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Issues: Capital Structure, S & P, Financial Ratio Guidelines and Credit Ratings
Witness: Lee R. Nickloy
Sponsoring Party: Union Electric Company
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Case No.: ER-2007-0002
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2007-0002

REBUTTAL TESTIMONY

OF

LEE R. NICKLOY

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

St. Louis, Missouri
January, 2007

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OF

LEE R. NICKLOY

CASE NO. ER-2007-0002

Q. Please state your name and business address.

A. My name is Lee R. Nickloy. My business address is One Ameren Plaza, 1901 Chouteau Avenue, St. Louis, Missouri 63166-6149.

Q. Are you the same Lee R. Nickloy that filed Direct Testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to 1) reiterate AmerenUE's recommended capital structure and costs of long-term debt, short-term debt and preferred stock in this proceeding and to address certain points in this regard made by other witnesses in their direct testimony; 2) address the use of S&P ratio guidelines in the context of utility ratemaking; and 3) make other points with respect to the credit ratings of AmerenUE.

I. CAPITAL STRUCTURE AND COSTS OF DEBT AND PREFERRED STOCK

Q. What capital structure does AmerenUE recommend for purposes of this proceeding?

A. As stated in my Supplemental Direct Testimony, as of June 30, 2006, the capital structure of AmerenUE consisted of 44.964% long-term debt, 0.795% short-term debt, 2.017% preferred stock and 52.224% common equity.

Q. What are the embedded costs of AmerenUE's long-term debt and preferred stock, and what is the cost of AmerenUE's short-term debt?

A. As of June 30, 2006, and as stated in my Supplemental Direct Testimony, AmerenUE's embedded cost of long-term debt was 5.473% and its embedded cost of preferred stock was 5.189%. For purposes of my Supplemental Direct Testimony, I used a current cost of short-term debt for AmerenUE of 5.360%.

Q. Missouri Public Service Commission Staff witness Mr. Steven G. Hill disagrees with your adjustment to AmerenUE's balance of common equity to remove the effects of AmerenUE's investment in its subsidiary, Union Electric Development Corporation ("UEDC"). Should the adjustment be disregarded as Mr. Hill proposes?

A. No, the adjustment should be included as originally recommended. The intent of the adjustment is to remove the effects of AmerenUE's investment in its wholly owned subsidiary, UEDC, from its balance of common equity. The rationale for this adjustment is similar to that for removing the effects of AmerenUE's investment in Electric Energy, Inc. ("EEI") from its balance of common equity, though it is useful to point out that, given AmerenUE owns 100% of its stock, UEDC is a consolidated subsidiary of AmerenUE whereas EEI is not, given AmerenUE only owns 40% of its stock. Though, when starting with a consolidated balance of common equity for AmerenUE, an adjustment needs to be made in either case. In the instance of UEDC, which had a negative balance of common equity at June 30, 2006, the amount of the negative common equity would be added to AmerenUE's consolidated balance of common equity to remove the effects of AmerenUE's investment in that company. Through consolidation of UEDC, AmerenUE's balance of common equity reflects this investment. The consolidating balance sheet provided in response to the data request Mr. Hill refers to in his direct testimony indicates balances of AmerenUE's common equity which reflect its investment in UEDC in each case – one balance on a fully consolidated basis, the other accounting for the investment on a non-consolidated basis (as would be the case for EEI) but nonetheless impacting AmerenUE's common equity balance.

Q. Office of the Public Counsel witness Mr. Charles W. King proposes that an adjustment should be made to AmerenUE's capital structure for double leverage. Is such an adjustment appropriate or necessary?

A. No adjustment should be made to AmerenUE's capital structure for double leverage because there is no double leverage present. Double leverage may exist if a parent company has made an equity investment in a subsidiary (such as by contributing to such subsidiary's equity capital) and used proceeds from the issuance of debt for that purpose. I would note that Mr. King's example of double leverage within the telecommunications industry is consistent with this description – i.e. the telephone parent companies issued debt which was subsequently infused as equity capital into the operating company.[1] Since the formation of Ameren Corporation ("Ameren") – the parent company of AmerenUE – in December 1997, Ameren has not issued debt and contributed to the equity capital of AmerenUE and thus there is no double-leverage in AmerenUE's capital structure. Ameren does make short-term loans to AmerenUE from time-to-time but these funds are reflected as debt on AmerenUE's books, not as equity. Ameren is a holding company for a number of other companies and thus its consolidated capitalization is a function or result of the

[1] For a discussion of recent regulatory decisions that have rejected the double leverage argument (including in the telecommunications industry discussed by Mr. King), see Dr. Vander Weide's Rebuttal Testimony.

capitalization of all of its subsidiaries. AmerenUE is capitalized independently of Ameren and of its affiliates.

