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Issues: Return on Equity, Off System Sales
Witness: Billie Sue LaConte
Sponsoring Party: Missouri Energy Group
Type of Exhibit: Direct Testimony
Case No.: ER-2008-0318
Date Testimony Prepared: August 28, 2008

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a	)	
AmerenUE for Authority to File Tariffs Increasing	)	Case No. ER-2008-0318
Rates for Electric Service Provided to Customers	)	
In the Company's Missouri Service Area.	)	

DIRECT TESTIMONY AND SCHEDULES

OF

BILLIE SUE LACONTE

ON BEHALF OF

MISSOURI ENERGY GROUP

NP

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Affidavit of Billie S. LaConte

STATE OF MISSOURI)
)
COUNTY OF ST. LOUIS)

Billie S. LaConte, being of lawful age and duly affirmed, states the following:

1. My name is Billie S. LaConte. I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

2. Attached hereto and made a part hereof for all purposes is my Direct Testimony consisting of Pages 1 through 27 and Appendix A.

3. I have reviewed the attached Direct Testimony and hereby affirm that my testimony is true and correct to the best of my knowledge and belief.

Billie S. LaConte

Duly affirmed before me this 28th day of August, 2008.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

SHERYL M. FENELON
My Commission Expires
December 29, 2010
St. Louis County
Commission #06514106

Sheryl M. Fenelon

Notary Public

My commission expires on December 29, 2010.

TABLE OF CONTENTS

DIRECT TESTIMONY OF BILLIE SUE LACONTE

CASE NO. ER-2008-0318

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Billie S. LaConte, 8000 Maryland Avenue, Suite 1210, St. Louis, Missouri.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

Q PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A These are given in Appendix A.

Q ON WHOSE BEHALF ARE YOU SUBMITTING THIS EVIDENCE?

A I am presenting it on behalf of the Missouri Energy Group. Members of the group served by AmerenUE include Barnes-Jewish Hospital, Buzzi Unicem USA, Inc. and SSM HealthCare.

Q WHAT TOPICS ARE COVERED IN THIS EVIDENCE?

A This testimony covers: the rate of return on equity (RoE) and the allowed amount of off system sales (OSS) revenues.

Q WHAT ARE THE MAIN POINTS OF THIS TESTIMONY?

A The main points of this testimony are:

- Based on current market conditions, the appropriate rate of return on equity is 10% if AmerenUE receives a fuel adjustment clause and 10.2% if it does not;
- A generic approach for calculating the RoE is preferable to the current method; and
- AmerenUE's revenue requirement and base fuel costs should be adjusted to reflect actual OSS through September 30, 2008.

Q HOW IS YOUR RETURN ON EQUITY TESTIMONY ORGANIZED?

A My RoE testimony comprises three sections:

1. Evaluation of AmerenUE's return on equity testimony;
2. My recommendation for AmerenUE's return on equity; and
3. A recommendation for using a generic cost of capital method.

Evaluation of Company's Analysis

Q WHAT IS THE RETURN ON EQUITY (ROE) THAT AMERENUE IS REQUESTING?

A If the Commission allows the Company to adopt a fuel adjustment clause, AmerenUE is requesting a RoE of 10.9%. If not, the requested RoE increases by 25 basis points to 11.15%.

Q WHAT IS THE BASIS FOR THIS LEVEL OF RETURN?

A AmerenUE's expert witness, Dr. Roger Morin, used several risk premium methods and the Discounted Cash Flow (DCF) method to estimate AmerenUE's return on equity.

Q WHAT RISK PREMIUM METHODS DID DR. MORIN USE?

A He used the Capital Asset Pricing Model (CAPM), an Empirical CAPM (ECAPM) method, historical equity risk premium method and a historical allowed equity risk premium method.

Q WHAT ROE DOES DR. MORIN ESTIMATE USING THE CAPM AND ECAPM METHOD?

A He estimates the RoE using the CAPM as 11.35%. Using these methods and ECAPM, his estimated RoE is 11.35%.

Capital Asset Pricing Model

Q PLEASE DESCRIBE THE CAPM.

A The CAPM uses a risk premium to estimate the return on equity. The risk premium method states that the expected return of a security equals the risk-free rate plus a risk premium. Simply put, investors require a premium over the risk-free rate if they are going to invest their money in a riskier security.

The formula for the CAPM is:

*Expected Return = Risk-free Rate + Beta * Market Risk Premium*

The equity risk premium is the market risk premium (MRP) times the security's beta. The beta is the volatility of the subject firm (i.e., its common stock) relative to the market as a whole.

Q WHAT IS THE MARKET RISK PREMIUM?

A It is the difference between the return on the market on average and the risk-free rate. Thus, it is the risk premium that reflects the risk on an average stock.

Q WHAT IS THE RISK-FREE RATE?

