Exhibit No.:	______________
Issue(s):	Response to Mr. Hevert's Rebuttal Testimony/ Response to Mr. Murray's Rebuttal Testimony
Witness/Type of Exhibit:	Schafer/Surrebuttal
Sponsoring Party:	Public Counsel
Case No.:	ER-2014-0258

SURREBUTTAL TESTIMONY

OF

LANCE C. SCHAFER

Submitted on Behalf of the Office of the Public Counsel

UNION ELECTRIC
D/B/A
AMEREN MISSOURI

CASE NO. ER-2014-0258

February 6, 2015

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a Ameren Missouri's Tariff to Increase Its Revenues for Electric Service	)))))	Case No. ER-2014-0258

AFFIDAVIT OF LANCE C. SCHAFER

STATE OF MISSOURI)
) **ss**
COUNTY OF COLE)

Lance C. Schafer, of lawful age and being first duly sworn, deposes and states:

1. My name is Lance C. Schafer. I am the Public Utility Financial Analyst for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

Lance C. Schafer
Public Utility Financial Analyst

Subscribed and sworn to me this 6th day of February 2015.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI
JERENE A. BUCKMAN
My Commission Expires
August 23, 2017
Cole County
Commission #13754037

Jerene A. Buckman
Notary Public

My Commission expires August 23, 2017.

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UNION ELECTRIC COMPANY
D/B/A
AMEREN MISSOURI

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SECTION 1: <u>INTRODUCTION AND BACKGROUND</u>

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Lance C. Schafer. My business address is P.O. Box 2230, Jefferson City, MO 65102.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Missouri Office of the Public Counsel (OPC or Public Counsel) as a Public Utility Financial Analyst.

Q. ARE YOU THE SAME LANCE C. SCHAFER WHO FILED TESTIMONY EARLIER IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

I will respond to the rebuttal testimony of Ameren Missouri ("Ameren" or "Company") witness Robert B. Hevert and Staff Witness David Murray.

SECTION 2: <u>RESPONSE TO MR. HEVERT'S REBUTTAL TESTIMONY</u>

Q. PLEASE SUMMARIZE MR. HEVERT'S REBUTTAL TESTIMONY REGARDING YOUR ANALYSIS OF AMEREN MISSOURI'S COST OF COMMON EQUITY.

A. Mr. Hevert states that he has the following five principal areas of disagreement with my analysis:[1]

1. The overall reasonableness of my 9.01% ROE recommendation;
2. My reliance on the constant-growth DCF model results, including my 45-basis-point upward adjustment;
3. The structure and application of my multi-stage DCF model;
4. My application of the CAPM; and
5. My conclusion that my recommendation supports the Company's credit and financial risk profile.

REASONABLENESS OF 9.01% RECOMMENDED ROE

Q. ON WHAT BASIS DOES MR. HEVERT QUESTION THE OVERALL REASONABLENESS OF YOUR 9.01% RECOMMENDED RETURN ON COMMON EQUITY?

A. Mr. Hevert questions the overall reasonableness of my recommendation on the basis that it "falls well below the returns authorized recently for the vertically integrated electric

[1] See Hevert Rebuttal, p. 68, lines 17-20 and p. 69, lines 1-2.

utilities against which Ameren Missouri must compete for capital – it even falls well below the returns authorized for natural gas distribution utilities."[2]

Q. DOES MR. HEVERT USE THE SAME ARGUMENT TO OBJECT TO THE RECOMMENDATIONS OF MIEC WITNESS MICHAEL P. GORMAN AND STAFF WITNESS DAVID MURRAY?

A. Yes. Mr. Hevert compares all of the witnesses' recommended ROEs to a list of recently authorized ROEs for vertically integrated electric utilities.[3] Noting that only his recommendation falls within the range of recently authorized ROEs, Mr. Hevert concludes that the "opposing ROE witnesses' recommendations […] fail to meet that basic test of reasonableness,"[4] which implies that Mr. Hevert would find questionable any recommendation outside the range of his list of recently authorized ROEs.

