Exhibit No.:
Issues: Case Overview; Summary of Company Positions; Financial Impact Of and Problems With the Staff's Proposal; UE's Proposed New Alternative Regulation Plan
Witness: Warner L. Baxter
Sponsoring Party: Union Electric
Type of Exhibit: Rebuttal Testimony
Case No.: EC-2002-1
Date Testimony Prepared: May 10, 2002

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EC-2002-1

REBUTTAL TESTIMONY

OF

WARNER L. BAXTER

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

Exhibit No. 123 N.P
Date 7/11/02 Case No. EC-2002-1
Reporter JL

**** DENOTES PROPRIETARY INFORMATION ****

St. Louis, Missouri
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REBUTTAL TESTIMONY
OF
WARNER L. BAXTER

CASE NO. EC-2002-1

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Warner L. Baxter. My business address is One Ameren Plaza, 1901 Chouteau Avenue, St. Louis, Missouri, 63103.

Q. By whom and in what capacity are you employed?

A. I am employed by Ameren Corporation (Ameren) as Senior Vice President of Finance for Ameren, Union Electric Company (UE), and Central Illinois Public Service Company (CIPS).

Q. Please describe your educational background and work experience.

A. I graduated from the University of Missouri–St. Louis in 1983 with a Bachelor of Science degree with a major in Accounting. I am a licensed Certified Public Accountant in the state of Missouri and a member of the American Institute of Certified Public Accountants and the Missouri Society of Certified Public Accountants.

In September 2001, I was promoted to my current position and named, Senior Vice President, Finance, and Chief Financial Officer. I have been with the Company since 1995. First as the Assistant Controller at Union Electric, then in 1996 as the Controller of Union Electric, and as Vice President and Controller of Ameren starting in May 1998. Since I joined the Company in 1995, I have played a major role in the development of operational and financial strategies. I was also a key member of the

Company team that negotiated UE's second Experimental Alternative Regulation Plan ("EARP").

Prior to my employment at Ameren, I was employed by Price Waterhouse LLP (now PriceWaterhouseCoopers LLP) as Senior Manager in the company's St. Louis and New York City offices. My principal responsibilities at Price Waterhouse included supervising audit and consulting services to clients in the public utility industry (including Union Electric) and manufacturing industries, among others. I also developed Price Waterhouse's financial statement disclosure and content guide for public utilities and authored various sections of Price Waterhouse's annual Survey of Financial Reporting and Industry Developments for the public utility industry. I was a member of Price Waterhouse's National Public Utilities Industry Services Group and their Accounting and SEC Services Department.

I am also a former Chairman of the executive committee of the chief accounting officers of Edison Electric Institute member companies and currently serve as Vice President of the Chancellor's Council and a member of the Dean's Advisory Board of the University of Missouri–St. Louis.

Q. Please describe your duties in your current position.

A. My responsibilities include the oversight of the financial, accounting and regulatory functions of Ameren, as well as the treasury, tax, risk management, internal audit and budget and corporate modeling functions of the Company. In this role, I also act as the primary company spokesperson in communications with the financial community, including financial analysts and credit rating agency analysts.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to: (1) discuss the Staff's rate recommendation from a broader Company, industry, and public policy perspective; (2) summarize the benefits our customers and other stakeholders receive from the low rates, the reliable service, and the superior performance that UE achieved under alternative regulation; (3) discuss the ramifications that the implementation of the Staff's proposal would have on the Company and its ability to make needed infrastructure investments and provide reliable service at reasonable rates; (4) summarize UE's specific areas of disagreement with the Staff's cost of service presentation; (5) present an overview of the Company's cost of service filing; and (6), building on the experience of the Company's preceding EARPs, present the proposed new Alternative Regulation Plan ("Alt Reg Plan") for the Commission's consideration.

Q. Please summarize your testimony and conclusions.

A. The significance of this case to energy policy and sound regulation in Missouri cannot be overstated. Sound energy policy and regulation is critically important in today's energy market to create the reliable energy infrastructure so necessary to maintain favorable economic conditions in the State. Whatever the Commission decides in this case will undoubtedly become a foundation for energy policy in Missouri. After all, UE is the largest energy provider in the State, and the Staff's proposed rate decrease is the largest in the Company's history and, to the best of my knowledge, the largest in the Commission's history of electric complaint cases.

As the Commission begins to consider this enormous rate cut, it would do well to remember that the target of the Staff's complaint (i.e., UE) is not a bloated, inefficient company burdening its customers with high rates. Rather, UE has reduced rates four times since 1987, providing customers with more than $1 billion in rate reduction benefits. More importantly, in the last 6 years, the Company operated under the EARPs in Missouri, as a result of which: (1) UE's customers now enjoy some of the lowest rates and best customer service in the country; (2) the Company has the flexibility and financial strength to make infrastructure investments and operate more effectively and efficiently; while, at the same time, (3) the Company's efficient operations provide investors with a solid return on investment. This experience also shows that UE has worked well with this Commission in the past to create a forward-looking, reasonable, and innovative regulatory framework that created significant benefits for all stakeholders.