A The risk-free rate is the current yield on 30-year U.S. Treasury bonds, which is 4.5% (as of August, 2008). This rate is considered to be risk-free because the return is guaranteed by the U.S. government.

Q WHAT IS BETA?

A Beta measures the volatility of a security as in comparison to the market as a whole. A beta equal to 1.00 implies that a security's price will move with the market. A beta higher than 1.00 implies the security's price is more volatile than the market; a beta less than 1.00 implies the security's price is less volatile than the market.

Market Risk Premium (AmerenUE)

Q PLEASE COMMENT ON THE METHODS DR. MORIN USED TO CALCULATE THE MARKET RISK PREMIUM.

A Dr. Morin's market risk premium for his CAPM analysis is based on historical data (7.1%) and a forecast method based on a DCF analysis (7.7%). He used the average, 7.4%, as his market risk premium.

Q PLEASE COMMENT ON THE USE OF FORECAST DATA.

A Dr. Morin forecast the MRP by "applying a DCF analysis to the aggregate equity market using Value Line's VLIA software" (Direct Testimony of Roger A. Morin, Page 38, Lines 10-11). This produced an expected return on the aggregate equity market of 12%. He adjusted this upward by 20 basis points to reflect "the quarterly timing of dividend payments rather than the annual timing." He subtracted the current yield of long term bonds, which is 4.5%, from his 12.2% DCF estimate to come up with an implied forecast market risk premium of 7.7%.

Q DO YOU HAVE ANY COMMENTS ABOUT THE FORECAST MRP?

A Yes. Most CAPM analyses rely on the historical data when calculating the MRP. Dr. Morin's forecast method is not as common as the historical approach to estimating the market risk premium. In addition, it is based on a snapshot of the market, whereas the historical MRP represents 81 years of market performance.

Beta (AmerenUE)

Q WHAT IS DR. MORIN'S ESTIMATED BETA?

A His estimated beta is 0.87.

Q PLEASE EXPLAIN DR. MORIN'S METHOD OF ESTIMATING BETA.

A Dr. Morin estimated the beta used in the CAPM model using a group of "widely-traded investment-grade vertically integrated electric utilities covered by S&P with at least 50%

of their revenues from regulated operations." This group's average beta was 0.87. He also analyzed the average beta of the companies that make up Moody's Electric Utility Index, which is 0.86.

Q IS THIS THE APPROPRIATE BETA?

A No. As discussed later in my testimony, the utilities that Dr. Morin used to estimate AmerenUE's beta are not comparable, in that they have more risk and, therefore, have higher betas, which has the effect of overstating the estimated RoE for AmerenUE.

Q WHAT IS THE RISK-FREE RATE USED BY DR. MORIN?

A His risk-free rate is 4.5%, the current yield on long-term US Treasury bonds.

Q WHAT IS THE ROE FOR AMERENUE BASED ON DR. MORIN'S ESTIMATED CAPM ANALYSIS?

A Using the risk-free rate of 4.5%, a 0.87 beta and a MRP of 7.4, the RoE is 10.9%. He then adjusted this upwards to reflect flotation costs, for a recommendation of 11.1%.

Q PLEASE COMMENT ON DR. MORIN'S EMPIRICAL CAPITAL ASSET PRICING MODEL (ECAPM) ANALYSIS.

A The ECAPM is a variant of the CAPM method. It is based on the theory that the beta values usually calculated from stock price variations–called the "unadjusted" betas–do not accurately reflect the riskiness of a stock. That is, if the unadjusted beta is less than

1, the CAPM underestimates the return. If the unadjusted beta is greater than 1, then the CAPM overestimates the return. The ECAPM formula "adjusts" the beta to more closely reflect the stock's risk.

Q HOW DOES THE ECAPM ADJUST THE BETA?

A The CAPM formula is:

$$RoE = R_f + B * MRP$$

where

R_f is the risk-free rate;

B is the beta; and

MRP is the total market risk premium.

so

B * MRP = equity risk premium

The ECAPM formula used by Dr. Morin is:

$$RoE = R_f + .25 (MRP) + .75 * B * MRP$$

The ECAPM gives less weight to the equity risk premium and more weight to the total market risk premium, which increases the RoE.

Most regulated electric utilities have a beta that is less than one, so ECAPM will always result in higher RoEs. If the theory that beta represents a stock's riskiness is true, then adjusting a low-beta stock to produce a higher return contradicts the efficient market theory.

Q DO YOU AGREE WITH DR. MORIN'S ECAPM ANALYSIS?

A No. The betas he uses, which come from Value Line and Zacks Investments, have been adjusted by analysts; no further adjustment is necessary.

Q DO YOU HAVE ANY COMMENTS ABOUT THE UTILITIES DR. MORIN USED FOR HIS PROXY GROUPS?

