AMERENCIPS/UE EXHIBIT NO. 25.0

ILLINOIS COMMERCE COMMISSION

DOCKET NOS. 02-0798/03-0008/03-0009 (Consolidated)

SURREBUTTAL TESTIMONY

OF

MICHAEL G. O'BRYAN

Submitted On Behalf Of

CENTRAL ILLINOIS PUBLIC SERVICE COMPANY,

d/b/a AmerenCIPS,

and

UNION ELECTRIC COMPANY,

d/b/a AmerenUE

June 2003

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Q. Please state your name and business address.

A. My name is Michael G. O'Bryan. My business address is One Ameren Plaza, 1901 Chouteau Avenue, St. Louis, Missouri 63103.

Q. Are you the same Michael G. O'Bryan who filed direct and rebuttal testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Staff witness Michael McNally regarding the proper means of estimating short-term interest rates, which in this case affect the cost of preferred stock for Central Illinois Public Service Company, d/b/a AmerenCIPS ("AmerenCIPS"), as well as the proper cost of debt for Union Electric Company, d/b/a AmerenUE ("AmerenUE") (collectively referred to as the "Companies"). Also, I will respond to Mr. McNally's calculation of the net short-term debt balance for AmerenUE.

Q. Mr. McNally cites Burton Malkiel's book *A Random Walk Down Wall Street* claiming that interest rates closely approximate a type of time series called a random walk. And in a random walk, the future steps or directions cannot be predicted on the basis of past actions. Due to this fact, Mr. McNally claims historical averages are inappropriate estimates for future short-term interest rates.[1] Please respond.

A. Malkiel's book *A Random Walk Down Wall Street* refers to stocks and stock price behavior; his theory does not apply to interest rate activity. Furthermore, his theory is not universally accepted, as critics typically point to high profile portfolio managers such as Warren Buffet and Peter Lynch who have historically found ways to detect inefficiencies in the markets which counter arguments made by Malkiel. In fact, several statistical studies have made it clear that stock prices are, in fact, not completely random.[2]

I never claimed that historical averages will accurately predict future short-term interest rate movements. Rather my position is that short-term interest rates are typically highly volatile and the use of many data points, such as those taken over a twelve-month test year period, will factor in the highs and lows over a period of time and give a more representative rate than a spot rate. Given that the rates set upon the conclusion of these proceedings will be in effect for an extended period of time, it is imperative to determine as best we can a level of short-term interest rates that is fair and

[1] ICC Staff Exhibit 13.0 pp. 2-4.
[2] Andrew W. Lo and A. Craig MacKinlay. *A Non-Random Walk Down Wall Street*. Princeton University Press, 1999.

representative given recent history, current conditions and the relationship of current rates to historical and expected rates. Current consensus forecasts,[3] along with plain common sense, indicate that short-term rates will trend higher in the coming months and years that the order will be in effect, given the fact that rates are the lowest they have been in decades and the economy will eventually return to a mode of expansion.

Q. Mr. McNally claims that the behavior of short-term interest rates does not exhibit a repeating pattern such as that of a utility's use of short-term debt. Therefore, he claims, an average taken of historical rates is useless. Please respond.

A. Short-term rates are cyclical, typically rising when the economy is either in expansion or is thought to be on the verge of expanding and typically falling when the economy is in recession or on the verge of contracting. Although my twelve-month average of short-term interest rates during the test year period does not factor in a full cycle of the economy, it did incorporate an expectation, albeit false, of a pending expansion. This happened over the first quarter of 2002 when the three month LIBOR increased from a January 2002 low of 1.71563% to a high on March 26, 2002, of 2.0475%, a 19% increase, as many economists turned bullish on the economy. Salomon Smith Barney economist Robert DiClemente wrote on March 4, 2002, "The flood of positive news last week erased any lingering doubt that the economy is surging at the start of the year". He continued ". . . if a Q1 explosion in GDP spills over into spring, with a tailwind of supportive financial conditions, the first tightening likely would be moved up from September to June in our forecast". Finally he wrote ". . . our target for ten-year yields remains near 5.50%". As more economic data was released, this