Such innovative approaches to the State's energy and regulatory policy are even more imperative now, because utilities must operate in an increasingly complex, and volatile industry environment. Simultaneously utilities must respond to increased customer demands in terms of usage and reliability. UE faces the need to make very significant infrastructure investments over the next 5 years in order to continue to support our customers' power demands and provide reliable, high-quality service.

Despite all these important facts and considerations, the Staff has made a recommendation to cut UE's Missouri annual electric revenues by between $245 million to $285 million, or by approximately 13% to 15%. This recommendation does not employ sound cost of service methodologies, does not provide an adequate return on and recovery of investment, and is technically flawed in numerous other respects—virtually all of which serve to effectively disallow appropriate recovery of the Company's true costs that it incurs today and, as important, those costs it expects to continue to incur in the future.

As I step back and look at what this Company has achieved with its successes of the past six years and the benefits which all stakeholders have enjoyed, the Staff's position and recommendation simply do not make any sense.

Q. Please explain further why the Staff's position does not make sense to you.

A. In what is a very complex case, I believe that the fundamental reasons why the Staff's position does not make sense can be summed up in a fairly straightforward fashion.

- Our rates have been decreasing for 15 years despite increasing costs and customer demands. Today, UE's effective electric rates are among the lowest in the county, region and in the state—especially in light of the fact that we serve a major metropolitan area where costs to serve customers are greater than in smaller urban and more rural areas.
- Since 1995 alone (the year the EARP began), UE's customers have been provided with over $425 million in benefits in the form of rate reductions and sharing credits.
- UE's customer satisfaction is high and ranked among the best in the country based on a recent University of Michigan study. This is no coincidence. Infrastructure investments in our system, tree trimming, investment in automated meter reading and outage analysis have made the delivery of

electricity to our customers more reliable and have enhanced our ability to serve our customers more effectively.

- Rising customer demands and maintaining high levels of reliability require significant energy infrastructure investment over the next five years.
- These infrastructure investments require strong cash flows and ready access to the capital markets. The EARP regulatory framework facilitated both.
- UE took its operations to new heights and productivity markedly improved during the EARP. As a result, customers have benefited and our investors were rewarded with solid returns on equity.
- UE is a financially sound utility—not by luck or coincidence, but by the formidable efforts taken under a sound regulatory framework that took a long term view towards sound energy policy and was based on a partnership between this Commission, the Company, and our customers.

As I look at these successes, documenting a clear win-win scenario for all stakeholders, I simply cannot understand the Staff's punitive $245 million to $285 million rate reduction recommendation and its willingness to abandon the farsighted EARP framework, in favor of the traditional regulatory model. As our recent annual meeting made clear, I am not alone in my failure to understand the Staff's rate proposal in light of these facts. The *St. Louis Post-Dispatch* article attached as Schedule 2 to my testimony documents this from the perspective of one of our shareholders *and* customers.

Q. What would be the ramifications of Staff's proposal?

A. The Staff's proposed rates would significantly curtail the Company's cash flows, sharply lower UE's credit rating, drive both financing requirements and financing costs higher, limit our access to capital markets, impair our ability to make necessary infrastructure investments timely and efficiently, and ultimately harm our customers and the State as a whole. In addition to seriously damaging the financial integrity of UE, it would also severely punish our investors, many of whom are Missouri residents.

Q. What is the Company proposing in place of Staff's recommendation?

A. Based on the success of the past 6 years, UE now proposes for the Commission's approval a new Alternative Regulation Plan ("Alt Reg Plan") which will take our partnership with the Commission and all of our stakeholders to the next level. Over its 3 year term, this Alt Reg Plan will provide, for all practical purposes, a minimum of $120 million in customer benefits from its rate reduction, customer credits, and the funding of low income customer assistance and economic development programs. The proposed plan also includes a substantial infrastructure investment commitment, a revised sharing grid, monitoring of service quality, greatly accelerated payment of customer credits, the payment of interest on any delayed credits, and various features that will substantially reduce the potential for disputes during the operation of the new plan.

However, if the Commission should decide to set UE's Missouri rates under a traditional regulatory model, those rates need to be based on a correct, fair, and reasonable determination of the Company's cost of service. We have carefully determined UE's Missouri electric retail cost of service and, as presented in this filing, find, with one exception I will discuss below, that it would justify a rate <u>increase</u> of $148 million under the traditional regulatory framework. This is in stark contrast to Staff's proposal and highlights the inherent unreasonableness of Staff's cost of service recommendation.

I sincerely believe, however, that a continuation of alternative regulation is the preferable solution. The plan presented later in my testimony is fair and equitable for all stakeholders. Therefore, I strongly recommend that the Commission approve UE's proposed Alt Reg Plan.