A Yes. The utilities that Dr. Morin included (Schedule RAM-E2-1 and RAM-E2-2) include utilities that do not share the same risk profile as Ameren, much less AmerenUE. For example, his proxy groups include Constellation Energy, Dominion Resources and NiSource, Inc., which have regulated electric revenues of 12%, 38% and 17%, respectively, as compared to Ameren, which has 83% regulated electric revenues. He also included companies with a much lower market capital than Ameren ($9.1 billion), such as Empire Electric ($675 million) and MGE Energy ($775 million). Lower market capital may overstate beta due to lack of trading. He also included companies with a lower financial rating than Ameren's (A), such as Unisource (C++) and CMS Energy (B). Value Line Investment Analyzer's financial ratings range from C (lowest) to A++ (highest).

Q PLEASE COMMENT ON DR. MORIN'S OTHER RISK PREMIUM STUDIES.

A In addition to the CAPM, Dr. Morin estimated AmerenUE's return on equity using two risk premium methods that calculate the historical equity risk premium.

The first method, the historical equity risk premium, uses historical data from *Moody's Electric Utility Index* for the period 1931-2006. The actual return for the index for each year was calculated and he subtracted the corresponding year's risk free rate to determine the annual equity risk premium. The average equity risk premium for this index is 5.7% over long-term Treasury bond returns and 5.8% over long-term Treasury bond yields. Dr. Morin used the 5.7% as his ERP and added the current risk-free rate of 4.5% for a return on equity of 10.2%. He then adjusted this figure upwards by 30 basis points for flotation costs.

The second method, the implied allowed RoE, is based on the average allowed return on equity for electrical utilities for the period 1998-2007. From this, he subtracted the corresponding average risk-free rate to estimate an equity risk premium of 5.6%. He added the current risk free rate of 4.5%, which equals a ROE of 10.1%. He did not adjust this figure for flotation costs "since the return figures are allowed book returns on common equity capital" (Direct Testimony, Page 47, Lines 4-5). Presumably, the flotation adjustment has been accounted for in the allowed return.

Q DO YOU AGREE WITH DR. MORIN'S RISK PREMIUM ANALYSES?

A I do not disagree with the implied allowed RoE. The method provides a good estimate of the equity risk premium for the *regulated* electric utility, AmerenUE, rather than the equity risk premium for its parent company, Ameren. Ameren has more risk than AmerenUE because it also has non-regulated revenues. Therefore, the estimated RoE for AmerenUE that is estimated using companies that are comparable to its parent

company, Ameren, may be higher than necessary. The Moody's list includes companies that are not comparable to Ameren, let alone AmerenUE.

Q HOW DID DR. MORIN PERFORM HIS ANALYSES?

A Dr. Morin performed four DCF analyses, using two separate groups of utilities (the same two groups he used in his CAPM and ECAPM analyses). For each group, he estimated the RoE using two different growth forecasts, one based on Value Line estimates and the other from Zacks Investments.

Table 1

AmerenUE RoE Based on DCF Analysis

	RoE	w/Flotation Adjustment
Moody's Electrics with Value Line Growth	10.9%	11.1%
Moody's Electrics with Zacks Growth	10.8	11.0
S&P Integrated Electrics with Value Line Growth	10.2	10.4
S&P Integrated Electrics with Zacks Growth	11.3%	11.6%

Q DO YOU AGREE WITH THE GROWTH RATES USED IN HIS DCF ANALYSES OF HIS MOODY'S ELECTRICS GROUP?

A No. The growth rate that he used for certain utilities were unrealistically high, which had the effect of increasing the estimated RoE. In his group of Moody's electrics using long term growth rates from Zacks Investments, the projected earnings per share for Constellation Energy and Public Service Enterprise were 18% and 18.5%, respectively. He removed these from this study, which had the effect of lowering the average RoE by

110 basis points, from 12.1% to 11.0% (including flotation costs). However, he included them in the version using the Value Line long term growth rates. Value Line's long term growth rate for Constellation Energy is 15.5% and for Public Service Enterprise is 11.5%. Value Line's forecast long term growth rate for PPL Corporation is 14%. The RoE for this group excluding Constellation and PPL Corporation (yet still including Public Service) is lowered by 80 basis points, from 11.1% to 10.3% (including flotation costs). Without flotation costs, the RoE is 10.1%.

Q DO YOU HAVE ANY COMMENTS ABOUT THE LONG TERM GROWTH RATES USED IN HIS S & P INTEGRATED ELECTRIC UTILITIES GROUP?

A In the S&P Integrated Electric Utilities group, Dr. Morin included utilities that had high growth rates. The Zacks forecast included analysts growth rates of 13.3% for Entergy Corporation and 12.7% for Northeast Utilities. The Value Line forecast for these same utilities was 9.5% and 17%, respectively.

Excluding only Northeast Utilities from the Value Line forecast has the effect of reducing the average RoE from 10.4% to 9.6%, with flotation costs. Excluding Entergy and Northeast Utilities from the Zacks forecast lowers the RoE from 11.6% to 10.3%.

