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REVISED DIRECT TESTIMONY
(PUBLIC VERSION)

of

MICHAEL McNALLY

Finance Department

Financial Analysis Division

Illinois Commerce Commission

Ameren Illinois Company d/b/a Ameren Illinois
Proposed General Increase in Gas Rates

Docket No. 15-0142

June 12, 2015

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WITNESS IDENTIFICATION

Q1. Please state your name and business address.

A1. My name is Michael McNally. My business address is 527 East Capitol Avenue, Springfield, IL 62701.

Q2. What is your current position with the Illinois Commerce Commission ("ICC" or "Commission")?

A2. I am a Senior Financial Analyst in the Finance Department of the Financial Analysis Division.

Q3. Please describe your qualifications and background.

A3. I received both a Bachelor of Arts degree in Economics and a Master of Business Administration degree with a concentration in Finance from the University of Illinois at Urbana-Champaign and I hold the Chartered Financial Analyst designation from the CFA Institute. I have been employed by the Commission since 1999 and have previously testified before the Commission on a variety of financial issues.

Q4. Please state the purpose of your testimony in this proceeding.

A4. The purpose of my testimony is to respond to the direct testimony of AIC witness Steven M. Fetter (AIC Ex. 12.0) and to present my evaluation of the reasonableness of the recovery through rates of fees billed to Ameren Illinois Company ("AIC" or the "Company") by Regulation UnFettered and Sussex Economic Advisors, LLC ("Sussex") related to the cost of common equity testimonies of Mr. Fetter and Mr. Robert B. Hevert (AIC Ex. 5.0 (Rev.)), respectively.

RESPONSE TO MR. FETTER

Q5. Please provide an overview of Mr. Fetter's direct testimony.

A5. Mr. Fetter's direct testimony relates almost exclusively to credit ratings: the effect that the regulatory environment has on them and the effect they have on utilities and their customers. He also endorses Mr. Hevert's cost of capital recommendations. (AIC Ex. 12.0, 4-5.)

Q6. Mr. Fetter warns several times of "financial crisis" and "disruptions to credit markets" and the potential dire effects on utilities if such conditions arise. (AIC Ex. 12.0, 5, 9-10, 21.) Please comment.

A6. Despite the recently experienced "turmoil in the financial markets" that according to Mr. Fetter "tested the financial standing of the utility sector like never before," when asked to identify any Illinois utility that defaulted on its debt obligations or failed to provide acceptable service as a result of those purportedly unprecedented conditions, he states that he is not aware of any. (AIC Ex. 12.0, 9; see Attachment A, 10.) He also cautions that a credit rating downgrade for AIC, which *could* result from a "less than constructive" return on common equity ("ROE") decision from the Commission, "would be very financially injurious to both customers and investors," yet could not identify any specific threat to AIC to prompt such a hypothetical warning, just the general concern that accompanies any rate case in any regulatory jurisdiction. (AIC Ex. 12.0, 17; see Attachment A, 4.)

Q7. Mr. Fetter notes that "Illinois is viewed by the market as among the less credit supportive states." (AIC Ex. 12.0, 4.) Please comment.

A7. Mr. Fetter's characterization represents a relative ranking rather than an absolute description. That is to say, simply because Illinois may be viewed as less credit supportive than other states does not mean that it is not credit supportive generally and does not indicate that the regulatory framework in Illinois is unjust or unreasonable. Indeed, S&P classifies the Illinois regulatory environment as "Strong/Adequate," the second-highest of its five categories, which indicates that the Illinois regulatory environment is credit supportive. (Standard & Poor's, "Utility Regulatory Assessments For U.S. Investor-Owned Utilities", January 7, 2014) Similarly, Moody's states that The Peoples Gas Light and Coke Company ("Peoples"), which operates in the same regulatory environment as AIC, has a "fairly supportive regulatory environment." (Moody's Investors Service, "Credit Opinion: Peoples Gas Light and Coke Company," May 26, 2015.) Likewise, S&P states that Nicor Gas Co. has "moderately <u>low</u> regulatory risk in Illinois that Nicor manages better than its peers." (Standard & Poor's Ratings Services, "Summary: Nicor Gas Co.," June 3, 2015, 2 (emphasis added).) This not only demonstrates that the relative description "less supportive" does not equate to high regulatory risk, but also that a utility's absolute regulatory risk assessment is a function of how well that utility manages its regulatory environment. Even in relative terms, Mr. Fetter notes that Illinois is ranked by S&P as the 35th most credit-supportive jurisdiction of the 53 regulatory bodies assessed. (AIC Ex. 12.0, 14.) That puts Illinois in the middle third of all jurisdictions - hardly an outlier. More importantly, such relative rankings fail to indicate how much more or less supportive Illinois is than other jurisdictions. For example, the difference between Illinois and California, the highest ranked jurisdiction in S&P's "Strong/Adequate" category, is not disclosed. (Standard & Poor's, "Utility Regulatory Assessments For U.S. Investor-Owned Utilities", January 7, 2014.)