Q. Given that perspective, how does UE propose to present its case?

A. Well, because this case was initiated by the Staff in a rate reduction complaint, the Staff has the burden of proof here, which it may fail to meet even if UE presented no rebuttal. However, we have marshaled a very thorough rebuttal, through a variety of witnesses, both from within UE and from outside the Company. For the Commission's convenience, we have had each of our witnesses prepare an Executive Summary of his or her testimony, which is included as an appendix to, and is a part of, each witness's testimony. In addition, all the Executive Summaries have been collected in a binder, copies of which have been submitted to the Commission. The Table of Contents to that binder lists all our witnesses, along with the topics about which they will testify.

At the outset, though, I want to emphasize that, in addition to offering testimony on the technical details common to any rate case, we have assembled a body of experts to help the Commission address the broader variety of issues that must be confronted in a case of this seriousness and significance. These experts include Professor Roger Morin, an eminent scholar of regulatory finance, whose classic work, Utilities'

Cost of Capital, is acknowledged as an authoritative treatise even by the Staff. Dr. Morin will address the profound flaws in the unique methodology the Staff has used to generate a cost of equity estimate. In so doing, Dr. Morin will bring to your attention how far out of the mainstream of finance theory and practice the Staff's analyses have fallen, with troubling implications for the long-term energy policies for which the Commission is responsible.

Dr. Peter Fox-Penner is a distinguished economist, who has worked both in distinguished posts in the government and in the private sector. Most recently, in the Clinton Administration, Dr. Fox-Penner worked on energy policy issues as a Senior Advisor in the White House Office of Science and Technology Policy and as a Special Assistant to the Deputy Secretary of Energy. He will address how developments in the economic and regulatory conditions of the electric industry generally and in the Midwest in particular, bear on the issues before you in this case.

Professor Dennis Weisman, a scholar specializing in strategic behavior and government regulation, with an emphasis on incentive regulation, is already known to the Commission, having discussed incentive regulation issues at the Commission's Electric Roundtable Discussion Group on December 17, 2001. Dr. Weisman will explain the evolution and economic benefits of incentive regulation, respond to issues raised by the Staff concerning the EARPs, and discuss our proposed Alt Reg Plan.

Mr. Steven Fetter, a former Chair of the Michigan Public Service Commission and Managing Director at the Fitch credit rating agency, will address regulatory policy matters and the serious financial ramifications which would flow from Staff's proposal.

Finally, Ms. Suedeen Kelly, currently a Professor of Law at the University of New Mexico School of Law, and formerly the Chair of the New Mexico Public Service Commission and a Fellow with the US Senate Energy and Natural Resources Committee (chaired by Senator Jeff Bingaman), will address the serious legal and policy implications of the Staff's case. In her testimony, Ms. Kelly will draw upon, not only her substantial legal expertise in these matters, but on her practical experience as a former commissioner.

Though we have assembled these witnesses in rebuttal to support our perspective on this case, we offer them well aware of the important policy threshold regarding Missouri's energy future on which we now stand. It is our hope that this Commission will draw upon these resources, engage these experts in a productive dialogue, and find the decision-making in this case illuminated by their insights.

Q. How have you organized the remainder of your testimony?

A. <u>Section III</u> discusses in more detail the Company and industry context within which Staff's rate complaint needs to be assessed—these important considerations are notably absent in Staff's filing. <u>Section IV</u> summarizes evidence documenting that UE's customers currently realize significant benefits from low rates and superior performance achieved under alternative regulation. <u>Section V</u> discusses the implications of Staff's financially punitive rate proposal on the Company's investors and its ability to finance infrastructure investment requirements. <u>Section VI</u> then summarizes the Company's rebuttal of Staff's cost of service filing and highlights certain areas where the Staff has failed to employ sound regulatory policy and cost of service methodologies in their determination of UE-Missouri's retail electric cost of service (to which I will refer simply as the Company's "cost of service"). Section VII of my testimony summarizes the Company's affirmative cost of service presentation. And finally, Section VIII introduces the Company's proposed new Alt Reg Plan and discusses the benefits that alternative regulation plans, both the proposed new and the preceding plans, offer over traditional cost of service regulation in Missouri.

III. COMPANY AND INDUSTRY CONTEXT

A. AMEREN'S PERSPECTIVE ON STAFF'S RATE COMPLAINT

Q. What is the Company's overall perspective on the Staff's complaint case and the magnitude of Staff's proposed rate reduction?

A. Simply put, the Company's overall perspective on the Staff's recommendation in this case is that it is wholly inappropriate once one considers the relevant facts and circumstances. I discuss this more fully later in my testimony.

In my view, the Staff's proposal is essentially an accounting exercise based on highly questionable positions taken on energy and regulatory policy matters, incompatible with sound cost of service ratemaking principles, and technically flawed in many respects. The Staff's proposal is irresponsibly short-sighted in that it ignores key longer-term issues critical to sound energy policy in Missouri, such as the substantial infrastructure investments needed to maintain adequate, reliable service.

Recent years' reliability problems in Chicago, the Northeast, and California have reminded us of the obvious, electric power is a critical factor in our economy. The Staff's complaint case against UE will define the State's energy and regulatory policy for years to come. This is particularly important considering (1) the magnitude of the proposed rate reduction; (2) the fact that UE has operated under the Commission-approved EARPs for 6 years; and (3) the Company's need for up to $3 billion in energy infrastructure investment through 2006.