Q IS IT REASONABLE TO EXCLUDE THESE UTILITIES FROM THE CALCULATIONS DUE TO THEIR EXTREMELY HIGH GROWTH RATES?

A Yes, for two reasons. First, even Dr. Morin recognizes the need to exclude certain utilities because of their unrealistic long term growth rates. Second, Constellation

Energy is not comparable to AmerenUE not only because of its forecast long term growth rate, but also because it generates only 12% of its revenues from regulated electricity sales. Public Service Enterprises has only 66% of its revenue from regulated electricity sales.

Q PLEASE COMMENT ON THE ADJUSTMENT FOR FLOTATION COSTS.

A Flotation costs include two components. The first is the actual cost paid by the company to the underwriter for issuing the stock. The second is indirect and represents the claimed decrease in the price of the stock resulting from the issuance of new shares. Dr. Morin estimated the flotation cost for AmerenUE by increasing his estimated RoEs an average of 20 basis points.

Q WHAT IS THE EFFECT OF THE FLOTATION COST ADJUSTMENT ON THE ESTIMATED RETURN FOR AMERENUE?

A The flotation cost adjustment increases AmerenUE's revenue requirement by over $9 million.

Q SHOULD THE FLOTATION COST ADJUSTMENT BE INCLUDED WHEN ESTIMATING AMERENUE'S RETURN ON EQUITY?

A No. AmerenUE's parent company is planning to issue stock during the test year period, therefore no cost is incurred.

Q PLEASE SUMMARIZE YOUR COMMENTS REGARDING DR. MORIN'S ANALYSIS.

A Dr. Morin's estimated ROE for AmerenUE is 10.9% if the Commission grants the Company a FAC. His estimate is based on several analyses and an adjustment for flotation costs. The estimated RoE is too high. It overcompensates for the amount of risk AmerenUE faces, based on the higher risk of the comparable utilities he included in his studies; furthermore, the flotation cost adds an additional 20 basis points to AmerenUE's ROE, at a cost of about $9 million to ratepayers.

Q WHAT WOULD BE THE RESULTS WITH YOUR SUGGESTED CHANGES TO DR. MORIN'S CALCULATIONS?

A AmerenUE's estimated RoE, using Dr. Morin's data groups adjusted as described above, would be:

Table 2

Dr. Morin's RoE Calculations with MEG's Adjustments

Method	Dr. Morin	Changes
CAPM	11.2%	10.4%
Empirical ECAPM	11.5	–
Average	11.4	10.4
Allowed Risk Premium	10.1	10.1
Historical Risk Premium	10.5	–
Average	10.3	10.1
DCF S & P Value Line Growth	10.4	9.6
DCF S & P Zack's Growth	11.6	10.1
Moody's Electric Utilities Value Line Growth	11.1	10.1
Moody's Electric Utilities Zack's Growth	11.0	10.8
Average	11.0	10.2
Overall average	10.9%	10.2%

Return on Equity

Q WHAT RETURN ON EQUITY DID YOU CALCULATE FOR AMERENUE?

A Based on my analysis, I have determined a return on equity in the range of 10.1% to 10.6%. The components of this are shown in Table 3.

Table 3

Recommended Return on Equity

Method	RoE
CAPM	10.4%
Risk premium	10.1%
Discounted cash flow	10.6%
Average	10.3%

Q HOW DID YOU CALCULATE THE RECOMMENDED RETURN ON EQUITY?

A I used the Capital Asset Pricing Model (CAPM), a risk premium method and the Discounted Cash Flow (DCF) method.

Market Risk Premium

Q HOW DID YOU DETERMINE THE MARKET RISK PREMIUM?

A I used the average spread between the return on the market and the risk-free rate using historical market data from the Ibbotson SBBI 2008 Classic Yearbook, Market Results for Stocks, Bonds, Bills and Inflation 1926-2007. The average historical market risk premium is 7.1%. This reflects the difference between the average of the total return of

large company stocks, 12.3%, and the average income return on long-term government bonds, 5.2%.

Beta

Q HOW DID YOU DETERMINE AMERENUE'S BETA?

A To determine AmerenUE's beta, I reviewed the betas of several regulated electric companies that are comparable in risk to Ameren, as shown in Table 4.

Table 4

Betas of Regulated Energy Utilities

Line	Name	Beta
1	ALLETE	0.90
2	Alliant Energy	0.80
3	Ameren	0.80
4	American Electric Power	0.85
5	Cleco Corporation	1.00
6	DPL, Inc.	0.80
7	Edison International	0.90
8	Entergy Corp.	0.85
9	FPL Group, Inc.	0.80
10	Hawaiian Electric	0.75
11	IDACORP	0.90
12	PG & E Corp	0.85
13	Pinnacle West	0.80
14	Portland General	0.80
15	Progress Energy	0.80
16	Southern Co.	0.70
17	Westar Energy	0.90
17	Xcel Energy Inc.	0.80
18	Average	0.83

Based on this proxy group, I used 0.83 as the beta for AmerenUE (although Ameren's beta is 0.8).