[3] *See* Blue Chip Financial Forecasts June 1, 2003, attached as AmerenCIPS/UE Exhibit No. 25.1.

expansion thought to be underway was ultimately proved to be false. By mid-June 2002, when short-term rates started their prolonged plummet to historical lows, economists changed their tune. On June 17, 2002, Mr. DiClemente wrote that "the combination of softer final demand and eroding financial market conditions has prompted us to downgrade chances of any Fed rate hikes this year." As it turned out the Fed actually continued to ease (lower) rather than tighten (raise) short-term interest rates, and the ten year yield never reached 5.50% during 2002 as Mr. DiClemente predicted in March, ending the year at 3.816%. Nevertheless, this example underscores how even a time period of as short as three months can incorporate wide variability in short-term interest rates. It also points out that economists' view of the state of the economy, where rates are headed and predictions of future Fed moves can change 180 degrees in very little time.

Although a one-quarter, one year or even five year sampling and average are not going to be a perfect "normalized" short-term rate, a twelve month average should be much more representative of a normalized short-term rate than would be a "snap shot" of an arbitrary date chosen after the test year period. This arbitrary date could very well be a date occurring on or just after an event such as a high profile corporation declaring bankruptcy, a currency devaluation, a declaration of war or an event such as September 11th. Such events typically lead to a "flight to quality" into treasuries and result in large, but short-lived declines in interest rates. Even without such events, a spot rate taken amid today's volatile markets can easily lead to an abnormally high or low rate being used as the "proper" short-term rate to be used for the duration of the order. The three month LIBOR rate (a short-term interest rate

benchmark) has continued to be highly volatile this past year as it has declined a further 44% from what was already thought to be a very low rate exactly one year prior to the date of this testimony. I cannot imagine anyone arguing that the historically low short-term rates of today will prevail during the time that the rates established by the order in this proceeding will be in effect.

Q. Mr. McNally claims that part "b" of Staff's short-term debt balance formula is necessary. Please respond.

A. Staff apparently has recently revised its formula for calculating a company's net balance of short-term debt.[4] Rather than calculating the balance by using the traditional formula of the monthly ending gross balance of short-term debt outstanding minus the corresponding monthly ending balance of construction work-in-progress ("CWIP") accruing an allowance for funds used during construction ("AFUDC"), Staff has added part "b", which is the monthly ending gross balance of short-term debt outstanding, minus the corresponding monthly ending value of CWIP accruing AFUDC, times the ratio of short-term debt, to total CWIP; the greater of the two parts being the net short-term debt balance. Mr. McNally's basis for the part "b" approach centers on an accounting formula used to determine an AFUDC <u>rate</u>.

Although the equation seems to be correct from an accounting standpoint, it falls short when analyzed from a sources and uses of cash flow point of view. This formula, by design, is used to determine an AFUDC rate for accounting purposes.

[4] ICC Staff Exhibit 13.0 pp. 5-6.

Through the use of this formula, Mr. McNally is claiming that if CWIP is not financed on a cash basis through short-term debt, then it must be financed through permanent capital, either long-term debt, preferred stock or common equity. This is one area where the use of the AFUDC formula falls short and highlights the inappropriate application of the formula for this purpose.