II. USE OF S&P FINANCIAL RATIO GUIDELINES

Q. What is the stated purpose of the financial ratio guidelines published by S&P?

A. In its 2004 publication providing revised financial guidelines for U.S. utilities (*New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised*, published June 1, 2004), S&P stated that these financial guidelines represent three principal ratios that S&P uses as an "integral part" of evaluating the credit quality of U.S. utility and power companies.

Q. What is the significance of this statement?

A. Certainly these ratios are important; however it is also important that S&P is indicating that these measures are only a *part* of S&P's *evaluation*. So, clearly these measures do not constitute anything even close to the *entirety* of their analysis. Too, they are used as part of an *evaluation*, i.e. an analysis or assessment, of the credit quality of the subject entity. Taken together, this means the ratios are used in the context of an overall, comprehensive credit analysis including, as we know, both quantitative factors such as these and other ratios along with a variety of qualitative factors. This does not mean that simply by achieving one or more of these ratio guidelines for a given rating level that any given rating will automatically be assigned. It is also noteworthy that S&P has characterized these measures as "guidelines."

Q. In their direct testimony, Mr. Hill and Missouri Industrial Energy Consumers witness Mr. Michael Gorman support their return recommendations by

indicating their recommendations would support certain ratings for AmerenUE or possibly improve these. Is it appropriate to use S&P's published financial ratio guidelines as the basis for the reasonableness of a recommendation for a given cost of equity or weighted average cost of capital and determining a presumed ratings outcome?

A. No, it is not, for a number of reasons which would include the following:

1) Although financial ratios are important in any evaluation of an entity's credit quality, ratios alone do not define the analysis, especially if only considering a single ratio. In the S&P publication referenced above, S&P includes the following language immediately before and immediately after the table listing their ratio guidelines:

> "It is important to emphasize that these metrics are *only guidelines* associated with *expectations* for various rating levels. Although credit ratio analysis is an important part of the ratings process, these three statistics [FFO interest coverage, FFO/total debt, and debt/capital] are by no means the only critical financial measures that [S&P] uses in its analytical process." (Emphasis added.)

And,

> "Again, rating analysis is not driven solely by these financial ratios, nor has it ever been. In fact, [these revised financial guidelines] reinforce the analytical framework whereby other factors can outweigh the achievement of otherwise acceptable financial ratios." (Emphasis added.)

We simply cannot ignore what the rating agencies have said here – the ratio guidelines are not definitive in terms of the assignment of ratings.

2) The ratio guidelines principally at issue here are only those published by S&P. The S&P guidelines would not be instructive or helpful in attempting to presuppose any ratings assigned by Moody's based on a similar analysis.

3) The rating agencies are the arbiters of credit ratings. Any analysis performed by others in an attempt to support or assume a given rating can be dangerously misleading. This would be especially true given the qualitative factors which are important to the rating agencies at the time they are reviewing or assigning ratings. The specific factors, and the relative importance or weighting those factors receive in the rating agencies' analyses are known with certainty only by the agencies.

4) As part of their ratio analysis, the rating agencies typically make certain adjustments. Any ratio analysis must reflect such adjustments in the same manner as performed by the rating agencies.

5) For purposes of assigning ratings, the rating agencies use ratios for projected financial performance 1 ½ to 2 years in the future, not ratios for historical periods or on a pro-forma basis for an historical period as would be the case if performing a ratio analysis based on a rate-making test year.

Q. What are some of the shortcomings associated with the use of S&P's published financial ratio guidelines in the context of setting cost of service rates for regulated utilities?