Q WHY DID YOU CHOOSE THESE COMPANIES?

A The companies I included are comparable to Ameren; i.e., they exhibit similar characteristics of the company and therefore provide an appropriate proxy. The characteristics of these companies include:

- S&P integrated electric utility;
- At least 70% of revenues from regulated electricity sales (Ameren's electricity sales represent 83% of its total revenue);
- Market capital of at least $1 billion (Ameren has market capital of $9.1 billion); and
- A financial strength rating (as determined by Value Line Investment Analyzer) of B+, B++, A or A+ (Ameren's is A).

Please see Schedule BSL-1 for the complete list.

Q BASED ON YOUR ANALYSIS, WHAT IS THE RETURN ON EQUITY FOR AMERENUE USING THE CAPM?

A The return on equity for AmerenUE, using a risk free rate of 4.5%, a beta of 0.83 and market risk premium of 7.1%, is 10.4%.

Q DO YOU HAVE ANY OTHER COMMENTS ABOUT THE CAPM?

A Yes, as pointed out in Dr. Morin's testimony (Direct Testimony, Page 26, Lines 3-6), the majority of analysts, investors and corporations rely on the CAPM when estimating the cost of equity.

The CAPM provides a good approximation of the return on equity based on long-term historical market conditions.

Risk Premium Method

Q ARE THERE OTHER RISK PREMIUM METHODS USED TO ESTIMATE RETURN ON EQUITY?

A Yes. Another method is the allowed risk premium method. This method is based on the same theory as the CAPM, i.e., that stocks should provide a greater return than a risk-free investment (such as Treasury bonds), to compensate the buyer for the additional risk. However, this method estimates the equity risk premium based on the difference between historical allowed return on equity and the risk-free rate, whereas the CAPM estimates the total market risk premium and adjusts it with the beta.

Q IS THE ALLOWED RISK PREMIUM PREFERABLE TO THE RISK PREMIUM CALCULATED BY THE CAPM?

A Yes. The allowed risk premium provides the equity risk premium for the *regulated* portion of an electric (in this case) utility, whereas my CAPM analysis is limited in that it estimates the equity risk premium for a company that is partially regulated and has 83% of regulated electric revenue. The beta I used actually is a measure of Ameren's risk,

not AmerenUE, *per se*. The group of companies used to estimate beta for AmerenUE include companies that have a risk profile similar to Ameren. The risk for AmerenUE is less than for Ameren.

Q DID YOU ESTIMATE THE ALLOWED EQUITY RISK PREMIUM?

A No. I did not have access to reliable data at the time of this filing. However, AmerenUE's witness did provide an allowed equity risk premium analysis. He calculated the equity risk premium using the average RoE spread over long-term Treasury bonds from 1998-2007.

Q WHAT IS THE ALLOWED EQUITY RISK PREMIUM?

A It is 5.6% for regulated electric utilities.

Q WHAT IS THE ESTIMATED RETURN ON EQUITY FOR AMERENUE USING THE ALLOWED RISK PREMIUM METHOD?

A Using the current risk-free rate of 4.5%, the allowed risk premium method produces a return on equity of 10.1%.

Discounted Cash Flow Method

Q WHAT OTHER METHOD DID YOU USE TO ESTIMATE AMERENUE'S ROE?

A I used the constant growth Discounted Cash Flow (DCF) method. The DCF model is used by investors to determine the present value of a stock, based on future cash flows (dividends) that are discounted by the stock's *known* return and its forecast growth rate. The formula is:

$$P = \frac{D}{r-g} \quad \text{where}$$

P is the current stock price
D is the dividend yield
r is the rate of return
g is the growth rate

We can re-arrange the model to estimate the cost of equity, which is:

$$r = \frac{D}{P} + g$$

Q HOW DID YOU DETERMINE THE VALUES FOR THE DIVIDEND, STOCK PRICE AND GROWTH ESTIMATE?

A These values are calculated using data from companies that were evaluated in Value Line Investment Analyzer.

Q WHAT COMPANIES DID YOU INCLUDE IN YOUR DCF ANALYSIS?

A The companies I used are the same as those used in my CAPM analysis.