Q. If CWIP is not financed through either short-term debt or permanent capital, how else could it be financed?

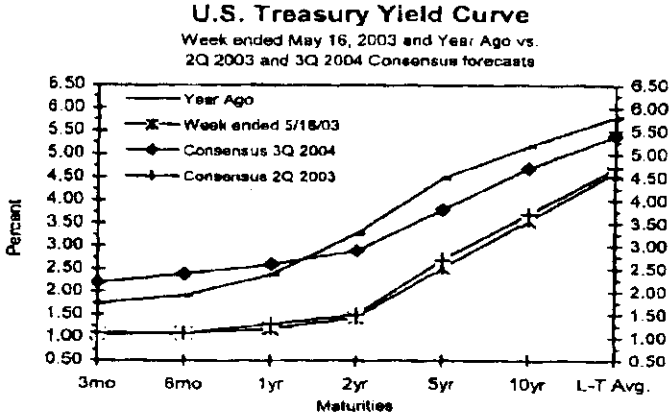
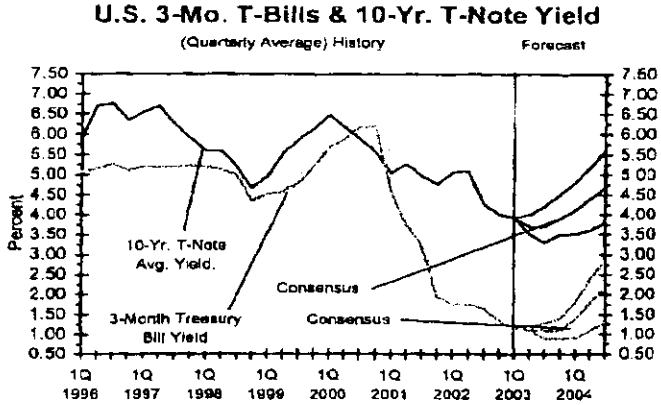
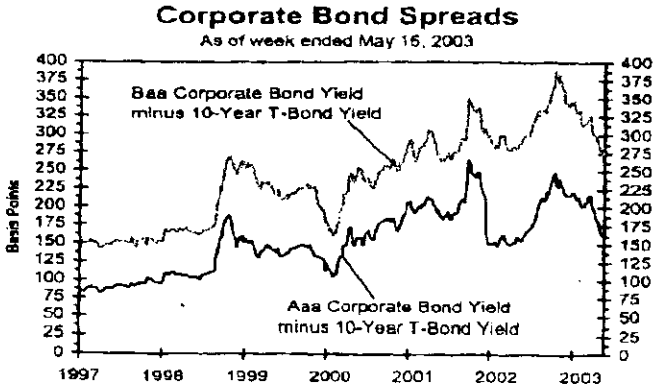
A. Contrary to an underlying assumption in the AFUDC rate formula Mr. McNally uses as the basis for his argument, CWIP is financed by short-term debt only if, and to the extent, internally generated cash is insufficient to finance it. In other words, short-term debt is a secondary financing source. Mr. McNally assumes internally generated cash must be financed through a combination of long-term debt, preferred stock and common equity, specifically in the amounts and proportions that are detailed in the Company's capital structure. This assumption Mr. McNally makes is too simplistic. Internally generated cash flow is also reflected or accounted for by non-cash items such as Accumulated Depreciation and Amortization, Deferred Income Taxes and Credits, changes in Working Capital as well as other miscellaneous non-cash charges. These items reflect cash flow used as a source of cash for financing CWIP. This is why Mr. McNally's formula is inappropriate for calculating the proper level of a company's short-term debt balance. The traditional, more conservative, formula for calculating net short-term debt (part "a" only), should be used until a more accurate formula can be devised.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

Consensus Forecasts Of U.S. Interest Rates And Key Assumptions[1]

