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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EC-2002-1

CROSS-SURREBUTTAL TESTIMONY

OF

DENNIS L. WEISMAN

ON

BEHALF OF

**UNION ELECTRIC COMPANY
d/b/a AmerenUE**

**St. Louis, Missouri
June, 2002**

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1 **CROSS-SURREBUTTAL TESTIMONY**

2 **OF**

3 **DENNIS L. WEISMAN, Ph.D**

4 **CASE NO. EC-2002-1**

5 **I. Introduction**

6 **Q. Please state your name and business address.**

7 A. My name is Dennis L. Weisman. My business address is Department of
8 Economics, Waters Halls, Kansas State University, Manhattan, KS 66506-4001.

9 **Q. Are you the same Dennis L. Weisman who previously filed rebuttal**
10 **testimony in this proceeding?**

11 A. Yes.

12 **Q. What is the purpose of your cross-surrebuttal testimony?**

13 A. The purpose of my testimony is to respond to various economic issues
14 raised in the testimony of Mr. Drazen on behalf of the Missouri Energy Group. These
15 issues are concerned primarily with prospective cost-control initiatives as discussed in
16 AmerenUE planning documents and the structure of the earnings sharing provisions in
17 AmerenUE's proposed Alternative Regulation Plan ("Alt Reg Plan").

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II. Incentive Regulation and Cost Control

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Q. Do you believe that Mr. Drazen is generally supportive of incentive regulation?

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A. Yes. Mr. Drazen states on page 3 of his testimony that “We agree with AmerenUE on the principle of a new Alt Reg Plan...” though he may quibble with some of the structural features of the plan. These structural issues are discussed in the next section. In fact, Mr. Drazen’s testimony provides further support that AmerenUE has responded to the incentives to control costs under the EARPs and that these efforts are continuing.

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Q. Mr. Drazen states on pages 8 of his testimony that some of the AmerenUE testimony suffers from a focus on the “here and now” and suggests further that expected costs should figure more prominently in the Commission’s deliberations as to reasonableness of the proposed Alt Reg Plan. Do you have any thoughts about Mr. Drazen’s observations?

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A. Yes. I have concerns regarding his suggestion that AmerenUE’s planning documents—that discuss certain prospective cost-control initiatives—should be accorded more weight in the Commission’s deliberations concerning incentive regulation generally and the Alt Reg Plan in particular. Indeed, there is the possibility, if not the likelihood, that this information could be used in a manner that will serve to (i) mislead the Commission with respect to AmerenUE’s future costs; and (ii) seriously undermine incentives for superior performance.

1 **Q. Please explain your concerns.**

2 A. My first concern relates to possible bias. Using cost projections for one
3 set of costs, which may or may not be declining, but not for other cost categories which
4 may be increasing, *e.g.*, transmission and distribution (see Drazen p. 6), could lead to an
5 understated projected cost-of-service. Second, even if certain planning documents
6 indicate that AmerenUE is attempting to control certain costs, such planning documents
7 often reflect highly ambitious targets that are achievable only under the best possible
8 circumstances. Finally, the incentive problems associated with the possible misuse of
9 this information are perhaps the most troubling of all and it is to a discussion of these
10 specific issues that I now turn.

11 The key to success with any incentive regulation plan is a credible
12 commitment on the part of the regulator to allow the regulated firm to retain some portion
13 of its efficiency gains. As discussed in my rebuttal testimony (pp. 68-69), a recent report
14 of the Missouri Energy Policy Task Force that was presented to Governor Bob Holden
15 recognizes this important principle. This underscores my primary concern with Mr.
16 Drazen's suggestion that the Commission place greater weight on certain projected future
17 costs in evaluating the reasonableness of the Alt Reg Plan. In point of fact, I would hope
18 we could agree that there is a "right way" and a "wrong way" to use such planning
19 information and the "right way" is as beneficial as the "wrong way" is detrimental.