Additionally, Mr. Hevert applies the same test of "reasonableness" to individual results of financial models, noting, for example, that Mr. Murray's CAPM results have "no practical meaning" because they fall well below the "benchmark" of the average of his list of recently authorized ROEs.[5]

Q. DOES MR. HEVERT APPLY THIS TEST OF "REASONABLENESS" TO THE RESULTS OF HIS OWN INDIVIDUAL MODELS?

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[2] *Ibid.*, p. 72, lines 9-12.

[3] *Ibid.*, p. 4, line 1.

[4] *Ibid.*, p. 7, lines 10-11.

[5] *Ibid.*, p. 11, lines 12-19.

A. No, he does not. However, if he did, eight of Mr. Hevert's 29 results (i.e., 27.6% of his results) would be considered unreasonable under the guidelines he has established. Five of his results would be too high; three of his results, too low.[6]

Q. SHOULD WITNESSES LIMIT THEIR RECOMMENDATIONS TO ONLY THOSE RESULTS THAT CONFIRM HISTORICALLY AUTHORIZED ROES?

A. No. According to the seminal U.S. Supreme Court decision *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of West Virginia et al.*, 262 U.S. 679 (U.S. 1923), "a rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally."[7] Mr. Hevert believes that the opposing witnesses' recommendations fail a test of "reasonableness" in that they do not correspond to historical ROEs. However, the *Bluefield* decision clearly indicates that rate-of-return witnesses should account for changes in market data rather than perpetuate estimates that may have become too high or too low with time.[8] If rate-of-return witnesses adopted Mr. Hevert's belief, they would value only those results that agreed with the past and, therefore, might unreasonably neglect current economic information.

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[6] See Hevert Rebuttal p. 122, line 1 and p. 123, line 3.

[7] *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of West Virginia et al.*, 262 U.S. 679, 693 (U.S. 1923).

[8] *Ibid.*

Q. SHOULD MR. HEVERT'S CONCEPTION OF REASONABLENESS BEAR WEIGHT IN THIS CASE?

A. While recent authorized ROEs from around the nation are one factor to consider when setting an authorized ROE in this case, it is also important to consider the Commission's opinion that this factor is not the *only* factor, or even the predominant one, as Mr. Hevert would have the Commission believe; this factor is not to be followed slavishly in setting an ROE. [9] The results of rigorous, accepted financial models should not automatically be declared unreasonable because they fall outside an artificial range of authorized ROEs established by different regulators in divergent jurisdictions regulating distinct utilities over an arbitrary period of time. Moreover, were this Commission to authorize an ROE not falling within Mr. Hevert's artificial range, it does not then follow automatically that the ROE would be unreasonable.

For his assertion of reasonableness, Mr. Hevert presents the 2014 national average of allowed ROEs (through November), which is 9.96%. The range establishing this average is characterized by ROEs as low as 9.5% and as high as 10.95%. The range is thus characterized by a spread of 145 basis points (10.95% - 9.50% = 1.45%). The existence of a range of such width demonstrates that regulators do not provide the undue emphasis on this measure of purported comparative reasonableness that Mr. Hevert suggests they do. Under Mr. Hevert's hypothesis, there should be a much tighter aggregation of authorized ROEs than that which is actually present in the artificial range he himself creates.

[9] *Report and Order*, case No. ER-2011-0028, p. 67, 12.

