *Principles of Corporate Finance*, Eighth Edition, page 221, "The noise in the returns can obscure the true beta. Therefore, statisticians calculate the *standard error* of the estimated beta to show the extent of possible mis-measurement. Then they set up a *confidence interval* of the estimated value plus or minus two standard errors..." The standard error is a measure of the precision of the estimated beta. The smaller the standard error, the smaller is the confidence interval and the greater is the confidence that can be placed in the result. As shown in Ameren Exhibit 52.0 Schedule 1 attached, the standard errors are consistently lower and the confidence intervals are consistently narrower for the weekly betas than the monthly betas. Using weekly betas which have 260 observations over a five-year horizon relative to a monthly betas with 60 observations lowers the chance that random fluctuations in the calculated beta will arise

as one observation is dropped and one added.[4] Obtaining dependable estimates of beta is the objective of the analysis; the estimates of the betas derived from weekly data are more precise and more dependable.

Q. Ms. Freetly also claims that your analysis of the relationship between utility betas and returns is flawed because it assumes that the systematic risk of both the gas distributors and electric utilities have not changed over the periods of analysis. Please comment.

A. In Staff Data Request 6.04 (attached), I was asked if I was aware of any academic studies that addressed whether weekly betas are more accurate predictors of utility returns than monthly betas. I responded that I was not aware of any such studies. I did point out that the actual returns for both gas distributors and electric utilities have been higher, on average, over time than the *Value Line* weekly betas would have predicted.

Ms. Freetly responded in her Rebuttal testimony that the implicit assumption underlying my response was that the systematic risk of the gas distributors and electric utilities had not changed over time. She indicated that the calculated beta may decrease (increase) when "true" systematic risk is rising (falling). I don't disagree with this proposition. Indeed, this issue can make the application of the CAPM problematic, because if this were happening, using the most recent calculated betas would tend to understate the cost of equity when systematic risk is rising and vice versa.

[4] Phillip Daves, Michael Ehrhardt and Robert Kunkel, "Estimating Systematic Risk: The Choice of Return Interval and Estimation Period", *Journal of Financial and Strategic Decisions,* Volume 13, Number 1, Spring 2000, note that most current empirical research is done using daily prices and recommend that the financial manager should always select daily returns "because daily returns result in the smallest standard error of beta or greatest precision of the beta estimate."

It was precisely for this reason that I did not simply compare the most recent betas to the most recently achieved returns for the two samples of utilities. Instead, I compared a series of calculated betas for both the gas distributors and electric utilities to the average returns to assess whether, over time, the actual returns were in line with what the betas would have predicted in arriving at my conclusion that the adjusted weekly *Value Line* betas underestimated the actual returns for both the gas distributors and electric utilities.

Q. Ms. Freetly contends that there is no merit to the adjustment to the market-derived cost of equity for the different levels of financial risk between the Ameren Utilities' capital structures and the capital structures measured in the capital markets for the proxy companies. Do you accept her conclusions?

A. No. Ms. Freetly states that it is appropriate to use a market-based cost of equity for regulatory rate setting. I accept that a market-based cost of equity is appropriate. Ms. Freetly also states that it is necessary to use a book value rate base for regulatory rate setting. I also accept that is the applicable regulatory construct.

Ms. Freetly also states that the application of the market return to the book value simply takes the return investors demand to earn from a dollar invested in the common equity of a company, given the amount of risk in the common equity of that company and the current price of risk, and applies it to the number of common equity dollars invested in the rate base of the Company.

The market return is the return that investors demand to earn on the market value of the equity as Ms. Freetly explains at lines 719 to 723 of her Rebuttal testimony. That return is measured using proxy companies which are deemed to be of similar risk to the specific company for which the allowed return is to be determined. The current price of

risk (both business and financial) is reflected in the market values of the proxy companies. Assuming that the business risk of the proxy companies is similar to the business risk of the specific company, it must be determined whether there are differences in financial risk.

