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Issues: Interim Rates
Witness: Lee R. Nickloy
Sponsoring Party: Union Electric Co.
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2010-0036

DIRECT TESTIMONY ON INTERIM RATES

OF

LEE R. NICKLOY

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

St. Louis, Missouri
October, 2009

DIRECT TESTIMONY ON INTERIM RATES
OF
LEE R. NICKLOY
CASE NO. ER-2010-0036

Q. Please state your name and business address.

A. My name is Lee R. Nickloy. My business address is 1901 Chouteau Avenue, St. Louis, Missouri 63103.

Q. By whom and in what capacity are you employed?

A. I am employed by Ameren Services Company as Assistant Treasurer and Director of Corporate Finance.

Q. Are you the same Lee R. Nickloy who filed Direct Testimony in this case?

A. Yes, I am.

Q. What is the purpose of your direct testimony on interim rates?

A. The purpose of my direct testimony on interim rates is to offer some fixed income and credit perspectives on the benefits to Union Electric Company d/b/a AmerenUE ("AmerenUE" or the "Company") and its customers of interim rates specifically, and more generally, how reducing regulatory lag is helpful in this regard.

Q. Why are fixed income or credit perspectives important to the Company and its stakeholders?

A. Because the Company (and, indirectly the Company's customers) depends upon fixed income investors and banks that extend credit to utilities for much of the capital needed to provide utility service and to invest in the energy infrastructure necessary to provide that service. Those fixed income investors and banks in turn assess the creditworthiness, or "credit quality," of the Company and depend on the Company's credit ratings, which are set by the major credit rating agencies, in determining the return (i.e., the interest rate) that they will demand from the Company in exchange for buying the Company's bonds or extending credit to the Company. Consequently, the perspectives of fixed income investors, banks, and credit rating agencies determine the Company's cost of debt, which in turn ultimately impacts the rates paid by customers. Similarly, trade creditors assess the Company's credit quality and rely on its ratings in determining the level of unsecured trade credit they are willing to extend for their sales before they will require the posting of collateral – principally cash – to protect their exposure. (I think it is important to note here that any evaluation of credit quality will include both a quantitative assessment consisting of an analysis of the subject entity's credit measures, and a qualitative assessment incorporating other factors such as the entity's operating environment, business risks, management, etc.).

Q. From a fixed income or credit perspective, how are interim rates helpful?

A. Interim rates represent another tool, like a fuel adjustment clause or an environmental cost recovery mechanism, which reduces regulatory lag. The benefits of this are realized in several ways: a) cash flow is improved (i.e. cash is received sooner rather than later and in some cases cash is received that would otherwise be lost forever), b) liquidity is enhanced as short-term funding needs are reduced (i.e., there is a reduced need to "bridge" or fund the gap between cash expenditures and cash receipts), and c) by definition, this improvement in cash flow and reduction in debt borrowings enhances key financial measures which are important for fixed income investors (who provide permanent debt capital by purchasing the Company's debt securities), bank lenders (who provide bank facility capacity which supports short-term borrowing needs), credit rating agencies (which rate the Company's debt securities thus affecting its access to, and the cost of, debt capital), and trade counterparties (which supply the Company with necessary commodities such as coal, natural gas, and other goods and services).

Q. Is reducing regulatory lag important for a qualitative assessment of credit quality?

A. Yes, employing measures such as interim rates to reduce regulatory lag is indeed helpful in a qualitative assessment of the Company's credit quality. To the extent regulatory lag-reducing measures are supported and/or implemented, this will enhance a creditor's view of the Company's legislative and regulatory environment. These would be the views of fixed income investors, bank lenders, rating agencies, and trade counterparties as I mentioned above. The implementation of measures that reduce regulatory lag sends a positive signal to these stakeholders, and, like the enhancement of credit measures as discussed later in this testimony, can further support existing ratings or result in better ratings, lower borrowing costs, reduce collateral posting needs, etc. The fact that reducing regulatory lag is supportive of better credit quality is evidenced by the credit rating agencies' repeated discussion of this topic, including in recent reports from Moody's Investor Services ("Moody's") and Standard and Poor's ("S&P"). In an August 17, 2009 Credit Opinion on the Company, Moody's indicated that "[a]s part of the most recent rate case decision, AmerenUE will be able to pass through 95% of fuel and purchased power costs which should provide some additional stability of cash flows going forward and work to reduce regulatory lag." Also, in a November 7, 2008 Research report entitled "Assessing U.S. Utility Regulatory Environments," S&P made several comments regarding regulatory lag and the ability of utilities to timely recover their costs, and specifically noted that it considers the timing of interim rates:

> …we concentrate on whether established base rates fairly reflect the cost structure of a utility and allow management an opportunity to earn a compensatory return that provides bondholders [fixed income investors] with a financial cushion that promotes credit quality.
>
> A regulatory approach that allows utilities the opportunity to consistently earn a reasonable return is a positive factor in our view of credit quality."We analyze the issue of "regulatory lag" in a comprehensive manner and not just as a matter of the efficiency of the regulator in completing rate cases. …we take into account the timing of interim rates, and other practices that affect the appropriateness of rates periodically established by the regulator. We do not view the issue of regulatory lag as an intermittent concern, consequential only during times of acute inflation or rising capital spending, but as a consistent part of our credit analysis.