In fact, Mr. Fetter could not name a single Illinois utility experiencing default or service failure despite never-before seen economic turmoil. (See Attachment A, 10.) Further, he acknowledges that AIC's BBB+ S&P issuer credit rating is precisely the rating that AIC management has set as the Company's target rating.[1] He does not contend that AIC management's chosen target credit rating is too low; to the contrary, he concludes that "'BBB+' is adequate for the utility's investors and customers" and that BBB+ is a "level that should allow a utility to access the capital markets upon reasonable terms even during times of stress within the capital markets." (AIC Ex. 12.0, 7, 10.) Thus, even Mr. Fetter implicitly acknowledges that the Illinois regulatory environment has been more than sufficiently credit supportive to maintain AIC's target credit rating. In fact, he notes that achieving a higher credit rating could come at a higher cost to customers, such as through a significantly stronger capital structure. (AIC Ex. 12.0, 10.)

Q8. Please respond to Mr. Fetter's discussion of S&P's rating methodology.

A8. Mr. Fetter devotes a great deal (approximately 20%) of his testimony to describing in detail S&P's rating methodology. (AIC Ex. 12.0, 7-8, 15-19) At the conclusion of his recitation, he broadly proclaims a truism that a "constructive decision" would allow the Company to maintain or improve it current rating.

Mr. Fetter's overview of S&P's rating methodology overlooks a critical aspect of that methodology, namely, that S&P's ratings reflect a consolidated perspective. That is, as stated in AIC's recent credit rating report, "the BBB+ ICR [issuer credit rating] on AI reflects parent Ameren Corp.'s group credit profile." (Standard & Poor's Ratings Services, "Research Update: Ameren Illinois Co. Assigned 'A-2' Short-Term Credit Rating; $300 Million Commercial Paper Program Rated 'A-2'," May 9, 2014.) Therefore, a "constructive decision," however that is defined, might

[1] In fact, AIC maintains the same BBB+ rating that the Company targets or higher from each of the three primary credit rating agencies (i.e., S&P, Moody's Investors Service ("Moody's"), and Fitch Ratings ("Fitch")).

have no effect on AIC's S&P credit rating at all. In contrast, Moody's credit ratings are evaluated predominantly on a stand-alone basis. (Moody's Investors Service, "Rating Methodology: Regulated Electric and Gas Utilities," December 23, 2013.) On that stand-alone basis, Moody's rates AIC A3 (the equivalent of an A– rating from S&P), to which it was just upgraded in April of this year. (AIC Resp. to Staff DR SK 3.02, Attach. 1.) This is significant in two respects. First, that AIC was *upgraded* to a credit rating even higher than its target credit rating in the midst of the very same regulatory environment that Mr. Fetter warns could lead to a credit rating downgrade, further undermines Mr. Fetter's implication that the Illinois regulatory environment is less than credit supportive. Second, AIC's A3 credit rating on a standalone basis, combined with the lower Baa1 rating Moody's currently assigns Ameren Corp. and Ameren Missouri, indicate, contrary to Mr. Fetter's implication, that AIC's S&P credit rating is not suppressed by the Illinois regulatory environment, but by AIC's affiliation with Ameren Corp. and Ameren Missouri. (AIC Resp. to Staff DR SK 3.02, Attach. 1.)

Q9. Mr. Fetter compares certain recent Commission-authorized ROEs to those authorized for other gas utilities in 2013 and 2014 throughout the country. (AIC Ex. 12.0, 13.) Please comment.

A9. It is not clear precisely what role Mr. Fetter believes ROEs authorized outside of Illinois should play in the Commission's approach to rate setting. First, his discussion of authorized ROEs is presented as a part of a general discussion of the Illinois regulatory environment and is not directly related to the appropriate authorized ROE in this proceeding. Second, he states that "outside ROE judgments should not necessarily influence the setting of ROEs within a particular state." Nonetheless, he does seem to indicate that ROEs authorized outside of Illinois should be considered to some degree in Commission decision making.

However, as presented, that outside ROE data is uninformative with respect to determining AIC's required rate of return on common equity. Mr. Fetter's testimony fails to specify many critical factors that influenced the allowed returns in those outside proceedings. For instance, Mr. Fetter does not identify the relative risk, as exemplified by credit rating or any other metric, of each of the utilities involved in those return decisions. Nor does he identify the capital structure that was adopted or the amount of the common stock flotation cost adjustment, if any, that was included in each of those decisions. He also fails to provide any context regarding the market environment in which those decisions were made. Further, despite his emphasis on the regulatory environment as it relates to AIC, he presents no information regarding the regulatory environment under which each of those outside ROEs was determined, such as the ability of a utility to achieve its authorized rate of return. Without such data, any evaluation of the proper ROE in this proceeding via comparison to the returns authorized in those outside cases is useless, since we have no basis on which to assess comparability.