As I will discuss further in my testimony, the EARPs have resulted in low rates and high quality of service for UE's customers, timely infrastructure investment, and reasonable rates of return for the Company and its investors. This proven track record of alternative regulation should clearly be allowed to continue. In contrast, the Staff's proposal would abandon that model and seriously damage the financial integrity of UE—causing sharply lower credit ratings, increased financing costs, lower share prices, potentially lower dividends, and limited access to debt and equity markets. These factors would make it very difficult to make timely and cost effective investments in needed generation, transmission and distribution infrastructure. This would not only result in higher long-term costs to customers and the State, but could also impair the independence of Ameren—which could have further economic consequences as well.

Going forward, the mission of sound regulation is clear. Establishing just and reasonable rates includes not only addressing the concerns of today, but also responsibly planning for the long term. Should the Commission decide that a return to the traditional regulatory model is warranted, it should do so based on a correct, fair, and reasonable determination of the Company's cost of service and without failing to consider the full industry and company context of this case. While UE is willing to operate under a fairly-applied traditional regulatory model, the Company also strongly believes that providing broad-based performance incentives through the Alt Reg Plan we are proposing is a superior approach to regulating utilities in today's industry environment—both from a company and customer perspective.

B. STAFF'S RATE COMPLAINT FAILS TO TAKE INTO CONSIDERATION IMPORTANT RELEVANT FACTS AND CONTEXT

Q. Please summarize the facts and considerations that Staff has failed to address in its rate complaint filings.

A. In addition to certain methodological problems and technical flaws associated with Staff's cost of service presentation, which I will summarize in Section VI of my testimony, Staff's rate complaint fails to take into consideration the following facts and context:

1. <u>Sound energy policy and regulation requires consideration of factors beyond a Company's test-year cost of service</u>. As Dr. Fox-Penner notes, Staff's rate complaint and cost of service determination looks largely like an accounting exercise. The Staff's case does not take into account industry trends and non-cost objectives of sound regulation, such as rate stability, the facilitation of necessary infrastructure investments, and the need to provide a structure which permits a utility to operate effectively and efficiently in the increasingly complex industry environment. Given the current status and rapid development of the utility industry, the importance of sound energy policy and regulation to the long-term interests of all stakeholders cannot be overstated.

2. <u>Substantial new infrastructure investments are required over the next several years</u>. Like other parts of the country, load growth and increasingly active power markets in the Midwest necessitate very substantial infrastructure investments in

new generation, transmission, and distribution facilities. The need for new infrastructure investments is recognized broadly, including in the report of the Governor's Missouri Energy Policy Task Force, in resource planning reports and presentations given to the Commission Staff since the mid 1990s, and even in several Schedules of Dr. Proctor's testimony. As explained in the testimonies of Mr. Randolph, Mr. Whitely, Mr. Voss, and Mr. Nelson, due to increased customer demands and a rapidly changing industry environment, the total generation, transmission, and distribution infrastructure investment requirement of UE amounts up to approximately $3 billion through 2006. As shown graphically in Schedule 7-1 of Mr. Stout's testimony (also attached to my Executive Summary), this is a substantial increase from the level of investment activity required in recent years.

3. Implementation of the Staff's rate proposal would undermine timely and cost-effective infrastructure investments in Missouri. The Staff's rate recommendation not only fails to address the Company's infrastructure needs but, in fact, serves to undermine UE's ability to make these needed infrastructure investments in a timely and cost-effective fashion. This is particularly troublesome given the fact, as demonstrated by Dr. Proctor's testimony and schedules, that the Staff is well aware of, and indeed has been closely involved with, UE's resource planning efforts and assessment of infrastructure investment requirements. The Staff's proposed rates would drastically reduce the Company's internally generated cash flows and make the financing of the necessary infrastructure investments significantly more risky, costly, less timely, and potentially impossible. Mr.

Stout's Schedule 7 also shows that Staff's proposal would drastically reduce UE's depreciation-related cash flows exactly at a time when these cash flows are needed more than ever to provide part of the capital necessary to finance new infrastructure. As I explain in Section V, implementation of Staff's proposal would also have significant adverse implications for both the Company's debt and equity holders, many of whom are State residents. The Staff's deferral of many costs and the Company's sharply reduced ability to make the required infrastructure investments timely and efficiently would inevitably lead to significantly higher long-term costs to Missouri utility customers.

4. UE's customers currently have some of the lowest rates and best customer service in the country. UE's rates have been decreasing since 1987 and are significantly below the national and regional averages. In fact, electricity prices in St. Louis are among the lowest for major metropolitan areas in the country. Moreover, since the Company has started to operate under the EARPs in mid 1995, UE's Missouri electric customers have enjoyed declining, predictable rates and realized over $425 million in rate reductions and sharing credits. At the same time, the company achieved one of the highest customer satisfaction ratings of electric utilities in the country. I address these facts and the Staff's failure to consider them in their rate filing further in Section IV.A of my testimony.