20 The "right way" to use this information is to recognize that incentive
21 regulation, by way of the EARPs, has provided enhanced incentives for AmerenUE to
22 innovate and plan effectively in a continuing effort to reduce costs while maintaining
23 high levels of service quality and reliability. Dr. Lowry's rebuttal testimony attests to the

1 fact that AmerenUE has responded to these superior incentives by improving operating
2 efficiency on both an absolute level and relative to a benchmark group of firms. The
3 planning documents confirm that AmerenUE's efforts are ongoing in this regard. They
4 establish that incentive regulation is doing precisely what it is supposed to do—challenge
5 the firm to continually improve performance to the benefit of all key stakeholders.

6 The “wrong way” to use this information is as a mechanism to appropriate
7 the dollars that may be saved through the planned cost-control initiatives before the fact.
8 This penalizes AmerenUE for innovating and serves to discourage the very type of
9 behavior that sound incentive regulation should seek to encourage. In other words, it
10 upsets the critical balance of benefit sharing that is essential to any sound, incentive
11 regulation plan. Should these cost-control initiatives actually prove to be effective in
12 enhancing performance, customers will share in the realized efficiency gains through
13 consumer dividends.

14 **Q. You stated in your rebuttal testimony that regulation should seek to**
15 **emulate a competitive market outcome. Would the appropriation of the regulated**
16 **firm's expected cost savings be consistent with that objective?**

17 **A.** No, it most certainly would not. In fact, it would represent the antithesis
18 of how competitive markets work. A firm in a competitive market that innovates and
19 discovers a new way to reduce costs would not instantaneously reduce prices to reflect
20 realized (much less prospective) cost savings. It is precisely due to the fact that the price
21 adjustment lags behind the innovation that serves to reward the competitive firm's
22 successful innovation. As other firms across the industry adopt this cost-reducing
23 innovation, prices will gradually fall to reflect the realized decline in costs. This is the

1 manner in which competitive markets reward superior performance (respectively,
2 penalize inferior performance) and preserve socially-desirable incentives for innovation.
3 It is also why the government awards patents and copyrights. Consequently, if the
4 Commission were to appropriate the gains from prospective innovations and immediately
5 pass them on to consumers in the form of lower rates, it would not be emulating a
6 competitive market outcome, but destroying incentives to innovate.

7 **Q. How will consumers benefit from preserving AmerenUE's incentives**
8 **to innovate?**

9 A. AmerenUE's proposed Alt Reg Plan calls for "guaranteed rate stability" in
10 that rates will be frozen for three years. This is equivalent to AmerenUE guaranteeing
11 consumers real (inflation-adjusted) rate reductions of approximately 2 to 3 percent per
12 year, *i.e.*, the expected rate of inflation. It is AmerenUE's aggressive cost-control
13 initiatives and planning processes that make the deferral of actual rate increases possible
14 and, in fact, enable AmerenUE to bear the considerable risk associated with a rate freeze.
15 This is significant because the Alt Reg Plan would represent AmerenUE's third round of
16 incentive regulation and it is generally recognized that additional cost efficiencies
17 become increasingly more difficult to achieve. (Recall that cost efficiencies have, in part,
18 been systematically passed on to consumers in the form of permanent rate reductions.)
19 Continuing with this practice, the Alt Reg Plan proposes a permanent rate reduction of
20 \$15 million, a one-time credit of \$15 million, and \$10 million in initial funding of low
21 income customer assistance and economic development programs. Should AmerenUE's
22 innovation and cost-control initiatives result in returns of at least 10.5%, an additional
23 \$17 million in performance dividends to consumers is triggered. This provides

1 consumers with more than \$120 million in expected benefits over the plan's three-year
2 term. Consumers benefit further still through the additional sharing of returns above
3 12.5%. It is, of course, important to keep these rate reductions and credits in proper
4 perspective as AmerenUE's customers already receive high quality, reliable service at
5 some of the lowest rates of any metropolitan area in the country. Hence, in terms of a
6 "competitive" benchmark, AmerenUE's customers have fared well under the EARPs and
7 would continue to fare well under the proposed Alt Reg Plan.