There does not appear to be any disagreement between Ms. Freetly and myself that (1) differences in financial risk need to be accounted for in the cost of equity; and (2) higher or lower financial risk than the proxy companies, given similar business risk, requires an adjustment to the proxy companies' cost of equity. The disagreement appears to be how to measure the difference in financial risk.

Ms. Freetly refers to my adjustment for financial risk as a market-to-book adjustment. However, the need to make an adjustment for differences in financial risk is *independent of the market-to-book ratio.* Presumably Ms. Freetly would not disagree with the proposition that, if the market-to-book ratio of the proxy firms were 1.0, and their market and book value common equity ratios were both 40 percent, then an adjustment to the proxy firms' cost of equity would be required if the common equity ratio to which the market-based cost of equity is to be applied were 50 percent; i.e., the utility has a higher equity ratio than the average for the proxy group – so the utility has lower financial risk. Therefore, the issue is not whether an adjustment for differences in financial risk is required, but how to measure the differences in financial risk.

The price of financial risk is determined in the capital markets and reflected in the market value capital structures of the proxy companies. It is the market value capital structures which determine the amount of financial risk that is reflected in both the DCF cost of equity and the betas which underpin the Capital Asset Pricing Model. When the

capital structure to which the return on equity is to be applied differs from the market value capital structure associated with the cost of equity (assuming similar business risk), an adjustment to that cost of equity is required.

Q. In her direct and rebuttal testimony, Ms. Freetly makes adjustments to the sample utilities' cost of equity for what she claims is the financial strength of the individual Ameren Utilities relative to the sample companies, the impact of the rate design adopted for the gas utilities in Order 07-0585 *et. al*. (Cons), and the impact of the proposed uncollectibles riders. In her rebuttal testimony, she continues to contend that these adjustments are warranted. Has she made convincing arguments?

A. No. In her Rebuttal testimony, Ms. Freetly makes downward adjustments to the cost of equity for the electric and gas proxy samples as follows:

Table 2

Ameren Utility	Sample Cost of Equity	Adjustment for Financial Strength	Adjustment for Rate Design	Adjustment for Uncollectibles Riders	Total Adjustment to ROE	Recommended ROE
CILCO-Gas	9.63%	+0.105%	-0.10%	-0.875%	-0.87%	8.76%
CIPS-Gas	9.63%	-0.15%	-0.10%	-0.795%	-1.05%	8.58%
IP-Gas	9.63%	+0.105%	-0.10%	-0.605%	-0.60%	9.03%
CILCO-Electric	10.44%	-0.06%	--	-0.63%	-0.69%	9.75%
CIPS-Electric	10.44%	-0.30%	--	-0.645%	-0.945%	9.50%
IP Electric	10.44%	--	--	-0.34%	-0.34%	10.10%

The total adjustments to Ms. Freetly's estimated cost of equity for the proxy samples effectively represent the extent to which Ms. Freetly believes each of the Ameren Utilities is less risky on a net basis compared to her proxy sample utilities due to

(1) staff's recommended revenue requirements, (2) the rate design of the gas utilities and (3) the adoption of riders for uncollectibles.

With respect to the adjustments for financial risk, Ms. Freetly claims that Staff's revenue requirement recommendations, including her cost of common equity recommendations, indicate credit metrics that are commensurate with debt ratings that are higher or lower than the implied debt ratings suggested by the credit metrics of her proxy utility samples. She claims that her

> "analysis of the implied level of financial strength of the gas and electric utility operations of each of the AIUs is not an attempt to predict the rating outcome of Staff's position in these rate proceedings. I did not attempt to determine my own credit ratings for the AIUs nor am I suggesting that simply because the Companies' metrics fall within the guideline ranges that the implied ratings will result. Rather, I performed the ratio analysis in order to compare the financial strength of the Companies, based on the FFO to interest coverage, FFO to total debt, RCF to total debt coverage and debt to capitalization, to those of my Gas and Electric samples. I translated the resulting ratios into implied credit ratings only to have a metric on which to base an adjustment to the cost of equity."