5. The Staff has not undertaken any meaningful efforts to evaluate the extent to which the Company has improved its performance under the EARPs to the benefit of all stakeholders. In addition to financial analysts' high regard for the Company's performance, the evidence presented by Dr. Lowry and Professor

Weisman shows that the incentives created by UE's EARPs have in fact resulted in superior performance. Section IV.B summarizes these facts in more detail. Implementation of Staff's rate proposal would penalize UE for its achievements and suggest that striving for superior performance is not in the interest of Missouri utilities and their customers. This would undermine the significant benefits that alternative regulation has provided in the past and can provide in the future.

6. Incentive regulation, such as UE's EARPs, is the logical evolutionary step to regulate utilities in today's rapidly-changing marketplace. As explained in Dr. Fox-Penner's testimony, today's industry is defined by changing technology, evolving wholesale markets, new regional transmission operators, and substantial innovation in energy markets' financial engineering and risk management. In this environment, traditional cost of service regulation is a perpetual catch-up game that is unable to provide proper incentives for companies to operate effectively and efficiently, and to capitalize on new opportunities that provide benefits to all stakeholders. The methods of utility regulation thus need to evolve with the industry. As Dr. Fox-Penner, Dr. Lowry, Mr. Fetter and Professor Weisman explain in their testimonies, broad-based incentive regulation and alternative regulation plans (such as the Company's previous EARPs) are a logical, evolutionary step to more effective regulation of public utilities today. Any such considerations are notably absent in Staff's complaint filing.

C. THE COMMISSION SHOULD SET UE'S RATES EITHER WITH A REASONABLY-APPLIED TRADITIONAL REGULATORY MODEL OR, PREFERABLY, BASED ON ALTERNATIVE REGULATION

Q. Given your recommendation that the Commission reject Staff's rate proposal, how should the Commission set rates for UE that are just and reasonable.

A. The Commission should set just and reasonable rates for UE through one of two basic alternatives: (1) a fairly-applied traditional regulatory model taking into account the full industry and Company context of this rate case; or, preferably, (2) the Alt Reg Plan based on earnings sharing as proposed by UE in this filing.

Q. How should the Commission set just and reasonable rates under the traditional regulatory model?

A. The Commission should set rates under a traditional regulatory model based on a correct, fair, and reasonable determination of the Company's cost-of-service, including taking into consideration important non-cost factors, such as rate stability, encouragement of management efficiency, and the facilitation of infrastructure investments required to provide safe and reliable service. Dr. Fox-Penner and Ms. Kelly also discuss these important non-cost considerations in their testimonies.

The Staff's filing is devoid of, and inconsistent with, any such considerations. In addition, as I summarize below, the Staff's cost of service determination does not employ sound cost of service methodologies and contains many technical flaws. Ultimately, the Staff's cost of service determination is neither fair nor reasonable. Moreover, in key cost of service areas, such as return on equity ("ROE") and depreciation, the Staff's proposal is fundamentally out of line with what regulators have been allowing for utilities in the rest of the country. Unlike the Staff's filed case, any determination of the Company's cost of service must provide a fair rate of return and otherwise accurately reflect the Company's costs.

Q. You noted that the Commission, preferably, should implement the Alt Reg Plan as proposed by UE in this filing. Please explain.

A. Virtually all industry and regulatory experts recognize the importance of performance incentives and the need for regulation to evolve with a rapidly-changing market place. The testimonies of Drs. Weisman, Fox-Penner, and Lowry discuss these issues in detail. The traditional regulatory model, particularly as applied by the Commission's Staff, provides only very limited performance incentives and is increasingly ill-suited to the regulation of utilities in today's restructured market place. Dr. Kenneth Costello of the National Regulatory Research Institute—who spoke at a recent natural gas roundtable at the Commission's invitation—summarized this point as follows in an article he wrote with Wayne Olson, the former Director of Finance of the Maine Public Utilities Commission:

> In order to determine whether the techniques of utility regulation need to change, regulators should understand the competitive forces that are affecting the electric services industry. Regulators need to consider whether the current system of utility regulation in the U.S., which relies heavily on modified cost-plus regulation (also known as rate-of-return regulation), encourages actions by the utility that enhance the utility's efficiency.
>
> Utilities and regulators should continue to explore creative and thoughtful restructuring proposals. Other aspects of utility regulation, such as the exploration of incentive regulation, should, however, be at the forefront of the regulatory agenda.... While modified cost-plus regulation provides some limited incentives for the utility to boost efficiency—such as regulatory lag and the risk of after-the-fact prudence disallowance—an alternative regulatory paradigm could provide stronger incentives. ("Electricity Matters: A New Incentives Approach for a Changing Electric Industry," *The Electricity Journal*, Jan-Feb 1995, pp. 30-32.)

