Exhibit No.:	
Issue:	Rate of Return
Witness:	Daniel J. Lawton
Type of Exhibit:	Rebuttal
Sponsoring Party:	OPC
Case No:	ER-2010-0036
Date Prepared:	February 11, 2010

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

	§	
In the Matter of Union Electric Company ,	**§**	
d/b/a Ameren UE's Tariffs to Increase its annual	**§**	**Case No. ER-2010-0036**
Revenues for Electric Service	**§**	
	§	

Rebuttal Testimony

of

Daniel J. Lawton

On behalf of

Missouri Office of the Public Counsel

February 11, 2010

AFFIDAVIT OF DANIEL J. LAWTON
FOR CASE NO. ER-2010-0036

STATE OF TEXAS §

COUNTY OF TRAVIS §

Daniel J. Lawton, being duly sworn on oath, says that he is the person identified in the foregoing prepared rebuttal testimony and exhibits; and that such testimony was prepared by or under the direct supervision of said person; that such answers and/or information appearing therein are true and correct to the best of his knowledge and belief; and if asked the questions appearing therein, his answers would, under oath, be the same.

Daniel J. Lawton

Subscribed and Sworn to before me on this 11th day of February, 2010.

JANELLE M. EDMISTON
MY COMMISSION EXPIRES
May 21, 2013

NOTARY PUBLIC STATE OF TEXAS

My Commission Expires 5-21-2013

REBUTTAL TESTIMONY OF

DANIEL J. LAWTON

CASE NO. ER-2010-0036

Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 701 Brazos, Suite 500, Austin, Texas, 78701.

Q2. ARE YOU THE SAME DANIEL J. LAWTON WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS PROCEEDING ON OR ABOUT DECEMBER 18, 2009?

A. Yes, I am.

Q3. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of this testimony, in the rebuttal phase of these proceedings, is to address the direct testimony of Union Electric Company d/b/a AmerenUE ("Company" or "Ameren") witness, Dr. Roger Morin's, cost of capital recommendation in this proceeding, which was filed on or about July 24. 2009. In addition, I will address other Company testimony related to rate of return and/or financial risks and metrics.

Q4. BEFORE ADDRESSING DR. MORIN'S SPECIFIC COST OF CAPITAL ANALYSES AND RECOMMENDATIONS, DO YOU HAVE ANY GENERAL COMMENTS?

A. Yes. First, Dr. Morin's recommended 11.5% equity return is outdated and overstated with the passage of time since his July 2009 direct testimony filing. Moreover, Dr. Morin's recommendation of an 11.5% return on equity, which is driven in large measure by his discounted cash flow ("DCF") results of 12% to 12.5%, is so extreme relative to the equity returns currently being granted by regulatory authorities; little, if any, consideration should be afforded his analysis. I would expect that Dr. Morin would update his original analysis, which should show a much lower equity return is justified in this proceeding. I should point out that Dr. Morin's DCF analyses indicating a 12% - 12.5% equity return are at the extreme high end when originally presented in July 2009. Even though I expect an updated analysis to be provided, I will address a few general issues regarding Dr. Morin's Capital Asset Pricing Model ("CAPM"), Historical Risk Premium ("RP") and Discount Cash Flow ("DCF") analyses.

Q5. IN LIGHT OF CURRENT ECONOMIC CONDITIONS AND IMPACTS FROM THE RECESSION HAVE REGULATORS BEEN AUTHORIZING HIGHER EQUITY RETURNS?

A. No, my experience is that lower equity returns are being granted by regulatory authorities. There is no question that the recent financial crisis has spared few in its devastating impacts. Moreover, the impacts of the economic recession have greatly stressed business conditions and consumer economics. For business, including utilities, demand has declined and many pressing capital projects have been put off to the future periods where demand is expected to bounce back. Many consumers are dealing with record levels of unemployment, home foreclosures, the loss or serious erosion of retirement accounts and/or life savings. These conditions are not the ideal for increasing consumer electric rates.

In two recent cases decided in the past two months by the Florida Public Service Commission, in both of which I submitted testimony on financial integrity and cash flow issues, the regulator denied most, or all, of the requested rate increase and set authorized equity returns at between 10% and 10.5%. For example, in Docket Nos. 080677-EI and 090130-EI, Florida Power & Light Company requested an annual base rate increase of $1.250 billion with an equity return midpoint of 12.5%. The Florida Commission recently rejected the request and authorized a $75 million increase, about 6% of the original increase request, and adjusted the equity return request to a 10.0% equity return.

In Docket No. 090079-EI, Florida Progress requested approximately a $500 million annual base rate increase with a 12.50% equity return. The Florida Commission denied the entirety of the $500 million annual base rate increase and set the equity return at 10.5%.