A. First, rating agency ratio guidelines and traditional cost of service rate-making principles have different and distinct purposes, and the analyses done under each are accordingly different. One cannot be used as a substitute for the other. The cost of service elements in a given utility's revenue requirement/rates should be determined to be just and reasonable on their own merits and not because it could be argued that a certain rating should result. For example, would a 5% ROE become reasonable simply because some party was able to demonstrate that, if adopted, the ratings result would be still be investment grade based on an analysis of S&P's ratio guidelines? I'm not saying that such an analysis could indeed yield this result, I'm only pointing out the weakness in this approach.

Second, this approach naturally leads to a discussion of what is the "right" rating for a given utility. A utility's credit rating should be deemed "reasonable" for regulatory purposes if that rating is reasonably consistent with ratings of other similar utilities and enables the utility to reliably attract capital at reasonable cost among other factors. There may not be a singular correct answer here (i.e. such as A-/A3).

Third, the use of ratios alone bifurcates the analytical process by which the rating agencies assess credit quality and assign ratings. By focusing on ratios alone, critical qualitative factors used in the ratings process are ignored. For example, if a given regulatory commission were to accept an unreasonably low ROE recommendation, the rating agencies could likely view that regulatory environment as being much more risky and much less constructive thus placing negative pressure on the ratings for the utilities that do business there, increasing business profile scores, requiring the achievement of stronger financial ratios for a given rating, etc.

It is true that the S&P ratio guidelines are in some ways transparent and thus they can be quite alluring to an analyst because they so readily adapt themselves to a financial analysis attempting to demonstrate the reasonableness of a given proposal.

However, the underlying premise is flawed: the assumption that ratio analysis defines the credit ratings process. Such an analysis is obviously incomplete. Of course ratios are important, but they are not the entirety of the assessment of the credit quality of the subject entity.

III. AMERENUE'S RATINGS

Q. Has Ameren taken steps to isolate its Illinois utilities from the holding company and Ameren's other operating entities such as AmerenUE?

A. Yes, it has. But first, I should make it clear that each of Ameren's utilities has its own independent capital structure – i.e. each one of these companies issues its own long-term debt and preferred stock, and relies on its own common equity, to fund its own utility operations. The permanent capitalization of these companies is not used to finance the capital needs of any of its affiliates. Thus, the capital structures of these companies are separate from one another and separate from any other affiliates. Through the utility money pool, Ameren's utilities do have the ability to provide temporary short-term funding support to one another, however, given the risks Ameren's Illinois utilities are facing in that state, Ameren has taken steps to further separate AmerenUE from these utilities in this regard – in other words, a financial ring-fencing of AmerenUE from Ameren's Illinois utilities. Too, Ameren has stated that it would not support its Illinois utilities if these entities were unable to fully recover their costs. Specific steps Ameren has taken to financially separate the Illinois utilities include:

1) Arranging a separate $500 million credit facility for these and related borrowers.

2) Amending Ameren's $1.15 billion credit facility (which AmerenUE also relies upon for liquidity support) to exclude any default by one of Ameren's Illinois utility subsidiaries from causing a default under this facility.

3) Repayment in full of the intercompany note between CIPS (as obligor) and AmerenUE.

4) AmerenUE ceasing to being a lender to the utility money pool.

Q. In addition to Ameren's challenges in Illinois are the rating agencies also concerned about the outcome of AmerenUE's electric and gas rate cases in Missouri?

A. Yes, they are. In its December 8, 2006 Ameren Corporation Summary, S&P stated, "A responsive rate order from the Missouri Public Service Commission (MPSC) with regard to UE's pending electric rate case is also crucial to help sustain current credit quality."

Q. Does this conclude your Rebuttal Testimony?

A. Yes, it does.

**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 Rates for Electric Service Provided to Customers in the Company's Missouri Service Area.	)))))	Case No. ER-2007-0002

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. My business address is One Ameren Plaza, 1901 Chouteau Avenue, St. Louis, Missouri 63166-6149.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 9 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 30th day of January, 2007.

Carolyn J. Woodstock
Notary Public

My commission expires: May 19, 2008

CAROLYN J. WOODSTOCK
Notary Public - Notary Seal
STATE OF MISSOURI
Franklin County
Commission Expires: May 19, 2008