A recommended ROE that does not fall within a consensus range of previously authorized ROEs should not immediately be discarded, but rather should provoke inquiry into the underlying conditions that have resulted in the recommendation—be that recommendation higher or lower than the current range. Market conditions and other conditions change, as do a utility's condition. Traditional application of regulatory ratemaking principles emphasizes the use of proxy groups for financial modeling of ROEs. In so doing, the regulator is afforded substantial, rigorous evidence regarding the material factors underlying the health of other regulated utilities in comparison to the utility at issue. Because the regulator is given this comparative analysis in the financial modeling, the regulator must exercise care not to over-emphasize other comparative criteria, such as a comparative review of historically authorized ROEs, in that, in so doing, the regulator risks biasing the final result in favor of historical factors extrinsic to the company before it instead of evaluating the current market, financial and other conditions relevant to ensuring the company at issue receives a fair rate of return.[10]

Finally, it is important to note that Mr. Hevert makes two arguments regarding recently authorized ROEs that contradict his own conclusions. First, he argues that recommendations outside the range of recently authorized ROEs do not pass his determination of what is reasonable. Second, he argues that recommendations which fall below the average of historically authorized ROEs are not reasonable. However, when applied in a consistent manner this cannot be one of his criteria because one of the authorized ROEs (10.95%) in the range on which Mr. Hevert relies is

[10] See Schafer Direct, p. 5-6, for general guidelines for an appropriate rate of return as established by the U.S. Supreme Court decisions *Hope* and *Bluefield*.

actually *farther* from the national average than all of the recommendations made by the opposing witnesses in this case. What Mr. Hevert seems to be saying is that if the ROE is lower than average it must be discarded, but if it is higher than average it must be considered. What this observation puts on display is that Mr. Hevert's analysis is misleading, and again, that his emphasis on this one particular factor is misplaced—it should not be used to determine whether a party's recommendation should be given more or less weight, nor is it a particularly strong indicator of what the correct outcome should be in this case.

CONSTANT-GROWTH DCF MODEL

Q. WHAT DOES MR. HEVERT SAY ABOUT THE DIVIDEND-YIELD ADJUSTMENT YOU APPLY TO YOUR CONSTANT-GROWTH DCF MODEL?

A. Mr. Hevert states that "because Mr. Schafer focused on only expected dividend yields and excluded the effect on expected growth, his adjustment is incomplete."[11]

Q. DO YOU AGREE WITH MR. HEVERT THAT YOUR PROPOSED ADJUSTMENT TO THE CONSTANT-GROWTH DCF MODEL IS "INCOMPLETE"?

A. No. Mr. Hevert does not describe or try to quantify the change in expected growth that he feels would make my adjustment complete. Furthermore, the earnings growth rates I use in my DCF models are from the same sources that Mr. Hevert uses. Mr. Hevert makes no

[11] See Hevert Rebuttal, p. 75, lines 9-11.

adjustment of any kind to the earnings growth rates he uses, even though he states that such an adjustment is necessary in my DCF models. Logically, if he believed such an adjustment were necessary, he would have made it to his own growth rates.

Q. IS MR. HEVERT CONSISTENT IN HIS CRITICISM OF YOUR DCF ADJUSTMENT?

A. No. On the one hand, Mr. Hevert states "I agree with Mr. Schafer that recent market conditions likely violate an important assumption underlying the Constant Growth DCF model (that the P/E ratio will remain constant in perpetuity), thereby calling into question the model's reliability";[12] on the other hand, Mr. Hevert appears to criticize my model for *not* making an adjustment to the P/E ratio: "Mr. Schafer's Constant Growth DCF results therefore assume that the unusually high utility P/E ratios observed during his study period will not change, ever."[13] After stating that my model does not address the problem of unusually high P/E ratios, he then attempts to explain my motivation for addressing unusually high P/E ratios: "it appears, therefore, that past Federal monetary policy was a significant factor in the recent increase in utility P/E ratios, and, therefore, in the depressed dividend yields that Mr. Schafer sought to address."[14]

Clearly, my model cannot both attempt to address unusually high P/E ratios *and* assume that the unusually high utility P/E ratios will never change. As Mr. Hevert

[12] *Ibid.*, p. 75, lines 2-4.

[13] *Ibid.*, p. 75, line 19, and p.76, lines 1-2.