Q6. YOU HAVE DESCRIBED TWO RECENT CASES WEHRE THE REGULATOR HAS RECENTLY ESSENTIALLY DENIED RATE INCREASES AND SET EQUITY RETURNS AT 10.0% TO 10.5% - DID THESE COMPANIES HAVE LARGE CAPITAL EXPENDITURE PROGRAMS SIMILAR TO THE LEVELS CLAIMED BY AMEREN IN THIS PROCEEDING?

A. Yes. Both Florida utilities discussed above proposed enormous capital expenditure programs involving infrastructure issues and the construction of nuclear power facilities. Their construction programs are on a much larger scale than that proposed by Ameren.

Q7. SHOULD THIS COMMISSION CONSIDER THESE RECENT FLORIDA DECISIONS IN SETTING RATES IN THIS CASE?

A. At page 57:17 through page 59:2, Dr. Morin discusses "zone of reasonableness" considerations employed by this Commission when evaluating and considering equity return recommendations. Thus, to the extent consideration or weight is given to other regulatory authority decisions, I would recommend serious consideration of the recent Florida cases described above. Both these Florida utilities are included in my comparable group analysis as well as Dr. Morin's comparable group and, like Ameren, are vertically integrated electric companies. Thus, Dr. Morin's concerns of comparing to a "wires only" company are addressed.[1] Moreover, these Florida decisions are very recent and reflect the current impact of the ongoing economic and financial market conditions.

Employing a 100 basis point band or range against the 10.25% average (10% and 10.5%) of the recent Florida decisions would indicate Dr. Morin's outdated and overstated 11.5% is outside the zone of reasonableness, but Missouri Staff and interveners' most current recommendations are within the updated zone of reasonableness.

[1] Dr. Roger Morin direct testimony at 58:13.

Q8. DO YOU HAVE ANY COMMENTS REGARDING DR. MORIN'S DCF MODEL?

A. Yes. As noted earlier, Dr. Morin's DCF results are outdated and overstated with the passage of time. I expect Dr. Morin will cure this problem with an update of his analysis. In addition, I do have comments with regard to Dr. Morin's dividend yield and growth rate assumptions.

Q9. WHAT COMMENTS DO YOU HAVE WITH REGARD TO DR. MORIN'S DIVIDEND YIELD CALCULATION FOR THE DCF?

A. First, Dr. Morin employs spot prices for his dividend yield calculation (see Dr. Morin direct at 48:3-12), while I employed a recent six week average price. I explained in my direct testimony why a spot price may distort and bias the yield analysis. Had I employed spot prices rather than a six-week average, my dividend yield recommendation would have been lower.

Q10. DO YOU HAVE ANY COMMENTS REGARDING DR. MORIN'S APPLICATION OF THE FULL GROWTH RATE TO ARRIVE AT EXPECTED DIVIDENDS AND DIVIDEND YIELD AS HE DISCUSSES AT PAGE 47:21 THROUGH PAGE 48:2 OF HIS DIRECT TESTIMONY?

A. Yes, his analysis will result in overstating the expected dividend yield by one-half the growth rate. The proper analysis is to calculate the expected dividend by increasing the current dividend by one-half the growth rate. The goal is to capture an estimate of next year's dividend, as an investor who is purchasing shares of stock will factor into his purchase decisions the expected dividend he will receive. When I calculated the dividend yield for the DCF analysis in this case, as shown in my direct testimony at Exhibit_Schedule (DJL-6), I could have employed the Value Line estimated 2010 dividend (next year's dividend) or increase the current dividend by one half the growth rate. Dr. Morin's approach overstates the dividend yield by one-half the growth rate.

Q11. DO YOU HAVE ANY COMMENTS ON DR. MORIN'S GROWTH RATE CALCULATION?

A. The major comment I would have is that this growth analysis needs to be updated. Dr. Morin employed Value Line and Zacks growth rates in his study. I also employed, albeit more current forecasts of, Zacks and Value Line growth estimates along with consensus estimates from Thomson or Yahoo Finance. Thus, there is not disagreement as to employing earnings per share forecasts for the DCF model.

Q12. AT PAGE 51:14 THROUGH PAGE 55:15 OF DR. MORIN'S DIRECT TESTIMONY, HE DISCUSES THE NEED FOR A FLOTATION COST ADJUSTMENT; DO YOU HAVE ANY COMMENTS?

A. Yes, I have a number of comments. In my opinion, Dr. Morin's proposed 30 basis point upward adjustment for "claimed" flotation costs should be rejected. If there are any flotation costs then those flotation expenses should be presented and requested in cost of service, just like any other cost requested by the Company. To include a 30 basis point adjustment as compensatory for assumed, or unidentified, flotation costs is not sound ratemaking.