Table 5

Utilities Used for DCF Analyses

Line	Name	VLIA Dividend Yield	Projected EPS Growth*	Forecast Dividend Yield	Return on Equity
1	ALLETE	3.9%	2.5%	4.0%	6.5%
2	Alliant Energy	3.9%	6.0%	4.1%	10.1%
3	Ameren	5.9%	3.5%	6.1%	9.6%
4	American Electric Power	4.1%	7.5%	4.4%	11.9%
5	Cleco Corporation	3.7%	10.5%	4.1%	14.6%
6	DPL, Inc.	4.0%	11.0%	4.4%	15.4%
7	Edison International	2.6%	5.0%	2.7%	7.7%
8	Entergy Corp.	2.7%	10.0%	3.0%	13.0%
9	FPL Group, Inc.	2.8%	9.5%	3.1%	12.6%
10	Hawaiian Electric	5.1%	7.5%	5.5%	13.0%
11	IDACORP	4.0%	2.0%	4.1%	6.1%
12	PG & E Corp	4.3%	5.0%	4.5%	9.5%
13	Pinnacle West	6.5%	2.0%	6.6%	8.6%
14	Portland General	4.3%	7.0%	4.6%	11.6%
15	Progress Energy	5.8%	5.0%	6.1%	11.1%
16	Southern Co.	4.6%	5.5%	4.9%	10.4%
17	Westar Energy	5.0%	1.5%	5.1%	6.6%
18	Xcel Energy Inc.	4.8%	7.5%	5.2%	12.7%
19	Average	**4.3%**	**6.0%**	**4.6%**	**10.6%**

* From Value Line Investment Analyzer, August, 2008

1

Q IS YOUR GROWTH RATE BASED ON FORECAST EARNINGS GROWTH OR DIVIDEND GROWTH?

A The growth component includes growth in dividend yield, the stock price and earnings. I used this growth rate since stock investors look at the total return of a stock when estimating its value, not only the growth in the dividend yield.

Q WHAT IS AMERENUE'S ESTIMATED RETURN ON EQUITY USING THE CONSTANT GROWTH DCF MODEL?

A Using an average dividend yield of 4.3% and an average projected growth in earnings of 6.0%, the estimated return on equity is 10.6%.

Q IS IT COMMON TO USE THE DCF WHEN ESTIMATING THE ROE FOR A UTILITY?

A Yes. Most Commissions accept the DCF model as one measure. However, one must be cautious when determining the appropriate inputs. The constant growth model does just that–assumes that the growth rate will remain constant. Sometimes analysts estimate unrealistic growth rates. For example, I excluded Northeast Utilities from my group of electric utilities because the forecast growth rate is 13.5%, or a return on equity of 17%. The growth rate is so high because Northeast expects higher revenues due to expansion of its transmission system, expected to be completed in 2009. The growth rate for Energy East Corporation is -0.5%, which results in a 4.5% RoE. For this reason, it was also excluded from the group. Common sense and good judgment must be used when relying on the DCF model.

Capital Structure

Q WHAT IS AMERENUE'S PROPOSED CAPITAL STRUCTURE?

A AmerenUE's capital structure is:

Table 6

AmerenUE Capital Structure
as of March 31, 2008

Long-term Debt	46.6%
Short-term Debt	0.7%
Preferred Stock	1.8%
Common Equity	50.9%
Total	100.0%

Q DO THE COMPARABLE COMPANIES USED IN YOUR ANALYSIS HAVE SIMILAR CAPITAL STRUCTURES?

A Yes. The common equity for the group ranges from 41.5% to 55.5%, with an average ratio of 47%.

Risk Factors

Q ARE THERE OTHER FACTORS TO CONSIDER WHEN DETERMINING THE COMPANY'S ROE?

A Yes, the Company's risk profile, including business risk and financial risk.

Q PLEASE COMMENT ON AMERENUE'S BUSINESS RISK PROFILE.

A Risk refers to the variability in income, more specifically, the potential for the return to fall below the desired level. An investment with returns that fluctuate between 20%

and 30% would not be considered risky. To the extent that such variability is small or has been reduced by other means, the risk to the Company is lower than for other enterprises or lower than before.

Q ARE THERE ANY FACTORS THAT WILL AFFECT AMERENUE'S RISK?

A Yes. The fuel adjustment clause (FAC) will affect AmerenUE's risk profile. By including a FAC, the risk that AmerenUE was exposed to, i.e., the risk that the forecast fuel cost would vary from the actual has been passed on to the customers.

Q DO YOU HAVE ANY OTHER COMMENTS ON AMERENUE'S ROE?

A Yes. In the latest rate case, the Commission allowed AmerenUE to earn a 10.2% return on equity. At the time, the Commission did not allow AmerenUE a fuel adjustment clause. The risk-free rate at the time was approximately 5.0% or about 50 basis points *higher* than the current risk free rate. Determining the appropriate return on equity for a utility is not an exact science; one must take into consideration several factors when doing so, including the current risk faced by the company, including business and financial risk. If the Commission allows AmerenUE a FAC, it seems appropriate that the allowed return on equity should reflect this reduction in business risk for the Company, as well as reflect the reduction in interest rates. Therefore, a return on equity of 10% is appropriate for AmerenUE.

Summary

Q PLEASE SUMMARIZE YOUR ROE TESTIMONY.