[14] *Ibid.*, p.76, lines 11-13.

himself has noted, the adjustment addresses the effects of the unusually high utility P/E ratios.

Q. IS THE ASSUMPTION OF A FIXED P/E RATIO STANDARD IN THE CONSTANT-GROWTH DCF MODEL?

A. Yes. Mr. Hevert's statement implies that use of a fixed P/E ratio in perpetuity is somehow specific to the model I chose to use and in error. However, this is not at all true—the same assumption applies to all the constant-growth models used by all the rate-of-return witnesses in this case.

Q. WHAT RECOMMENDATION DOES MR. HEVERT GIVE REGARDING THE CONSTANT-GROWTH DCF MODEL?

A. In concluding his remarks about my proposed adjustment, Mr. Hevert states:

> In my view, rather than develop an out-of-model adjustment (as Mr. Schafer has done) it is more appropriate to recognize that because the Constant Growth DCF model results are premised on a faulty assumption (i.e., that utility P/E ratios will remain elevated in perpetuity), its results are not reliable and should be given little weight in determining the Company's ROE.[15]

Q. DO YOU AGREE WITH THIS RECOMMENDATION?

A. No. Again, the assumption of a fixed P/E ratio in perpetuity is common to all constant-growth models, including the model that Mr. Hevert used. Moreover, because Mr. Hevert updated his stock prices in his rebuttal testimony to correspond to data available as of November 14, 2014 (only three days earlier than the date I used), this "faulty assumption"

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[15] See Hevert Rebuttal, p. 76, lines 19-21, and p. 77, lines 1-2.

must also be present in his constant-growth DCF model. Interestingly, Mr. Hevert never proposes that the results from his own constant-growth DCF model be given any less weight as a result.

MULTI-STAGE DCF MODEL

Q. WHAT SPECIFIC ISSUES DOES MR. HEVERT RAISE REGARDING YOUR MULTI-STAGE DCF MODEL?

A. First, Mr. Hevert believes that my model fails to take into consideration the likely change in payout ratios during the forecasted period. Second, he believes that his "mid-year convention" should be applied to my model. Third, he believes that the terminal growth rate used in my DCF model is based on an incorrect assumption. Finally, he reiterates his position regarding the dividend-yield adjustment that I applied to both the constant-growth and multi-stage DCF models.

Q. IS IT NECESSARY TO TAKE INTO CONSIDERATION LIKELY CHANGES IN THE PAYOUT RATIO WHEN USING THE MULTI-STAGE DCF MODEL?

A. No. One of the assumptions of the multi-stage DCF model is that earnings and dividends will grow at the same rate.[16] Since both Mr. Hevert's and my multi-stage DCF models feature earnings growth rates, it is unnecessary to factor in changes in payout ratios. In

[16] Morin, Roger A. Regulatory Finance: Utilities' Cost of Capital. Arlington, Virginia: Public Utilities Reports, Inc., 1994. p. 149.

fact, as I have shown in my rebuttal testimony, the effect of increasing the payout ratios as Mr. Hevert proposes is to increase unjustifiably growth rates.[17]

Q. IS MR. HEVERT'S "MID-YEAR CONVENTION" AN APPROPRIATE ADJUSTMENT?

A. No. As I discussed in my rebuttal testimony, Mr. Hevert's "mid-year convention" is characterized by the forecasting of twelve months worth of dividends in a six-month period.[18] Mr. Hevert himself gives conflicting explanations as to why he uses a model that doubles the amount of dividends that should be received during a six-month period. In his rebuttal testimony, Mr. Hevert justifies the mid-year convention as follows:

> As discussed in my responses to Messrs. Murray and Gorman, utilities (including the proxy companies) pay dividends on a quarterly basis. Assuming that the entire dividend is paid at year-end unrealistically defers the timing of the quarterly cash flows (that is, the quarterly dividends), even though they are paid throughout the year. The mid-year convention, on the other hand, assumes that cash flows are received (on average) in the middle of the year, ***such that half the quarterly dividend payments are received prior to the assumed dividend payment date, and half are received after*** [emphasis added].[19]

Thus, the "mid-year convention" that Mr. Hevert proposes in his rebuttal testimony is supposedly a matter of cash-flow timing. However, when comparing how Mr. Hevert described this same "mid-year convention" in his surrebuttal testimony for Ameren Missouri case No. ER-2012-0166, there is a significant difference:

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[17] See Schafer Rebuttal, pp. 26-32.