Ms. Freetly is comparing apples and oranges. She is comparing the credit metrics that her utility samples have **actually** achieved over the period 2006-2008 with credit metrics that could be achieved if the Ameren Utilities were able to earn the returns on equity that they are allowed. Recent history demonstrates that the Ameren Utilities have significantly under earned their allowed returns on equity and thus have not achieved the levels of financial strength that are implied by Ms. Freetly's financial risk adjustments. The average actual 2006-2008 returns on equity for the combined gas and electric operations of CILCO, CIPS and IP as reported in the year-end surveillance reports filed with the Commission were 8.45%, 4.22% and 0.92% for CILCO, CIPS and IP respectively. In its most recent credit rating reports for CIPS and IP (August 2009), Moody's explicitly referred to the fact that the companies earn significantly less than

their allowed rate of return. By comparing the potential financial performance and credit metrics of the Ameren Utilities (rather than the observed performance) to the actual financial performance and credit metrics of the proxy utilities, Ms. Freetly has understated the Ameren Utilities' financial risk relative to the proxy utilities.

With respect to the adjustments for the uncollectible riders, in her Rebuttal testimony, Ms. Freetly did not respond to my critiques of the methodologies she employed to support downward adjustments to the cost of equity of her gas and electric utility samples. In my Rebuttal testimony, I noted that Moody's conclusion that the entire political and regulatory climate in Illinois had improved (which included the legislation providing the Illinois utilities with a bad debt rider) had only resulted in a single notch debt rating upgrade for the Ameren Utilities and that the adoption of the single rider itself was unlikely to produce a full credit rating category improvement in both regulatory framework and sustainable profitability. In her Rebuttal evidence, as a result of the new Moody's rating methodology, Ms. Freetly speculates that the adoption of the uncollectibles riders would improve the utilities' credit rating on Moody's "Ability to Recover Costs and Earn Returns" factor by one full credit rating (equivalent to another single notch debt rating upgrade). She provided no empirical evidence, either by reference to credit rating actions taken for the Ameren Utilities or any other utilities, that the adoption of the uncollectibles riders would improve the credit rating on that factor by a full credit rating category.

Further, Ms. Freetly's downward adjustments for the uncollectible riders are effectively premised on the assumption that the Ameren Utilities were of similar business risk to the proxy utilities before the adoption of the riders. There is no recognition of

factors that would point to higher business risk for the Ameren Utilities than for the proxy companies, e.g., regulatory lag and rising operating costs and capital expenditures, both of which were referenced by Moody's in its most recent credit reports. The implied ratings for Regulatory Framework and Ability to Recover Costs and Earn Returns assigned to the Ameren Utilities, to which Moody's gives 50% weight in total in assigning ratings, are Ba and Baa respectively. The corresponding median ratings for the 21 U.S. utilities (gas and electric) reviewed in Moody's August 2009 *Rating Methodology: Regulated Electric and Gas Utilities* are Baa and A respectively. While the utilities for which Moody's reports the ratings include some which are in Ms. Freetly's proxy samples and some which are not, the fact is that a relatively broad sample of gas and electric utilities has higher implied credit ratings on these two factors than the Ameren Utilities, i.e., of lower business risk. That evidence strongly suggests that Ms. Freetly's implicit point of departure (similar business risk) for making her downward adjustments is incorrect and thus the downward adjustments she proposes for the uncollectibles riders based on credit ratings are not supportable.

Moreover, Ms. Freetly provided no response to my critiques of the "operating income" methodology from which she estimated downward adjustments to the proxy samples' cost of equity by 106 to 160 basis points for the Ameren gas utilities and 48 to 119 basis points for the Ameren electric utilities. As I discussed in my Rebuttal testimony (page 19), the "operating income" approach constitutes a reduction to the cost of equity for a risk for which the Ameren Utilities have never been compensated and for which there is no theoretical or empirical support.