In fact, as recognized on page 45 of the Governor's Energy Policy Task Force's Final Report, "[o]ver the last decade the Commission has experimented with other regulatory models in an effort to improve the incentives inherent in the traditional regulatory model." Of course, two of these experiments are the EARPs under which UE-Missouri has been operating since mid-1995. In my view, and that of the experts who carefully evaluated the Company's prior plans, the Commission's experiment with alternative regulation has been a resounding success and has created significant benefits for UE and its customers. Alternative regulation has provided UE with the flexibility and financial stability to undertake needed infrastructure investments and to operate effectively and efficiently in a rapidly changing energy market. As a result, UE today is a financially healthy, more efficient company while, at the same time, UE's customers enjoy reliable service at low rates. As Professor Weisman points out, "low prices and not low profits are the most important part of salutory economic performance (assuming a reasonable extent, variety, quality and reliability of service)."

UE's rates are lower today than they were prior to the EARPs and have decreased relative to the trend of rates for the other utilities in the Midwest. These important facts are discussed further in the testimonies of Professor Weisman and Dr. Lowry and are summarized in Section IV of my testimony. Some of this evidence also was presented to the Commission in the February 1, 2001 *White Paper on Incentive Regulation: Assessing Union Electric's Experimental Alternative Regulation Plan* (filed in Docket EM-96-149 with the Company's February 1, 2001 recommendations concerning the continuation of the EARP and attached as Schedule 4 to my testimony).

A new alternative regulation plan that preserves the incentives under which the Company was able to operate since 1995 is thus desirable. Based on a careful evaluation of the Company's previous experience under the EARPs, I recommend that the Commission approve the proposed Alt Reg Plan as presented in Schedule 1 of my testimony. The proposed plan builds upon the experience gained from the prior EARPs and also reflects features and parameters of similar recently-approved plans of other Midwestern utilities, such as MidAmerican Energy Company in Iowa. A more detailed discussion of how the previous EARPs have improved UE and a summary of the proposed new Alt Reg Plan is presented in Section VIII of my testimony. First, however, I would like to discuss the benefits that alternative regulation has achieved (Section IV), the financial implications of the Staff's rate proposal (Section V), some of the fundamental flaws in the Staff's rate proposal (Section VI), and the Company's cost of service (Section VII).

IV. CUSTOMERS AND THE STATE REALIZED SIGNIFICANT BENEFITS FROM THE LOW RATES AND SUPERIOR PERFORMANCE THAT UE ACHIEVED UNDER ALTERNATIVE REGULATION

A. UE'S MISSOURI RETAIL CUSTOMERS ENJOY SOME OF THE LOWEST RATES IN THE COUNTRY AND HAVE BENEFITED SIGNIFICANTLY FROM UE'S EXPERIMENTAL ALTERNATIVE REGULATION PLANS (EARPs)

Q. You noted that UE's Missouri retail customers enjoy some of the lowest rates in the country. Please discuss the facts that support your statement.

A. The fact that UE serves its electric customers with some of the lowest rates in the country is broadly recognized by a number of independent analyses. For example, Moody's Investor Service stresses in its June 2001 Global Credit Research report that UE's *"retail rates are among the lowest in the region"* (emphasis added). Similarly, Standard & Poor's November 2000 Research report—which Staff witness Ronald Bible quoted in his July testimony and supplied as a workpaper—compared UE's retail rates with regional and national levels and concluded that:

> [t]he average retail rate is competitive regionally and nationally. At UE, residential realization per kWh sold has fallen about 9% since 1988, is about 10% below the regional average, and 20% lower than the average of all investor owned utilities. Industrial rates have come down by 11% and commercial rates by 12% through cutting costs and negotiated rate reductions.

In S&P's November 2001 report, which is cited in Mr. Bible's recent testimony, the agency confirms these findings about the competitiveness of UE's rates—noting that UE's residential rates now are "about 12% below the regional average."

Q. Even if UE has some of the lowest rates in the region and in the country, isn't it also true that UE's rates are not the lowest in the State?

A. It is correct, as Staff witness Janice Pyatte shows in Schedule 8 of her testimony, that UE's rates are not the lowest in State. However, Ms. Pyatte's comparison overstates the effective rates that UE's customers have been paying because her calculations do not reflect any sharing credits that customers received under the EARP. Moreover, as even Ms. Pyatte's Schedule 8 shows, St. Joseph Power & Light ("SJPL") is the only Missouri utility with rates that are meaningfully below UE's current rates. Of course, this is a highly unfair comparison. In contrast to SJPL, UE's service territory includes one of the major metropolitan areas in the U.S.—which imposes on the

Company direct and indirect costs (such as higher labor costs, property and siting costs, taxes, and costs of underground distribution facilities, among others) that differ from those of most other utilities in the State. In addition, SJPL enjoys a cost advantage alone based on the closer proximity of its service territory to low-cost coal supplies.

Given these cost considerations and the fact that the EARPs have resulted in effective rates below the levels shown, Ms. Pyatte's rate comparison only serves to illustrate the reasonableness of UE's current rates. The fact that the Staff's recommended rate cut would reduce rates even below those of SJLP (as the rate comparison in Ms. Pyatte's Schedule 8 shows) only serves to highlight the inherent unreasonableness of the Staff's rate proposal.