[18] *Ibid.*, pp. 23-25.

[19] See Hevert Rebuttal, p. 79, lines 16-22.

> Consistent with the mid-year convention, my Multi-Stage DCF Model assumes that six months after the purchase of a stock, a shareholder will receive an annualized dividend payment that represents the quarterly dividends for the two quarters during which the shareholder has owned the stock, ***as well as the next two quarters***. The model discounts the first year's annualized dividend payment as if it had been received by the shareholder at mid-year. ***One year later, for calculation purposes, the model assumes that the shareholder receives another annualized dividend payment***, also in keeping with the mid-year convention [emphasis added].[20]

According to Mr. Hevert's 2012 surrebuttal testimony cited above, his "mid-year convention" adds two extra dividend payments that are *absolutely not* the result of a simple change in timing to account for cash flows occurring at mid-year.

Mr. Hevert may claim that the mid-year convention is appropriate, but his particular execution of that convention is consistent with what I have described in detail in my rebuttal testimony: Mr. Hevert's mid-year convention creates twelve months worth of dividend payments in a six-month period, thereby inflating the results of his multi-stage DCF model.[21] Therefore, Mr. Hevert's mid-year convention should certainly not be applied to my multi-stage DCF model.

Q. MR. HEVERT STATES THAT WHEN YOU DEVELOPED YOUR TERMINAL GROWTH RATE, YOU RELIED ON AN ARTICLE WHOSE ASSUMPTIONS WERE DIFFERENT THAN THE ASSUMPTIONS USED IN YOUR MULTI-STAGE DCF MODEL. IS THIS TRUE?

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[20] See Hevert Surrebuttal for Ameren Missouri case No. ER-2014-0166, p. 12, lines 17-21, and p. 13, lines 1-3.

[21] See Schafer Rebuttal, pp. 23-25.

A. I believe Mr. Hevert appropriately has pointed out that the number of years it takes for roughly 94% of the terminal value to be accounted for depends on each model's growth- and discount-rate assumptions.

Q. DOES THE PREMISE OF THE ARTICLE REMAIN TRUE?

A. Yes. Authors Rotkowski and Clough demonstrate that the terminal value calculation, which analysts regularly describe as extending in perpetuity, is in fact much more finite than the word "perpetuity" would suggest.[22] Owing to the time value of money, a cash flow that is forecast in the distant future will have much less impact on the terminal value than a cash flow that occurs relatively close to the beginning of the projection period.

Q. PLEASE GIVE AN EXAMPLE OF THE TIME VALUE OF MONEY'S EFFECT ON THE TERMINAL VALUE CALCULATION.

A. Mr. Hevert claims that extending the period on which my terminal value growth rate is based to the year 2125 covers only *half* of the time needed to realize the full value of the terminal value calculation.[23] Although Mr. Hevert has made this calculation based on my constant-growth DCF model, and not on the multi-stage DCF model to which the growth rate applies, he is approximately correct. However, what Mr. Hevert does not mention is the *value* of the cash flows from that second 100 years. Calculated with the assumptions used in my multi-stage DCF model (4.86% terminal growth rate and 9.01% discount

[22] See Rotkowki, Aaron & Clough, Evan (2013). "How to Estimate the Long-Term Growth Rate in the Discounted Cash Flow Method". *Insights*. Spring.