8 **III. Structure of Earnings Sharing**

9 **Q. What does Mr. Drazen propose regarding the structure of earnings**
10 **sharing in the incentive regulation plan for AmerenUE?**

11 A. Mr. Drazen proposes a so-called "progressive to the utility" earnings
12 sharing approach in which the utility retains an increasingly larger share of earnings as its
13 return on equity increases. This approach is sometimes referred to as a "reverse-taper"
14 because consumers retain a smaller share of earnings as the level of the utility's earnings
15 increase.

16 **Q. Do you agree with Mr. Drazen's characterization of AmerenUE's**
17 **proposed Alternative Regulation Plan as one that incorporates a "progressive to the**
18 **consumer" approach to earnings sharing?**

19 A. Not entirely. Mr. Drazen's expressed concern with a "progressive to the
20 consumer" approach is that the "easy savings come first and there should be greater
21 incentives for the Company to push harder and harder." In point of fact, the structure of
22 AmerenUE's proposed Alternative Regulation Plan calls for a \$17 million performance
23 dividend to customers if its return on equity reaches 10.5%. This is in addition to the up-

1 front benefits discussed above—guaranteed rate stability (real rate reductions) for 3
2 years, a permanent rate decrease of \$15 million, a one-time credit of \$15 million, and \$10
3 million of initial funding for certain customer benefit programs. Hence, it is not accurate
4 for Mr. Drazen to claim that AmerenUE is pocketing the “easy savings” and sharing with
5 consumers the less likely future gains from incentive regulation. To the contrary, I
6 believe that AmerenUE’s Alt Reg Plan is structured so as to provide significant up-front
7 benefits to consumers while enabling consumers to participate as quasi-shareowners
8 through additional performance dividends for returns in excess of 12.5%.

9 **Q. How do you respond to Mr. Drazen’s claim that this “progressive to**
10 **the utility” structure can provide stronger incentives for performance on the part of**
11 **the utility?**

12 **A.** As a theoretical matter, I do not take exception to Mr. Drazen’s claim.
13 The incentive properties of his preferred approach may well dominate a “progressive to
14 the consumer” approach if (1) there is a high probability that the utility can actually reach
15 the level of returns at which it retains a larger share of earnings; and (2) the regulator’s
16 commitment to the terms and conditions of the incentive regulation plan (*e.g.*, actually
17 allowing a utility to earn in the range where it retains a larger share of earnings) is a
18 credible one.¹ That said, should it be the case that the utility is unlikely to reach these
19 higher return-on-equity bands (*i.e.*, it is likely to remain in the “high-tax” earning bands),
20 or there is uncertainty surrounding the regulator’s commitment to the terms and

¹ These superior incentive properties derive from the fact that the firm will look upon the initial earnings shared with customers as essentially a “lump sum” tax and hence non-distortionary. A “lump sum” tax is a tax in which the amount paid is independent of the economic agent’s behavior or performance. As a result, a lump-sum tax does not influence the economic agent’s performance.

1 conditions of the incentive regulation plan,² these superior incentive properties will not
2 be present.

3 **Q. Could you please elaborate on this point with an example?**

4 **A.** Yes. Mr. Drazen proposes, for instance, that the utility retain only 20% of
5 incremental earnings for a return on equity between 12.5% and 15.0%. This means that
6 for each additional dollar of cost savings within this range, 80 cents are returned to
7 consumers and 20 cents are retained by the utility. If there is a high probability that,
8 despite very high effort on the part of the utility, returns will not reach beyond 15.0%, the
9 incentives provided by this approach are quite poor and would likely even be worse than