Q. You noted that UE is serving a major metropolitan area. How do electricity prices in St. Louis compare to rates in other major metropolitan areas in the country?

A. As Professor Weisman explains in his testimony, the U.S. Bureau of Labor Statistics ("BLS"), the government agency which compiles consumer price information, reports average electricity prices for 15 major U.S. metropolitan areas, including the St. Louis metropolitan area. Dr. Weisman's Schedule 2-1 (also attached to my Executive Summary) shows that during 2001 consumers in the St. Louis metropolitan area enjoyed the second lowest electricity prices of any of these major metropolitan areas. Only for Seattle, which benefits from abundant low-cost hydro electric power, does the BLS survey data show lower electric prices.

Q. Why is it useful to compare rates in St. Louis with rates of other major metropolitan areas?

A. Again, the cost of conducting utility operations in major metropolitan areas is higher than in smaller urban, more rural areas. As a result, a comparison across major metropolitan areas provides a more appropriate "apples-to-apples" comparison. Dr. Weisman's Schedule 2-2 (also attached to my Executive Summary) presents the 1998-2001 average cost of electricity in the Midwest and nationwide as reported by the BLS. The chart shows clearly that in the Midwest and nationwide (1) average electricity costs for mid-sized metropolitan areas significantly exceed the electricity costs in small metropolitan areas; and (2) electricity costs in large metropolitan areas on average exceed those of mid-sized metropolitan areas. Dr. Weisman's Schedule 2-2 specifically shows that average rates in large metropolitan areas in the Midwest are approximately 20% higher than the average rates of small Midwestern metropolitan areas. Importantly, these BLS data also show that electricity rates for consumers in St. Louis, a metropolitan area with approximately 2.4 million people, are almost as low as the average electricity rates for small Midwestern urban areas with less than 50,000 people. These differences between large and smaller metro areas further document the inherent reasonableness of UE's current rates.

Q. You mentioned that UE's customers have enjoyed declining rates since the Company has started to operate under alternative regulation plans. How does this decrease in UE's rates compare to the rate performance of other utilities in the Midwest?

A. In his Schedule 2-3, Professor Weisman compared consumers' average electricity prices for the 12 months before the first EARP with average electricity prices in the last year of the second EARP (the "sixth" sharing period). The chart specifically shows electricity prices in St. Louis relative to the average prices for small, large, and all urban areas in the Midwest. It shows that, regardless of the size of metropolitan area, average electricity prices in the Midwest have *increased* since 1994/95, while electricity prices in St. Louis have *decreased*.

As a result, while St. Louis electricity prices in 1994/95 (the year prior to the first EARP) were only somewhat lower than average prices for all Midwestern urban areas surveyed by the Bureau of Labor Statistics, electricity prices in St. Louis during the last year of the EARPs are *significantly* lower than the average for the Midwest. They are, in fact, closer to the much lower average prices for small metropolitan areas. As Schedule 2-4 of Dr. Weisman's testimony shows, these data for electricity prices in St. Louis even *overstate* the rates that UE's customers are paying due to the fact that the reported rates are based on rates in some St. Louis area counties not served by UE and do not reflect seasonal discounts and customer credits. The comparison of Ameren's rate performance with that of other utilities clearly documents the substantial benefits that customers have enjoyed under the EARP.

Q. The charts indicate that these data represent average residential electricity prices in St. Louis and do not reflect UE's seasonal discounts and sharing credits. Is there any evidence showing how UE's actual, effective rates have declined relative to other utilities in the region?

A. Yes. Such a comparison has been presented on pages 40-42 in the February 1, 2001 White Paper evaluating UE's EARP (attached as Schedule 4 to my testimony). This analysis, based on average rates for all investor-owned utilities in the North-Central region of the U.S. (including all utilities in Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, North Dakota, Ohio, South Dakota, and Wisconsin) showed that from the year before the EARPs through 1999 "*UE's customers enjoyed greater reductions in average electricity rates than customers of other utilities in the Midwest*." This result was found to be true both on average and within each customer class (*i.e.*, residential, commercial, and industrial). The authors of the White Paper also concluded that "these results suggest that annual expenditures by UE's customers may have already declined between $50 million to $100 million *more* than they would have had UE achieved only the average rate reduction of other Midwestern utilities."

Mr. Kovach, in his Schedule 9, has updated this comparison of rate reductions in Table 4 of the White Paper with available data through year-end 2000. This updated analysis shows that UE's effective Missouri retail electric rates declined even further. By the end of 2000, the overall average of UE's effective retail rates (*i.e.*, across all customer classes and considering seasonal discounts and customers' sharing credits under the EARP) were *6.8% lower* than the average of UE's retail rates at the end of 1994, just before the first EARP was implemented. In contrast, during the same time period, average rates have *increased* 0.7% in West North Central and decreased by only 5.8% in East North Central.

Q. You just explained that UE's average annual rates declined 6.8% from the end of 1994 through the end of 2000. How does the downward trend in UE's effective electricity rates compare to price trends that UE's customers have experienced for other goods and services?