[23] See Hevert Rebuttal, p. 82, lines 10-13.

rate), the second 100 years of the terminal value calculation are only worth approximately $0.86 in present-value dollars. Considering that the average stock price of my proxy group is $42.97, the second 100 years is only worth approximately 2% of the stock's value based on the assumptions I used in my model.

Q. SHOULD YOU AVERAGE GROWTH RATES FROM THE ENTIRE 200-YEAR PERIOD TO DERIVE THE TERMINAL-VALUE GROWTH RATE?

A. I believe that would be unwise. The cash flows toward the beginning of the projection period have a much greater impact on the terminal value, so it is only natural to give more weight to the growth rates that correspond to that period. If I were simply to extend my growth-rate averaging period into the future, I would be disregarding the impact that the cash flows actually have on the model.

Q. IS THERE A STANDARD PERIOD OF TIME THAT ANALYSTS USE TO CALCULATE THE TERMINAL-VALUE GROWTH RATE?

A. No. However, since the terminal value calculation that Mr. Hevert and I have used is in fact the same calculation as the constant-growth DCF model, an analyst would not be incorrect in choosing to use the same period of time that he or she used for the constant-growth model—that is, generally a period of three to five years. The period of time I used—20 years—is in fact quite conservative and resulted in a more conservative (i.e., higher) estimate than those used by Mr. Gorman and Mr. Murray.

Q. MOVING ON, DOES MR. HEVERT RAISE ANY NEW CONCERNS WITH YOUR PROPOSED DIVIDEND YIELD ADJUSTMENT IN THE CONTEXT OF THE MULTI-STAGE DCF MODEL?

A. No, he does not.

CAPM ANALYSIS

Q. WHAT CONCERNS DOES MR. HEVERT HAVE WITH YOUR CAPM ANALYSIS?

A. First, he believes the results are not meaningful because they do not correspond to his list of recently authorized ROEs.[24] Since I have already addressed this issue, I will not repeat the argument here. Second, he believes that my estimates of the market risk premia (4.6% and 6.2%) are too low.

Q. WHY DOES MR. HEVERT BELIEVE THAT THE MARKET RISK PREMIA YOU USED ARE TOO LOW?

A. Mr. Hevert objects to my use of the geometric mean and my reliance on long-term bond *total returns* rather than *income returns*.[25]

Q. WHY DOES MR. HEVERT OBJECT TO THE GEOMETRIC MEAN?

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[24] See Hevert Rebuttal, p. 83, lines 11-16.

[25] *Ibid.*, p. 84, lines 1-10.

A. Mr. Hevert believes that only the arithmetic mean "assumes that each periodic return is an independent observation and, therefore, incorporates uncertainty into the calculation of the long-term average."[26] Furthermore, Mr. Hevert states "in any case, Morningstar (the source of Mr. Schafer's data) makes clear that the arithmetic mean is the appropriate measure for the purpose of the CAPM."[27] As I explained in my direct testimony, the assumption that the arithmetic mean represents independent observations is problematic.[28] Furthermore, the fact that Morningstar espouses one particular method does not diminish the multiplicity of opinions on this issue, nor is Morningstar's data somehow dependent on their opinion regarding which mean to use in the CAPM. My use of both the geometric and arithmetic means takes into account the wide variety of beliefs held by analysts who help shape investor opinion.

Q. MOVING ON, WHY DOES MR. HEVERT PREFER THE INCOME RETURN ON LONG TERMS BONDS RATHER THAN THE TOTAL RETURN?

A. To explain his preference, Mr. Hevert states:

> The income return is generally defined as the coupon, or interest rate on the security, which does not change over the life of the security. In contrast, the value of the security rises or falls as interest rates change, resulting in uncertain capital gains. As such, the income return is the only "riskless" component of the total return. Consequently, it is the income-only portion of the return, as opposed to the total return, that should be used in calculating the MRP [market risk premium].[29]

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[26] See Hevert Rebuttal, p. 84, lines 14-16.