A I have estimated the return on equity for AmerenUE within the range of 10.1%-10.6%. In its latest rate case, the Commission authorized a return on equity of 10.2% for AmerenUE *without* a FAC. Interest rates are lower now (4.5%) than at the time of the latest decision (5.0%). If the Commission allows AmerenUE a fuel adjustment clause, the return on equity should be 10%.

Generic Return on Equity Proceeding

Q DO YOU HAVE ANY OTHER COMMENTS ABOUT DETERMINING THE RETURN ON EQUITY?

A Yes. The Commission may consider establishing a generic approach to determining the return on equity.

Q WHAT IS A "GENERIC" APPROACH AND HOW IS IT DETERMINED?

A A generic approach is one where the Commission decides on a standard method and resulting formula that sets a base return on equity for each year. This can be for a "low risk" utility, with a specified increment for utilities determined to have higher risks. The formula would be determined in a single hearing where all parties involved would submit expert testimony with recommendations on what the formula should be and how it should be modified for each utility to represent their level of risk. Once the base is set, the value is reset every year, reflecting changes in interest rates.

Q WHAT IS THE BENEFIT OF A GENERIC APPROACH?

A It simplifies the regulatory process, provides more certainty and reduces the costs of regulation. It reduces costs because it eliminates the need for return on equity testimony and analysis by the utility Commission Staff and interveners. It gives the Commission certainty and provides a fair method that is agreed upon by all parties for determining the cost of capital.

Q HAS THIS BEEN DONE ELSEWHERE?

A Yes. A similar concept has been considered in California and New York. Most major Canadian regulators have implemented this. The National Energy Board (similar to our Federal Energy Regulatory Commission), explained the reason thus:

> *. . . [T]he Board has noted that evidence submitted by expert financial witnesses has tended to be much the same from one proceeding to the next. While the financial parameters change from year to year, the techniques and interpretations used in making rate of return on common equity recommendations typically do not.* (Reasons for Decisions, RH-2-94, Page 1, March, 1995)

Off System Sales

Q PLEASE COMMENT ON AMERENUE'S OFF SYSTEM SALES REVENUE.

A AmerenUE generates additional revenues from the sale of energy and capacity on the market, after meeting the requirements of its native load. This additional revenue (net of fuel cost) is used as an offset to AmerenUE's revenue requirement.

Q HAS AMERENUE PROPOSED A TRUE-UP OF OFF SYSTEM SALES REVENUES (OSSR)?

A No. AmerenUE's witness, Gary Weiss, states in his testimony:

> *The Company proposes to update the test year for known and measurable changes through June 30, 2008, and to true-up certain items through September 30, 2008. The Company is proposing to true-up plant in service, depreciation reserve, accumulated deferred income taxes, customer growth for revenues, actual fuel prices, wage increases and new employee levels and depreciation expense.* (Page 4, Lines 1-5)

The company proposes to use the forecast amount of off system sales revenues, although the figure may be reduced if customer growth figures are increased (Direct Testimony of Gary Weiss, Page 19, Lines 11-12).

Q WHY SHOULD AMERENUE INCLUDE OFF SYSTEM SALES REVENUES IN ITS TRUE-UP THROUGH SEPTEMBER 30, 2008?

A OSSR are used to determine the base fuel cost in AmerenUE's proposed fuel adjustment clause (FAC). AmerenUE will true up fuel costs through September 30, 2008, but not OSSR. This could have the effect of artificially increasing the base fuel cost.

Q PLEASE EXPLAIN.

A The FAC uses a base fuel cost that is calculated by subtracting the forecast $436.2 million of OSSR for the test year plus an additional $30 million credit for capacity sales and MISO Day 2 revenues from the forecast fuel costs of $810.5 million, for a net base fuel cost of $344.3 million. If fuel costs are higher than forecast, then AmerenUE will reflect the higher costs in its calculation of the base fuel cost. However, if OSSR are higher, AmerenUE will not reflect this in its calculation.

Q IF FUEL COSTS AND OFF SYSTEM SALES REVENUES RESULT IN A LOWER BASE FUEL COST THAN FORECAST, WILL NOT CUSTOMERS RECEIVE THE DIFFERENCE WHEN THE FUEL COST IS ADJUSTED?

A AmerenUE's proposal adjusts the base fuel cost starting in March, 2009, so any change in actual off system sales during the test year and through February, 2009, will not be passed through to customers.

Q WHAT IF AMERENUE'S OSSR ARE LOWER THAN FORECAST?

A According to Data Response MPSC 0242, actual off system sales revenues through March, 2008, are **_____** higher than forecast.

Q PLEASE SUMMARIZE YOUR POSITION REGARDING AMERENUE'S OFF SYSTEM SALES REVENUES.

A AmerenUE should use actual off system sales revenues to determine its revenue requirement. If AmerenUE receives a Fuel Adjustment Clause, the base fuel cost should be updated to reflect actual off system sales revenues.

Q DOES THIS CONCLUDE YOUR EVIDENCE?

A Yes.