V. RESPONSE TO IIEC WITNESS GORMAN

Q. Please summarize briefly the issues raised in Mr. Gorman's Rebuttal testimony that you will address.

A. Mr. Gorman:

1. Disagrees with my conclusion that weight should be placed on both the constant growth and non-constant growth DCF models;
2. Agrees in principle that, in the application of the sustainable growth DCF model, it is appropriate to include an external growth component, but disagrees with my conclusion that its exclusion resulted in an underestimate of the cost of equity;
3. Disagrees with my critiques of his estimate of the market risk premium in his application of the CAPM; and
4. Disagrees with my conclusion that forecast interest rates should be relied upon not only in the application of the CAPM, but also in the application of the risk premium test.

Q. At pages 6 and 7 of his Rebuttal testimony, Mr. Gorman states that your conclusion that dividend yields are not abnormally high is inaccurate. Please respond.

A. At page 25 of his Direct testimony, Mr. Gorman rejected putting weight on the constant growth DCF model using analysts' forecasts because utility dividend yields are abnormally high in relation to the forecasts of earnings growth rates. In arriving at his conclusion regarding the level of dividend yields, Mr. Gorman compared the recent yields to the average yield over the prior five years. In my Rebuttal testimony (page 20),

I showed that recent dividend yields for electric utilities were representative of their longer-term historical average levels (1991-2009). Mr. Gorman responded that recent Treasury and utility bond yields are more aligned with levels over the past five years and that utility dividend yields are typically higher when utility bond yields are higher. While Mr. Gorman is correct that this is generally the case, the relationship between utility bond yields and utility dividend yields varies considerably.

As indicated on Ameren Exhibit 52.0, Schedule 2, the ratio of long-term Baa rated utility bond yields to the dividend yields on the proxy sample of electric utilities ranged between 1.25 times and 1.80 times between 1991 and 2008. The dividend yield on the electric utility proxy sample over the 13-week period utilized by Mr. Gorman in his updated DCF analysis was 5.0%, compared to a corresponding average long-term Baa rated utility bond yield of 6.2%, equal to a ratio of 1.23 times. That ratio is not materially different than the 1.25 times ratio observed in 2003. Further, with the expectation that the Bush Administration's dividend tax cuts introduced in 2001 will be allowed to expire in 2011, it is reasonable to expect that, all other things equal, utility dividend yields would rise relative to bond yields. With an increase in the tax rate on dividends, the stock price would need to fall (and the dividend yield increase) in order for the taxable investor to earn the same relative (to bonds) after-tax return on utility shares as with the benefit of the Bush dividend tax cuts.

With respect to the Mr. Gorman's conclusion at page 7 of IIEC Exhibit 6.0 that the analysts' forecast growth rates are too high to be reasonable estimates of sustainable growth, I have already addressed this issue in my response to Ms. Freetly.

I would add, however, that in Mr. Gorman's testimony in Docket 01-0432 September 2001 for Illinois Power referenced on page 22 of my Rebuttal testimony, while I accept his comment at page 8 that he did not recommend a return on equity based on the constant growth DCF model based on analysts' earnings forecasts, in that testimony, he concluded that a reasonable range for the return on common equity for AmerenIP included the result from his constant growth DCF model. That conclusion should be no less valid today.

Q. In his updated sustainable growth model, based on your comments in your Rebuttal testimony, Mr. Gorman added a component for growth from external financing, as discussed at pages 8 to 9 of IIEC Exhibit 6.0. Did Mr. Gorman estimate this component correctly?

A. No. The external growth component of the sustainable growth model represents the growth that investors expect to achieve through the issuance of additional shares of equity and invested in projects that are accretive to earnings. The external growth component ("sv") represents the impact on earnings and dividends of issuing additional shares of stock at a price above or below book value. If a utility is able to issue additional shares at a price above book value, the resulting increase in book value per share will accrue to existing shareholders, leading to higher expected earnings and dividends. The formula for the "sv" component is equal to the expected growth rate in shares outstanding ("s") multiplied by 1 minus the book/market value ratio ("v"). The latter measures the extent to which additional shares are expected to be issued above or below book value.