² As discussed at length in my rebuttal testimony, a strong regulatory commitment is the *sine qua non* for the performance of incentive regulation. In order to ensure that all stakeholders benefit from incentive regulation, the regulated firm must have confidence that the regulator will honor its commitment to the terms and conditions of the incentive regulation plan. The ability of this Commission to even make such a commitment upon which anyone can reasonably rely has been thrown into doubt due to a recent court decision involving earnings sharing under the EARP [*Union Electric Co. v. Public Service Comm'n*, Case Nos. 00CV323273 & 00CV323608 (Cole Co. May 17, 2002).] The implications of this decision for the current case are two-fold. First, if the law in Missouri is that the Commission has no legally-binding obligation to honor its commitment to the utility under incentive regulation, as the Circuit Court held, then no rational utility would ever seriously consider incentive regulation as an alternative to traditional regulation as it is virtually guaranteed an inferior outcome. In the "good" state of the world in which the utility's superior efforts lead to solid earnings, those earnings can presumably be taken away from the utility at the regulator's whim. In the "bad" state of the world in which the utility's earnings are deficient, the utility would presumably have little or no recourse to increase rates. What this strongly suggests is that, in order to realize the benefits of incentive regulation, the Commission that concludes that incentive regulation is sound policy must now take additional, affirmative steps to bolster its commitment to incentive regulation in a manner that the utility would find to be credible. Second, the Staff has indicated that it "views EARPs as a form of continuous revenue requirement scrutiny." (Weisman Rebuttal, p. 66, footnote 72, referencing page 14 of the Staff Report on the EARPs.) Staff's position is fundamentally at odds with the principles of incentive regulation for it is at war with any notion of a real commitment to an incentive plan. It is that point of view that the Staff advocated before the Circuit Court, and, unfortunately, it seems to have found a sympathetic ear there. That decision has been appealed, and whether the Staff's/Circuit Court's perspective will actually be the law in Missouri remains to be seen. Either way, the Court's decision cannot magically transform "bad economics" into good public policy. Either the Commission is committed to the principles of incentive regulation, or it is not. If it is the former, then it must take the opportunity that presents itself in this case to commit itself to the principles of incentive regulation in a manner that is able to withstand future legal challenge. In other words, the Commission must treat an agreed-upon incentive plan as a genuine obligation that the Commission wants to honor.

1 the incentives under traditional, rate-of-return regulation. This observation is particularly
2 important in light of the fact that the Alt Reg Plan would represent AmerenUE's third
3 round of incentive regulation and additional cost efficiencies become increasingly more
4 difficult to achieve.

5 **Q. What concerns do you have about the commitment problems**
6 **associated with a "progressive to the utility" approach?**

7 A. One of my concerns is expressed on page 25 of Mr. Drazen's own
8 testimony when he states that "this approach does not put a cap on the return on equity
9 that the utility can earn..." Earnings sharing serves a number of different purposes in an
10 incentive regulation plan and prominent among them is to ensure that earnings do not rise
11 to levels that may be considered "excessive" and hence politically-unpalatable. A
12 "progressive-to-the utility" approach does not score high on this dimension.

13 As discussed above, AmerenUE's proposed Alt Reg Plan calls for
14 consumers to receive an increasing share of incremental earnings for returns in excess of
15 12.5%. The "progressive to the consumer" structure that is triggered at this level of
16 returns reflects the importance of recognizing (i) that unbounded levels of earnings are
17 likely to undermine public support for the alternative regulation plan and hence weaken
18 the regulatory commitment; and (ii) that earnings that reach "inordinately high levels" are
19 more likely due to parameters of the incentive regulation plan that have not been
20 calibrated correctly or that reflect exogenous, beneficial events rather than high effort or
21 superior business acumen on the part of the utility. In reflecting upon these various
22 issues, I observed that

23 Concerns about adverse public reaction may explain why earnings-sharing
24 plans typically promise the firm decreasing, rather than increasing,

1 marginal rewards for cost reductions. A plan that provides the firm with
2 an increasing share of incremental earnings the higher the firm's earnings
3 may strike some observers as enriching the firm unduly despite its
4 attractive incentive properties. The possibility that substantial
5 technological change that is largely beyond the firm's control may be the
6 primary cause of exceptionally high earnings may also help explain the
7 prevalence of earnings-sharing plans in which the firm retains a smaller
8 fraction of incremental earnings the larger its realized earnings.³
9

10 It follows that a utility that is able to reach the high return-on-equity bands in which it
11 retains a larger share of earnings may reasonably question whether such performance
12 would undermine public support for the continuation of the incentive regulation plan.