[27] *Ibid.*, p. 84, line 20, and p. 85, lines 1-2.

[28] See Schafer Direct, pp. 31-34.

[29] See Hevert Rebuttal, p. 84, lines 5-10.

Q. CAN INVESTORS TAKE ADVANTAGE OF THE INCOME RETURN FROM A SECURITY WITHOUT ACTUALLY OWNING THE SECURITY?

A. No. In order to receive the coupon payments, investors must purchase the security. Logically, then, the total return represents the true return that investors have an opportunity to earn.

AMEREN MISSOURI'S CREDIT AND FINANCIAL RISK PROFILE

Q. ACCORDING TO MR. HEVERT, "MR. SCHAFER STATES THAT BECAUSE THOSE PRO FORMA CALCULATIONS FALL WITHIN THE BANDS ESTABLISED BY STANDARD & POOR'S FOR THE COMPANY'S CURRENT RATINGS, REDUCING THE ROE BY 79 BASIS POINTS (TO 9.01%) WOULD HAVE NO EFFECT ON AMEREN MISSOURI'S CREDIT PROFILE."[30] DID YOU SAY THAT?

A. No. I said the following:

> My recommendation, if enacted, should support Ameren Missouri's current rating. Although recreating a complete credit-rating report is beyond the scope of the present analysis, calculating key financial ratios for Ameren Missouri using my recommended return on equity and comparing them to Ameren Missouri's current credit rating will provide evidence that my recommendation supports the Company's current rating.[31]

Furthermore, I ended the discussion of each calculation with the following sentence: "Accordingly, my recommended ROE should support continuation of Ameren Missouri's

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30 See Hevert Rebuttal, p. 86, lines 16-19.

31 See Schafer Direct, p. 39, lines 3-7.

current credit rating and financial risk profile *using this measure* [emphasis added]."[32] However, when Mr. Hevert quotes my previous citation in his rebuttal testimony, he leaves off the last three words "using this measure,"[33] making it appear as if I intended to assess the entirety of Ameren Missouri's credit rating with two calculations. Clearly, I presented two calculations and considered the results of those calculations in the context of Ameren Missouri's current credit rating.

Q. DOES MR. HEVERT DISAGREE WITH THE RESULTS OF YOUR CALCULATIONS?

A. No. However, Mr. Hevert believes that "a wide range of ROE estimates produce coverage ratios associated with the Company's current rating."[34] When Mr. Hevert recreated my calculations, he found that an ROE as low as 7.05% produced ratios comparable to both my ROE estimate of 9.01% *and* to his estimate of 10.40%.[35] From this information, he concludes "although both fall within the same range, my recommended return provides stronger levels of coverage and, therefore, would provide investors with more confidence in the Company's ability to fund its fixed obligations."[36] Although I appreciate Mr. Hevert's concern for investor confidence, I believe that investor confidence should be balanced by the consideration of ratepayer interests. To the

[32] See Schafer Direct, p. 41 lines 11-13; See Schafer Direct, p. 43, lines 11-13.

[33] See Hevert Rebuttal, p. 86, lines 9-11.

[34] *Ibid.*, p. 87, lines 10-11.

[35] *Ibid.*, p. 87, lines 14-17.

[36] *Ibid.*, p. 87, lines 17-19.

extent that two ROEs fall into the same range of credit metrics, I don't believe the higher estimate should be given priority simply because it would provide "more confidence" to investors.

Q. MR. HEVERT STATES THAT YOUR RECOMMENDATION WOULD LIKELY AFFECT AMEREN MISSOURI'S CREDIT RATING BASED ON QUALITATIVE FACTORS USED BY STANDARD AND POOR'S TO ESTABLISH CREDIT RATINGS. WHAT FACTORS DOES HE CITE?