Mr. Gorman estimates the "v" component by utilizing the *Value Line*'s 3 to 5 year forward estimated book value per share in conjunction with a current share price. The underlying assumption of Mr. Gorman's analysis is that book values per share will increase, but stock prices will stay the same. In contrast to Mr. Gorman's assumption, *Value Line* projects that stock prices will also increase. It makes logical sense that share prices would be expected to increase as book values per share increase as earnings are retained. Mr. Gorman's assumption that stock prices will remain constant despite increases in book value per share implies a significant decline in the utilities' market/book ratios, an outcome for which there is no basis. This unsupportable assumption then leads to Mr. Gorman's erroneous conclusion that the external growth component of the sustainable growth model is negative for the electric utility sample and minimal for the gas utility sample.

Ameren Exhibit 52.0, Schedule 3 corrects Mr. Gorman's sustainable growth model results using the *Value Line* forecast stock prices that corresponds to its forecast book values per share to estimate the external growth component. The resulting average DCF costs of equity are 10.90% and 10.34% for the electric and gas samples respectively, compared to Mr. Gorman's reported average costs of 10.23% and 9.81%. Replacing the sustainable growth rates in Mr. Gorman's Table 2 of IIEC Exhibit 6.0 with the revised values produces the following:

Mr. Gorman's Table 2 Revised		
Description	**Electric**	**Gas**
Constant Growth (Analyst)	11.84%	10.31%
Sustainable Growth	10.90%	10.34%
Multi-Stage Growth	10.73%	9.46%
Average	**11.16%**	**10.04%**

Q. Mr. Gorman did not accept your Rebuttal testimony regarding the estimate of the market risk premium from historic data, specifically your conclusions regarding the use of income returns rather than total returns to measure historic risk premium and your critique of his estimated risk premium using the historic average of real equity markets plus an estimate of inflation. Do you have any further comments?

A. Yes. Mr. Gorman says that my market risk premium estimated from historic data is overstated because it relies on income returns rather than total returns on Treasury bonds. Mr. Gorman is correct that the estimated risk premium using income returns on Treasury bonds is higher than it would be if it were measured using total returns. The income return represents the return investors would have received if they had held the Treasury bond to maturity. The total return represents the return that investors would have received if they had bought and sold Treasury bonds each year throughout the historic period. The total returns on bonds, which include annual gains and losses from buying and selling (and thus incorporate the impacts of interest rate risk), are not a measure of the risk-free rate. As I indicated in my Rebuttal testimony (page 26), the application of the CAPM requires a risk-free rate. The income return is the best representation of the true long-term historical risk free rate.

Q. Mr. Gorman takes issue with your criticism of his risk premium method which estimates the market return by adding an estimate of the long-term rate of inflation to the historic average real return. He disputes your claim that it is necessary to demonstrate that the real return is correlated with historical stock returns. Please respond.

A. My rebuttal evidence demonstrated (Ameren Exhibit 36.0, Table 9, page 24) that the real return was higher when inflation was lower. Inflation is expected to be lower going forward (approximately 2%) than it was historically (approximately 3%). The experienced real returns were higher when inflation was in the 0-3% range than when inflation exceeded 3%. The higher experienced real returns at lower rates of inflation suggest that simply using a long-term average real return to estimate the future market risk premium will understate a reasonable estimate of the future equity market return and underestimate the equity market risk premium.

Q. Do you have any further comments regarding Mr. Gorman's rebuttal evidence on the market risk premium?

A. Yes. I would point out that the historic measured risk premiums through 2008 were negatively impacted by the significant sell-off in the equity market in 2008. Although a continuation of the market recovery through the end of 2009 is not assured, the upswing in the equity market during 2009 (through the end of October) points to a higher measured equity market risk premium than values calculated through the end of 2008 indicate.

Q. What do you conclude then regarding Mr. Gorman's estimate of the market risk premium and his resulting CAPM costs of equity?

A. They are too low. A conservative estimate of the market risk premium is 6.5% and the resulting CAPM costs of equity, using his updated betas (IIEC Exhibit 6.6), should be 9.8% and 9.4% for the electric and gas utilities respectively.

Q. What would be Mr. Gorman's costs of equity for the electric and gas utilities based on both his Table 2 Revised and your corrections to his CAPM test?