13 **Q. Is there a self-correcting property to the structure of earnings sharing**
14 **in AmerenUE's proposed Alt Reg Plan?**

15 A. Yes. A "progressive to the customer" structure to earnings sharing as
16 proposed by AmerenUE provides a self-correcting mechanism to avoid extreme and
17 hence politically-unpalatable outcomes. This self-correcting feature of earnings sharing
18 is largely absent under the "progressive to the utility" structure of earnings sharing. This
19 is an important attribute of AmerenUE's proposed Alt Reg Plan.

20 **Q. Do you have other concerns with the "progressive to the utility"**
21 **approach to earnings sharing as proposed by Mr. Drazen?**

22 A. Yes. I question whether the structure of earnings sharing favored by Mr.
23 Drazen will engender the same support for incentive regulation as that offered by
24 AmerenUE's Alt Reg Plan. As I stated in my rebuttal testimony,

25 An important attribute of earnings sharing regulation is that it fosters a
26 coincidence of financial fortunes for the regulated firm and its customers.
27 Customers benefit financially under earnings sharing plans precisely when
28 the regulated firm does. Consequently, earnings sharing plans help make

³ David E. M. Sappington and Dennis L. Weisman, *Designing Incentive Regulation for the Telecommunications Industry*. The MIT Press: Cambridge MA., 1996, p. 142.

1 clear the fact that all parties can benefit simultaneously under incentive
2 regulation. Recognition of this fact can help generate support for
3 incentive regulation, and thereby promote its longevity.⁴
4

5 In other words, the dollars that may be shared with consumers under
6 earnings sharing represent a dividend for superior performance. This coincidence of
7 financial fortunes is not present to the same degree under the “progressive to the utility”
8 structure that it is under the more typical earnings sharing regimes. What the
9 “progressive to the utility” approach does is to direct the utility to make dividend
10 payments to consumers first and then, if there is anything left, allow the utility to retain a
11 larger share of any incremental earnings. This aspect of the “progressive to the utility”
12 structure has the potential to undermine the commitment for the incentive regulation plan
13 because the dividend allocations are, in essence, more “sequential” rather than
14 “simultaneous” in nature. In other words, it can give rise to the sentiment on the part of
15 consumers and their representatives that essentially says “I know that you shared with us
16 the larger share of earnings at lower levels of return on equity, but what have you done
17 for us lately?” An important attribute of the earnings sharing structure proposed by
18 AmerenUE in its Alt Reg Plan is that, for returns in excess of 12.5%, consumers benefit
19 precisely when AmerenUE benefits—not before and not after. This attribute of the
20 earnings sharing structure helps the regulator’s constituency to understand the benefits of
21 earnings sharing and thereby reinforces the regulator’s commitment to the terms and
22 conditions of the incentive regulation plan itself.

⁴ David E. M. Sappington and Dennis L. Weisman, “Seven Myths About Incentive Regulation,” In *Pricing and Regulatory Innovations Under Increasing Competition and Other Essays*, ed. by Michael A. Crew, Boston: Kluwer Academic Publishers, 1996, p. 14.

1 Q. How common are “progressive to the utility” earnings sharing plans?

A. Some states, such as California, have experimented with such plans, but these plans tend to be the exception rather than the rule. For example, in the telecommunications industry, I am aware of relatively few cases in which the “progressive to the utility” structure for earnings sharing was incorporated into an incentive regulation plan. These observations suggest that the structure of earnings sharing in the Alt Reg Plan proposed by AmerenUE is more typical of the vast majority of incentive regulation plans in the telecommunications and electric power industries in comparison with the “progressive to the utility” approach favored by Mr. Drazen.