NP

Experience of Billie S. LaConte

Ms. LaConte joined Drazen Consulting Group, Inc. in May 1995. Her work has focused on cost allocation, rate design, sales and price forecasts, power cost forecasting, electric restructuring issues, cost of capital issues and contract interpretation.

Ms. LaConte has advised clients on economic and strategic issues concerning the natural gas pipeline, oil pipeline, electric, waste water and water industries. She has prepared cost allocation and rate design studies to provide timely support to clients engaged in settlement negotiations in electric and gas utility proceedings. Ms. LaConte has prepared cost of service studies for wastewater utilities. She has provided power cost forecasting studies to assist clients in project planning, negotiating contracts with electric utilities for standby services and interruptible rates. She has prepared studies on electric and gas utilities' performance-based rates (PBR) and benchmarking programs to evaluate their success and to provide recommendations on methods to be used. Ms. LaConte has worked on contract interpretation to resolve contract disputes for several clients.

Ms. LaConte has provided economic and strategic analysis and contract interpretation for clients located in several jurisdictions, including Georgia, Maine, Iowa, Virginia, Alberta, Québec and Nova Scotia. She has provided financial and cost of service analysis for natural gas pipelines certificate approval from the Federal Energy and Regulatory Commission (FERC) and the Canadian National Energy Board (NEB). Ms. LaConte submitted and delivered expert testimony before the Missouri Public Service Commission on cost allocation, rate design, cost of capital and other matters. She testified before the Alberta Energy and Utilities Board on power cost forecasting issues, electric restructuring issues, sales and price forecasts and cost allocation issues. She has similarly testified before the Iowa Utilities Board, the St. Louis Metropolitan Sewer District Commission and the Nova Scotia Utility and Review Board.

In 1989, Ms. LaConte received a B.A. in mathematics from Boston University, in Boston, Massachusetts. She has a M.B.A. in finance (1995) from the John M. Olin School of Business, Washington University, St. Louis, Missouri.

Drazen Consulting Group offers economic, strategic planning and regulatory consulting

services to clients that include industrial utility users, municipalities, schools, hospitals, utilities and government agencies. The founding firm (Michael Drazen and Associates) was established in 1937.

The firm's work covers all aspects of utility regulation (and deregulation), including revenue requirements, cost of capital, cost analysis, pricing, valuation, performance-based regulation and industry restructuring.

Schedule BSL-1

Utilities Used for CAPM and DCF Analyses

Line	Name	VLIA Dividend Yield	Projected EPS Growth	Forecast Dividend Yield	Return on Equity	Beta	Market Capital $B	Financial Strength	Regulated Elec Rev %	Common Equity %
1	**ALLETE**	3.9%	2.5%	4.0%	6.5%	0.90	$1.4	A	86%	54%
2	**Alliant Energy**	3.9%	6.0%	4.1%	10.1%	0.80	4.1	A	70	55.5
3	**Ameren**	5.9%	3.5%	6.1%	9.6%	0.80	9.1	A	83	50
4	**American Electric Power**	4.1%	7.5%	4.4%	11.9%	0.85	17	B++	90	41.5
5	**Cleco Corporation**	3.7%	10.5%	4.1%	14.6%	1.00	1.5	B+	96	54.5
6	**DPL, Inc.**	4.0%	11.0%	4.4%	15.4%	0.80	3.2	B++	100	47
7	**Edison International**	2.6%	5.0%	2.7%	7.7%	0.90	15.7	B++	80	48
8	**Entergy Corp.**	2.7%	10.0%	3.0%	13.0%	0.85	23	A	78	50
9	**FPL Group, Inc.**	2.8%	9.5%	3.1%	12.6%	0.80	26.8	A+	76	51.5
10	**Hawaiian Electric**	5.1%	7.5%	5.5%	13.0%	0.75	2.1	B++	83	54
11	**IDACORP**	4.0%	2.0%	4.1%	6.1%	0.90	1.4	B+	100	49.5
12	**PG & E Corp**	4.3%	5.0%	4.5%	9.5%	0.85	14.1	B++	72	51
13	**Pinnacle West**	6.5%	2.0%	6.6%	8.6%	0.80	3.2	A	83	50
14	**Portland General**	4.3%	7.0%	4.6%	11.6%	0.80	1.5	B++	99	51.5
15	**Progress Energy**	5.8%	5.0%	6.1%	11.1%	0.80	11.1	B++	100	50
16	**Southern Co.**	4.6%	5.5%	4.9%	10.4%	0.70	28	A	99	45.5
17	**Westar Energy**	5.0%	1.5%	5.1%	6.6%	0.90	2.2	B++	69	49.5
18	**Xcel Energy Inc.**	4.8%	7.5%	5.2%	12.7%	0.80	8.6	B++	78	48
19	**Average**	**4.3%**	**6.0%**	**4.6%**	**10.6%**	**0.83**	$9.7		81%	47%