The Company has not identified a single dollar of flotation expense incurred during the test year – yet the Company requests 30 basis points on equity or about $13,127,000 in higher revenue requirements to cover this claimed and un-quantified cost. Regulatory authorities, which I am familiar with, do not allow utility companies to inflate equity return for unknown and un-quantified flotation expenses.

I would urge the Commission to reject a flotation cost adjustment for equity return.

Q13. DO YOU HAVE ANY COMMENTS ON DR. MORIN'S CAPM AND ECAPM ESTIMATES?

A. Yes. Dr. Morin's original CAPM and ECAPM were a 9.3% to 9.7% equity return. These are Dr. Morin's original estimates without a 30 basis point adjustment for phantom flotation expenses. A review of current market rates indicate Dr. Morin's CAPM and ECAPM results would be about the same 9.3% to 9.7% estimates.

Q14. THERE HAS BEEN A GREAT DEAL OF DISCUSSION IN THIS CASE CONCERNING THE FINANCIAL METRIC FREE CASH FLOW AND NEGATIVE FREE CASH FLOW. DO YOU HAVE ANY GENERAL COMMENTS ON THIS MATTER?

A. Yes. First, it is important to understand what free cash flow is and what exactly is being measured. Simply, free cash flow is net income plus amortization and depreciation less changes in working capital less capital expenditures.

A firm with a large capital expansion program will often have a negative free cash flow measure.

Q15. DOES A HIGH VALUE OF FREE CASH FLOW METRIC INDICATE FINANCIAL STRENGTH?

A. Not always, higher values can sometimes indicate problems and weakness rather than strength. As an example, a company with high levels of free cash flow may be serving a low growth or declining market where it has minimal investment needs and declining or no investment prospects. On the other hand, growth companies will often exhibit thin or negative free cash flow because added investment is required to support growth.

A review of the low growth company financials will indicate that high free cash flow might not be sustainable, while the high growth company with low or negative free cash flow will have enhanced financial metrics once the current investment levels begin yielding cash returns.

The bottom-line is that interpretation of free cash flow or negative free cash flow ratios is not simple and straightforward. The above examples demonstrate that there is no simple correlation between a company's credit worthiness and the current level of free cash flow. There are numerous underlying considerations behind the numbers and particular facts and circumstances.

Q16. IS NEGATIVE FREE CASH FLOW A NEW OR UNEXPECTED OCCURANCE IN THE UTILITY INDUSTRY?

A. Negative free cash flow isn't new or unexpected in the electric industry. A "…June 2009 Edison Electric Institute (EEI) survey,…estimates shareholder owned electric utility capex will reach $84.2 billion in 2009, $84.8 billion in 2010, $86.6 billion in 2011."[2] Such levels of capital expenditures are likely to lead to negative free cash flow. The electric industry has been in a negative pre-dividend free cash flow position since 2007 and the trend continues.[3] Thus, any claims by Ameren that negative free cash flow is suddenly a problem are just not accurate. Instead, negative free cash flow reflects large investment that will be funded by borrowings, equity and internally generated capital.

Q17. CAN DR. MORIN'S EXTREME EQUITY RETURN RECOMMENDATION BE EXPLAINED BY HIGHER SPECIFIC RISKS IMPACTING AMERENUE?

A. Not in my opinion. I have found no basis to conclude that the Company should receive an upward adjustment in equity return because of specific or unique risk factors relative to the industry.

Q18. HAVE YOU REVIEWED THE COMPANY'S CLAIM REGARDING UNIQUE REGULATORY LAG IN MISSOURI?

A. Yes, I have reviewed the Company's claim and do not agree with the higher risk conclusion. Regulatory lag, under their definition, can be defined as the time between a rate case filing and a decision by the regulatory authority – regulatory lag represents the time period between when the utility requests a change in rates and the new rate.

As I understand the Company's testimony regarding interim rates, the Company asserted

[2] Edison Electric Institute, Electric Perpectives September/October 2009 at 84.
[3] *Id.*

a regulatory lag in Missouri of 11 months.[4] The average regulatory lag (period between rate request and rate decision) in the electric industry is about 10 months. Thus, Missouri regulation is certainly consistent with rate review and processing periods found around the country.[5]

I would also point out, based on my understanding of the true-up process as used in Missouri; it significantly impacts any asserted regulatory lag. The true-up period in this case is through January 31, 2010. Thus, the revenue requirement will be based on actual data as of a date that is less than five months prior to the operation of law date.

Q19. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[4] Direct testimony on Interim Rates of Warren L. Baxter, at 5:13-14, October 2009
[5] Edison Electric Institute Financial Update Quarter 4, 2009