Q10. Mr. Fetter suggests that the gas ROEs the ICC has authorized would "seriously jeopardiz[e] AIC's credit standing" if not for electric formula rates. (AIC Ex. 12.0, 19-20.) Do you agree?

A10. No. His suggestion that AIC is reliant upon electric formula rates to support both its electric and gas capital requirements because authorized gas ROEs are inadequate is baseless. When asked for any analysis or support that led to his characterization, he replied that he had performed no analysis. Rather, he indicates his conclusion is an extrapolation construed from his review of rating agency statements that cite formula rates for AIC's improving credit position. (Attachment A, 16.) However, in that same discussion, he acknowledges that he cannot say AIC's improving regulatory profile is due solely to formula rates. Even if one could isolate the effects of formula rates from the multitude of factors influencing AIC's credit ratings and conclusively determine that its improving credit strength is due solely to formula rates, to conclude that the Commission-authorized gas rates, and ROEs in particular, represent a "financial hurdle" is without support. The absence from credit rating reports of explicit citations to AIC's authorized gas ROEs as a basis for its improving credit position in no way demonstrates that AIC's gas rates, and ROEs specifically, would seriously jeopardize AIC's credit standing if not for electric formula rates. The example of Peoples Gas invalidates Mr. Fetter's argument. Peoples Gas, which does not have electric formula rates to "support" its credit worthiness, was authorized an ROE of 9.05% in its last rate case, yet maintains an even higher Moody's credit rating (A2) than AIC. The Peoples Gas Light and Coke Co. *et al.*, ICC Order Docket Nos. 14-0224/14-0225 (Cons.), 134 (January 21, 2015); (Moody's Investors Service, "Credit Opinion: Peoples Gas Light and Coke Company," May 26, 2015.)

RATE CASE EXPENSE – ROE WITNESSES

Q11. What documents did you review with regard to rate case expenses?

A11. I reviewed AIC Exhibits 2.0 (Rev.), 2.12, 2.13, 5.0 (Rev.), and 12.0, work paper WPC-10, and the Company's responses to Staff data requests MGM 1.01 through 1.20 and TEE 1.02. Those documents outline the rate case expenses incurred, or expected to be incurred, in association with cost of capital testimony in this docket.

Q12. Do you propose an adjustment to the rate case expense associated with Mr. Fetter's direct testimony?

A12. Yes. I propose that Mr. Fetter's consulting fees, estimated to be *** BEGIN CONFIDENTIAL *** XXXXXX *** END CONFIDENTIAL *** in AIC work paper

WPC-10 and Attachment 1 to AIC's response to Staff data request TEE 1.02, be disallowed.

Q13. Please explain why you propose to disallow Mr. Fetter's fees.

A13. Mr. Fetter's testimony is duplicative of that provided by other AIC witnesses. As noted previously, Mr. Fetter does not present any analysis or an independent estimate of AIC's cost of capital. In fact, when specifically asked to provide any studies or analysis underlying his positions, he declined ten times. (See Attachment A.) For the essentials on AIC's cost of capital, Mr. Fetter directs the reader to the testimony of AIC witness Hevert. Further, Mr. Fetter's work relates entirely to credit ratings and regulatory environment. Mr. Nelson, Mr. Martin, and Mr. Hevert already address those issues. (AIC Ex. 1.0, 5-7; AIC Ex. 4.0R, 5-8; AIC Ex. 5.0 (Rev.), 32-35.)

Additionally, Mr. Fetter was hired "to provide testimony supporting AIC's requested return on equity," which Mr. Hevert presents. (AIC Ex. 2.0 (Rev.), 33.) Yet Mr. Fetter's estimated fee is higher than Mr. Hevert's fee, which reflects Mr. Hevert's work on not only the actual analysis of the cost of common equity, but on a capital structure whitepaper detailing a study of the appropriate capital structure. Mr. Fetter's testimony does not address either of those issues. Even Mr. Fetter's expense estimate, which, primarily for travel and lodging, should not differ greatly from Mr. Hevert's, is *** BEGIN CONFIDENTIAL *** XXXXXXXX *** END CONFIDENTIAL *** than Mr. Hevert's. Further, AIC has not provided any documentation showing the details for the work hours that Mr. Fetter actually billed, only an estimate from before he even began working on the case. Absent proper supporting documentation the subject expense cannot be deemed just and reasonable.

Q14. Do you propose an adjustment to the rate case expense associated Mr. Hevert's direct testimony?

A14. Not at this time. However, I will be reviewing additional invoices and data request responses throughout the proceeding to determine if an adjustment is warranted.

Q15. Does this conclude your revised direct testimony?

A15. Yes, it does.