Q. Can you further explain why regulatory lag causes a drag on cash flow?

A. Regulatory lag represents a mismatch of costs and revenues – i.e., the Company's revenues (rates) are not reflective of, nor do they provide for recovery of, the Company's current level of operations and maintenance expenditures and cost of capital investment. This results in a cash shortfall, which drives a short-term funding or borrowing need, and, if persistent, can drive a need for permanent financing, including the need to issue long-term debt. Regulatory lag also creates risk for the Company's cash flows because costs are incurred but the ultimate recovery of those costs is uncertain and in some cases never occurs. This uncertainty becomes a function of timing (delay in recovery) and risk of under-recovery or lack of recovery. In the case of recovery risk, any under-recovery or lack of recovery for a previously incurred expenditure creates a permanent funding requirement, which means additional debt on the Company's balance sheet which must be serviced from the same revenue stream relied upon to service all of the Company's other capital, including both debt and equity. Further, the impact on the Company's credit quality, as assessed using key cash flow and other measures, is negative.

Q. Can you explain these measures and how they are harmed by regulatory lag?

A. Important for a quantitative assessment of an entity's credit quality are key cash flow-oriented measures including Funds From Operations (FFO) Interest Coverage – the relationship between the entity's operating cash flow and its interest obligations on its indebtedness – and FFO / Debt – the relationship between the entity's operating cash flow and its total debt obligations. In each case, higher measures represent better credit quality than lower measures. Also used in this assessment are leverage measures such as Total Debt / Total Capital which captures the level to which debt is utilized to finance the entity's assets. A higher leverage ratio represents weaker credit quality than a lower leverage ratio.

If cash receipts lag related cash expenditures, operating cash flow will decline. Funding this lag by borrowing will increase debt obligations and accordingly will increase interest expense. Thus, the numerator (FFO) in the two cash flow measures described above will decrease, and the denominators (interest and debt) will increase. Mathematically, this will cause these measures to decline thus indicating weaker credit quality. In the case of the entity's leverage, both the numerator and the denominator in the leverage ratio will increase by the same amount, but the mathematical impact of this will be an increase in the leverage ratio. This also is indicative of weaker credit quality. Weaker credit quality translates into increased debt costs and at times, unavailability of debt capital. Higher debt costs increase the rates the Company must charge, and higher capital costs and the unavailability of reliable, ready access to debt capital and liquidity will harm the Company's ability to make needed investments in infrastructure and finance its day-to-day operations.

Q. Why is it important to improve these measures of credit quality by reducing regulatory lag?

A. As I noted earlier, improvement in these measures of any meaningful level could drive improvement in credit ratings or prevent a ratings downgrade, thus reducing the cost of debt capital or preventing this cost from increasing to the ultimate benefit of the Company's customers. Also, fixed income investors (the investor base which buys the Company's long-term debt securities) evaluate the Company's credit measures in their analysis of whether or not to buy the Company's debt securities and the price or credit spread level at which they would be willing to do so. To the extent a fixed income investor perceives the Company to exhibit lower credit quality they will require a higher return (i.e., a higher credit spread) in order to invest in the Company's debt securities. This would increase the interest rate, or "coupon," of the debt security being issued and ultimately leads to greater interest costs in rates for customers. Moreover, trade counterparties such as suppliers of natural gas and coal also perform assessments of the credit quality of the Company in determining the level of unsecured trade credit they are willing to extend for sales of these commodities before they will require the posting of collateral – principally cash – to protect their exposure

Q. Please summarize your testimony and conclusions.

A. Through mechanisms that reduce regulatory lag, such as interim rates, the Company can improve its credit quality from both a quantitative and qualitative perspective. The improvement in credit quality is important for a number of credit-oriented stakeholders, including fixed income investors, bank lenders, the rating agencies, and trade counterparties. This can have a measurable impact on the Company's borrowing needs and borrowing costs, and access to capital including bank facility liquidity and availability of trade credit, all of which ultimately impact the level of interest costs reflected in customers' utility rates.

Q. Does this conclude your testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a AmerenUE's Tariffs to Increase its Annual Revenues for Electric Service.	) Case No. ER-2010-0036) Tracking No. YE-2010-0054) Tracking No. YE-2010-0055

AFFIDAVIT OF LEE R. NICKLOY

STATE OF MISSOURI)
) ss
CITY OF ST. LOUIS)

Lee R. Nickloy, being first duly sworn on his oath, states:

1. My name is Lee R. Nickloy. I work in the City of St. Louis, Missouri, and I am employed by Ameren Services Company as Director, Corporate Finance.

2. Attached hereto and made a part hereof for all purposes is my Direct Testimony on Interim Rates on behalf of Union Electric Company d/b/a AmerenUE consisting of 7 pages, which has been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Lee R. Nickloy

Subscribed and sworn to before me this 20th day of October, 2009.

Amanda Tesdall
Notary Public

My commission expires:

Amanda Tesdall - Notary Public
Notary Seal, State of
Missouri - St. Louis County
Commission #07158967
My Commission Expires 7/29/2011