A. The cost of equity is 10.5% for the electric utilities and 9.7% for the gas utilities before taking into account the higher financial risk of the Ameren Utilities inherent in the ratemaking capital structures relative to the financial risk of the sample companies as reflected in their market value capital structures.

Q. Mr. Gorman disagrees with your conclusion that he should have used forecast interest rates in both his CAPM and risk premium studies. He states that current yields are as likely to be an accurate forecast of future interest rates as economists' forecasts. Please respond.

A. The high probability that Treasury bond yields will increase was addressed above in response to Ms. Freetly. Utility bond yields, which Mr. Gorman uses in his risk premium test (to which he gives no weight), should also be expected to follow an upward trajectory. Mr. Gorman's risk premium test should incorporate the high probability that interest rate rates will rise, similar to his application of the CAPM.

VI. RESPONSE TO CUB WITNESS THOMAS

Q. Please summarize briefly the issues raised in Mr. Thomas's rebuttal testimony that you will address.

A. Mr. Thomas:

1. Takes issue with my comments regarding the inadequacy of his recommended returns;
2. Rejects the use of analysts' growth rates in applying the DCF model due to alleged optimism;
3. Claims that his use of real GDP growth as the estimate of investors' expectations of long-term growth in the multi-stage DCF model is supported by research;
4. Rejects the use of adjusted betas in the application of the CAPM absent empirical support that they result in more accurate betas; and
5. Disagrees with my conclusion that his estimate of the market risk premium in the application of the CAPM is too low.

Q. Mr. Thomas states that you compare his recommendations to the allowed returns that have been granted by other regulators and that there is little useful information in that comparison. Please comment.

A. It goes without saying that the estimation of the cost of equity and a fair return should be independent of what other regulators allow and that the allowed ROE should not blindly mirror the national average. Nevertheless, the national average allowed ROE can be interpreted as a consensus assessment of the expert testimony that has been proffered by a wide range of stakeholders. It is also a relevant indicator of the capital markets in which the Ameren Utilities will have to compete for capital.

Q. Mr. Thomas suggested that your comments regarding the adequacy of the returns he recommended were "alarmist". Do you agree?

A. No. They are simply underscoring the importance of a fair return. Taking account of Mr. Thomas' conclusions in his Rebuttal testimony that Ms. Freetly's methodology for estimating adjustments to the ROEs for the AIUs for the proposed uncollectible riders is reasonable but that her results are conservative (although he presents no supporting analysis), effectively his recommended returns would be even lower than the 7.97% and 8.76% returns on equity he proposed for the AIUs' gas distribution and electric utility operations respectively. Following the logic of his discussion of Ms. Freetly's proposed adjustments for the proposed uncollectibles riders, Mr. Thomas would have the Commission set the allowed ROEs for the AIUs no higher than a range of 7.02% to 7.23% for the gas distribution operations and 8.09% to 8.47% for the electric utility operations.[5] Returns at this level are significantly below any reasonable indicator of the returns investors expect to receive on investments of comparable risk.

Q. With respect to the DCF test, Mr. Thomas claims (page 6) that analysts tend to be optimistic about future growth rates and that analysts' growth rates cannot be relied upon. Please respond.

A. Mr. Thomas pointed to a number of studies in his Direct testimony which deal with growth forecasts generally (i.e., growth forecasts for companies in all industries), not growth forecasts for utilities specifically. A study entitled "The Level and Persistence of Growth Rates", *Journal of Finance*, Vol. LVIII, No. 2, 2003 by Louis C. Chan, Jason Karceski and Josef Lakonishok, which divided all U.S. stocks with available

[5] Equal to Mr. Thomas' recommended ROEs of 7.97% for the gas distribution operations and 8.76% for the electric utility operations less the adjustments for the individual Ameren Utilities shown in Mr. Thomas' Table 4 of CUB Exhibit 2.0.