A. Mr. Hevert believes my recommendation would affect the following regulatory stability factors:[37]

- Transparency of the key components of the rate setting and how these are assessed;
- Predictability that lowers uncertainty for the utility and its stakeholders;
- Consistency in the regulatory framework over time.

Q. HOW DOES MR. HEVERT BELIEVE YOUR RECOMMENDATION WOULD AFFECT THE ABOVE-MENTIONED CRITERIA?

A. Mr. Hevert believes that my recommendation would not support Ameren Missouri's credit rating based on the criteria presented above. Mr Hevert states:

> Rather, it is more likely that the qualitative factors considered by S&P and Moody's would reflect the inconsistent and essentially unpredictable nature of such an outcome, and would put considerable downward pressure on the Company's credit rating and profile.[38]

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[37] Ibid., p. 88, lines 17-23.

[38] See Hevert Rebuttal, p. 89, lines 2-5.

Q. ON WHAT DOES MR. HEVERT'S OPINION RELY?

A. Mr. Hevert's opinion relies entirely on his subjective interpretation of the words "transparency," "predictability," and "consistency." The implication in his argument is that authorizing an ROE that is lower than the Company's current ROE would not provide a positive example of transparency, predictability, and consistency.

However, it is just as likely that analysts and investors would interpret the words "transparency", "predictability," and "consistency," quite differently from what Mr. Hevert implies. Were Ameren Missouri's authorized ROE not reflective of current economic conditions, analysts and investors would have little confidence in their abilities to assess their investment in Ameren Missouri. Investors would also question if the regulatory environment was robust enough to adapt to economic changes that necessitate either an increase or a decrease to the authorized ROE.

Transparency, predictability, and consistency are not obtained by authorizing an ROE that simply provides investors the same return they received in the past. Transparency, predictability, and consistency are components of an entire process used to establish an ROE, be it higher or lower than the current one.

SECTION 3: <u>RESPONSE TO MR. MURRAY'S REBUTTAL TESTIMONY</u>

Q. WHAT CONCERN DOES MR. MURRAY RAISE REGARDING YOUR ANALYSIS?

A. He believes that the adjustments I made to account for interest-rate risk do not accurately present the current cost of equity.[39]

Q. DO YOU GENERALLY AGREE WITH MR. MURRAY THAT THE CURRENT INTEREST RATE IS THE RATE THAT SHOULD BE USED IN FINANCIAL MODELS?

A. Yes. I address this issue in my direct testimony.[40]

Q. MR. MURRAY STATES THAT A FORECAST OF THE COST OF EQUITY IS A TYPE OF SPECULATION THAT HAS PROVED TO BE ERRONEOUS OVER THE LAST SEVERAL YEARS.[41] GIVEN THAT YOU GENERALLY AGREE WITH MR. MURRAY REGARDING FORECASTED INTEREST RATES, WHAT MAKES THE PRESENT SITUATION DIFFERENT?

A. As I explain in my direct testimony, the Federal Reserve's extraordinary Quantitative Easing program came to an end in October, and interest rates are expected to rise by mid-2015.[42] Although I understand Mr. Murray's reluctance to use forecasted interest rates, I believe that the amount of influence the Federal Reserve has on the market is significant enough that its present actions must be taken into consideration.

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[39] See Murray Rebuttal, p. 20, lines 2-10.

[40] See Schafer Direct, pp. 17-18.

[41] See Murray Rebuttal, p. 2, lines 7-8.

[42] See Schafer Direct, p. 17, lines 10-13.

Q. DO YOU AGREE WITH MR. MURRAY THAT RATE OF RETURN WITNESSES SHOULD PROVIDE CURRENT DATA FOR THE CONSIDERATION OF THE COMMISSION?

A. Yes. My final recommendation is based on the information that I believe is the most relevant to setting Ameren Missouri's return on common equity. However, in my direct testimony, I quantify the effect that using a forecasted rate has on the results of my models, and I present the results of my models with and without my adjustments for interest-rate risk.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.