11 **IV. Summary and Conclusion**

12 **Q. Please summarize your testimony.**

13 A. Mr. Drazen is generally supportive of incentive regulation and his
14 testimony provides further evidence that AmerenUE has been successful in controlling
15 costs over the course of the EARPs. The issues in question, therefore, center primarily on
16 the appropriate calibration of the successor incentive regulation plan and the structure of
17 earnings sharing in the incentive regulation plan.

18 A sound, incentive regulation plan must maintain a critical balance. It
19 must challenge the firm to perform at a superior level while sharing benefits with key
20 stakeholders in an equitable, visible and forthright manner. Mr. Drazen's suggestion that
21 certain prospective cost-control initiatives discussed in AmerenUE's planning documents
22 be accorded greater weight in the Commission's deliberations regarding the Alt Reg Plan

1 has the potential to upset the critical balance of benefit sharing that makes incentive
2 regulation work. These cost-control initiatives should be viewed by the Commission in
3 the proper light—as evidence that AmerenUE has responded to enhanced incentives for
4 performance under the EARPs (and the expectation of a successor incentive regulation
5 plan) by innovating and continuing to search for new and better ways to improve
6 operating efficiency.

7 AmerenUE’s proposed Alt Reg Plan calls for significant up-front benefits
8 in the form of guaranteed rate stability (real price reductions), a one-time credit of \$15
9 million, a permanent rate reduction of \$15 million, and an initial \$10 million funding of
10 certain customer benefit programs. An additional credit of \$17 million is triggered when
11 a return of 10.5% is realized. This amounts to more than \$120 million in expected
12 benefits over the plan’s three-year term. For returns above 12.5%, AmerenUE’s Alt Reg
13 Plan calls for consumers to receive additional, and progressively larger shares of
14 incremental earnings. This “progressive to the customer” approach is typical of
15 incentive regulation plans that incorporate earnings sharing. Mr. Drazen proposes a
16 “progressive to the utility” sharing structure and contends that it would give rise to
17 superior incentive properties. As a theoretical matter, this claim may well be true in
18 certain cases. As a practical matter, however, there are serious drawbacks to this
19 approach that tend to argue against its adoption—prominent among these are the
20 weakened regulatory commitment and the prospect that, despite its best efforts, the utility
21 will never be able to reach the sharing bands associated with these higher returns.
22 Perhaps because of these drawbacks, the earnings sharing structure proposed by Mr.

1 Drazen is not common in either the telecommunications or the electric power industries
2 and should not be adopted by this Commission.

3 **Q. Does this conclude your testimony?**

4 **A. Yes.**

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

The Staff of the Missouri Public Service
Commission,

Complainant,

vs.

Union Electric Company, d/b/a
AmerenUE,

Respondent.

Case No. EC-2002-1

AFFIDAVIT OF DENNIS L. WEISMAN, Ph.D

STATE OF KANSAS

CITY OF MANHATTAN

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) ss
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Dennis L. Weisman, being first duly sworn on his oath, states:

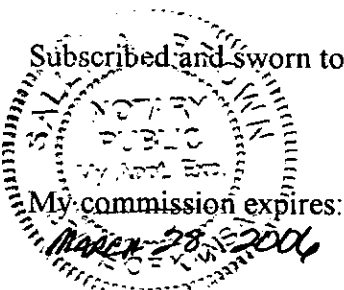
1. My name is Dennis L. Weisman, Ph.D. I work in Manhattan, KS and I am employed by Kansas State University as a Professor of Economics.

2. Attached hereto and made a part hereof for all purposes is my Cross-Surrebuttal Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 14 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.

Dennis L. Weisman
Dennis L. Weisman, Ph.D

Subscribed and sworn to before me this 14th day of June, 2002.



Sally A. Brown
Notary Public