I/B/E/S long-term growth rates into value-weighted portfolios, found that the portfolios of companies with the highest forecast growth rates achieved growth rates lower than those which had been forecast five years previously, but the lowest growth portfolio (where utilities would fall) did not exhibit the same tendency.[6] This outcome would not be unexpected, as the operating environment and business model for utilities are more transparent and predictable than that of many other industries, for example, high tech firms.

Q. Mr. Thomas performs a multi-stage DCF test using a forecast of real economic growth in the final stage, rather than nominal growth. He claims that research supports using real growth rather than nominal growth as the estimate of investors' expectations of long-term growth. Has he accurately characterized the research?

A. No. As I stated in my Rebuttal testimony (page 33), using a real rate of growth rather than a nominal rate of rate of growth as the estimate of long-term growth rate fails to consider that investors require both a real return as well as compensation for inflation. Mr. Thomas points to a citation from the same Chan, Karceski and Lakonishok article referenced above, which states, "With dividends taken out, the median estimate is the same magnitude as the growth rate of gross domestic product over this period, between 3 and 3.5 percent in real terms."

What Mr. Thomas fails to appreciate is that the authors of the study are analyzing actual and forecast growth rates over an extended period of time that reflects varying levels of inflation rates. The authors are not suggesting that the actual nominal rate of

[6] Ms. Freetly makes the same point in her Rebuttal testimony (Staff Exhibit 20.0, pages 37-38).

long-term growth has been equal to the real rate of growth in the economy, or that the expected nominal rates of long-term growth should be equal to the real rate of growth in the economy. Rather, when they adjust actual rates of growth across various inflationary environments for inflation, the authors find they have been approximately equal to the real rate of growth in the economy or GDP. That conclusion in no way supports using a real rate of GDP growth as a proxy for investors' expected long-term growth.

Q. In regard to the CAPM, Mr. Thomas concludes that, absent supporting empirical evidence that the adjustments improve the accuracy of beta estimates, the adjustments made by *Value Line* which move the beta toward the market mean beta of 1.0 should be excluded. Please comment on Mr. Thomas' recommendation.

A. As stated in my Rebuttal testimony, the purpose of applying the CAPM is to estimate the return that investors require or expect. The beta that is used in the application of the CAPM should be a reasonable predictor of the return that investors expect. There is significant empirical evidence that the application of the CAPM using "raw" or unadjusted betas underestimates the returns of low beta stocks (less than 1.0) and overestimates returns of high beta stocks (greater than 1.0). The adjustment to "raw" beta corrects for the empirically observed relationships between betas and returns. As indicated above in my discussion of the merits of weekly versus monthly betas, the implied betas of both gas and electric utilities (based on the ratio of their achieved risk premiums to the achieved risk premiums of the equity market as a whole) are higher than the adjusted *Value Line* betas. Based on that evidence, the adjusted betas as published by *Value Line* are better predictors of utility returns than the "raw" or unadjusted betas that upon which Mr. Thomas would have the Commission rely.

Q. Mr. Thomas takes issue with your criticism that his market risk premium is too low and provides a list of estimates that suggest the market risk premium may be lower than his 5%. Please respond.

A. I grant that there are estimates of the future market risk premium that are lower than 5%. However, as I stated in my Rebuttal testimony (page 41), a review of the historic evidence does not suggest that there has been any upward or downward trend in the U.S. equity market returns over the long-term. Based on historical trends, there is no reason to conclude that equity market returns will be lower in the future than they were in the past. The average equity market returns since before the Great Depression (1926-2008) averaged 11.7% and 12.2% over the post World War II period (1947-2008) (and slightly higher in both cases when the returns to date in 2009 are included); see AmerenCILCO Exhibit 12G.7.1. The long-term forecast of Treasury bond yields, as indicated in Ameren Exhibit 36.0, page 37, is approximately 5.5%, which suggests a future equity market risk premium in the range of 6.2% to 6.7% (11.7% to 12.2% minus 5.5%), and slightly higher if the returns to date in 2009 are taken into account. The results support an equity risk premium equal to or slightly higher than 6.5% rather than a premium of 5% or lower.

VII. CONCLUSION

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.