Interest Rates	History: Average For Week Ending May 16	May 9	May 2	Apr. 25	Average For Month Apr.	Mar.	Feb.	Latest Q 1Q 2003	Consensus Forecasts-Quarterly Avg. 2Q 2003	3Q 2003	4Q 2003	1Q 2004	2Q 2004	3Q 2004
Federal Funds Rate	1.25	1.26	1.28	1.26	1.26	1.25	1.26	1.25	1.2	1.1	1.2	1.3	1.7	2.1
Prime Rate	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.2	4.1	4.2	4.3	4.7	5.1
LIBOR, 3-mo.	1.29	1.29	1.30	1.32	1.30	1.29	1.34	1.33	1.3	1.3	1.3	1.5	1.9	2.3
Commercial Paper, 1-mo.	1.22	1.20	1.22	1.23	1.22	1.21	1.24	1.23	1.2	1.2	1.3	1.5	1.9	2.3
Treasury bill, 3-mo.	1.07	1.11	1.13	1.16	1.15	1.15	1.19	1.18	1.1	1.1	1.1	1.4	1.8	2.2
Treasury bill, 6-mo.	1.10	1.14	1.16	1.20	1.17	1.16	1.20	1.19	1.1	1.2	1.2	1.5	1.9	2.4
Treasury bill, 1 yr.	1.20	1.23	1.25	1.31	1.27	1.24	1.30	1.30	1.3	1.3	1.4	1.7	2.1	2.6
Treasury note, 2 yr.	1.44	1.48	1.56	1.66	1.62	1.57	1.63	1.65	1.5	1.6	1.7	2.0	2.4	2.9
Treasury note, 5 yr.	2.52	2.70	2.88	2.97	2.93	2.78	2.90	2.91	2.7	2.7	2.9	3.2	3.5	3.8
Treasury note, 10 yr.	3.56	3.77	3.92	3.97	3.96	3.81	3.90	3.92	3.7	3.7	3.9	4.1	4.4	4.7
Treasury Long-Term Avg.	4.62	4.81	4.90	4.97	4.99	4.90	4.93	4.97	4.7	4.6	4.8	5.0	5.2	5.4
Corporate Aaa bond	5.23	5.42	5.56	5.68	5.74	5.89	5.95	6.00	5.5	5.5	5.7	5.9	6.1	6.4
Corporate Baa bond	6.39	6.52	6.68	6.79	6.85	6.95	7.06	7.12	6.6	6.5	6.7	6.8	7.0	7.3
State & Local bonds	4.35	4 5	4.58	4.66	4.74	4.76	4.81	4.82	4.5	4.5	4.6	4.7	4.9	5.1
Home mortgage rate	5.45	5.62	5.70	5.79	5.81	5.75	5.84	5.84	5.6	5.6	5.7	6.0	6.2	6.5

Key Assumptions	History: 2Q 2001	3Q 2001	4Q 2001	1Q 2002	2Q 2002	3Q 2002	4Q 2002	1Q 2003	Consensus Forecasts-Quarterly Avg. 2Q 2003	3Q 2003	4Q 2003	1Q 2004	2Q 2004	3Q 2004
Major Currency Index	105.3	104.4	105.3	108.2	104.4	100.0	100.0	95.1	91.3	90.2	90.3	90.6	91.3	91.9
Real GDP	-1.6	-0.3	2.7	5.0	1.3	4.0	1.4	1.6	2.1	3.4	3.5	3.6	3.6	3.6
GDP Price Index	2.5	2.2	-0.5	1.3	1.2	1.0	1.6	2.5	1.5	1.5	1.7	1.9	1.9	1.9
Consumer Price Index	3.2	0.9	-0.7	1.4	3.4	2.2	2.0	3.8	1.4	1.8	2.0	2.2	2.3	2.3

[1]Individual panel members' forecasts are on pages 4 through 9. Historical data for interest rates except LIBOR is from Federal Reserve Release (FRSR) H.15. LIBOR quotes available from *The Wall Street Journal*. Definitions reported here are same as those in FRSR H.15. Treasury yields are reported on a constant maturity basis. Historical data for the U.S. Federal Reserve Board's Major Currency Index is from FRSR H.10 and G.5. Historical data for Real GDP and GDP Chained Price Index are from the Bureau of Economic Analysis (BEA). Consumer Price Index (CPI) history is from the Department of Labor's Bureau of Labor Statistics (BLS).