A. The decline in the electricity rates that UE's customers have enjoyed during the EARPs compares very favorably to the price trends that customers have faced for other goods and services. As Professor Weisman shows in his testimony, during the period from 1994 to 2000, within which UE rates *declined* by 6.8%, average consumer prices in the St. Louis metropolitan area have *increased* by 15.4%. Dr. Weisman's Schedule 2-5 also shows that during this period: (1) the average prices for all "services" in the St. Louis area increased by 17.9%; (2) consumer prices for all energy services and energy products (including gasoline) were up 24.3%; and (3) even prices for all household-related fuels and utilities in the St. Louis area (including items such as natural gas, water, sewer, and trash collection) were up 13.6% since 1994, the year before UE started operating under its first EARP.

B. UE's Performance Is Highly Regarded and Has Improved Significantly During the EARPs

Q. You noted earlier that the Staff's rate proposal would penalize UE for achieving superior performance under the Company's alternative regulation plans. Has the Company's strong performance generally been recognized in the industry?

A. Yes. The Company's strong performance has been recognized explicitly by a number of industry observers, including Moody's Investors Service, Standard and Poor's, the Environmental Protection Agency (EPA), and the University of Michigan's National Quality Research Center, as well as the Missouri Governor's office, among others. For example, Moody's June 2001 Global Credit Research report for Ameren stresses that "*AmerenUE both produces and sells electricity cheaply*" (emphasis added) and notes that the Company's strengths include: (1) an "existing well running low cost generating fleet…"; (2) a "well-rated Callaway nuclear facility"; (3) "excellent intrastate and interstate electric transmission access…"; and (4) a "solid risk management culture…."

Similarly, Standard & Poor's November 2001 research report for Union Electric stresses that UE's strengths include: (1) "competitive rates"; (2) "superb nuclear performance"; (3) "it's position as one of the lowest-cost producers in the Midwest"; (4) "strong transmission ties"; (5) a "[s]trong cost-conscious management team that is committed to credit quality"; and (6) the fact that the "UE/CIPS merger created a bigger, more efficient utility."

Standard & Poor's specifically elaborated on several of these points by stressing that:

> Management has done an excellent job operating the Callaway nuclear station…. The station, currently operating at full capacity, is an industry leader in terms of production and safety. . . .Management has also been successful in controlling Callaway's O&M expenses;…average production annual costs were among the lowest of all U.S. nuclear plants.

Similarly, the rating agency pointed out that:

> [The Company's] total costs of production are competitive at an average 3.1 cents per kWh, compared with the 1999 Mid-America Interconnected Network (MAIN) group average of 3.5 cents per kWh. Its fixed production costs are also significantly less than the regional average and the average for all investor-owned utilities.
>
> On the fuel-cost management front, virtually no one can compete with UE. The company's cost of fuel is the lowest in the region and 40% less than the industry average. UE's favorable fuel cost position can be traced to its enterprising use of cheaper, low-sulfur Powder River Basin coal, economical use of purchased power, efficient power plant management, and aggressive negotiations for fuel-related services.

However, as I will discuss below, despite these strong reviews of UE's performance, recent reports by the credit rating agencies also voice great concerns about the financial impacts that the Staff's proposed rate reduction would have on the Company.

Q. You mentioned that Ameren's performance has been recognized by the EPA, the Missouri Governor's office and the National Quality Research Center, among others. What did these entities find with respect to the Company's performance?

A. In 2001, the Environmental Protection Agency ranked 6 of UE's main coal-fired generating units—all located in the metropolitan St. Louis area—among the nation's generating units' 10 lowest emitters of nitrogen oxide (NOx). Similarly, during the 6 years of operating under the EARPs, UE twice won the Missouri Governor's Pollution Prevention Award. The Company received its first award, in 1996 for the Sioux Plant initiative to burn more than 2 million discarded used tires a year, thereby reducing landfill volume and generating electricity for more than 4,000 residential customers. In 1998, the Company received a second award for pioneering low-cost NOx emission control technology and voluntarily reducing nitrogen oxide emissions by more than 50% below the Clean Air Act requirements—in spite of an increase in the amount of coal burned.

The Company's customer satisfaction rating also has been consistently high and well above the national average. For example, Ameren has been shown to have one of the highest customer satisfaction ratings of electric utilities in the country in a survey by the University of Michigan's National Quality Research Center. As Professor Claes Fornell, the author of this survey noted: "There's no mystery in explaining [customer satisfaction] scores for a utility. *Reliable service and reasonable prices lead to* *high customer satisfaction*" (emphasis added). The rebuttal testimony of Mr. Voss presents additional evidence concerning the Company's service quality and customer satisfaction performance.

Q. Is UE presenting any analyses which document that the Company's performance has, in fact, accelerated during the alternative regulation experiments?

A. Yes. I have already summarized rate comparisons and other evidence presented in the White Paper and the testimony of Professor Weisman. These facts already make a strong point that UE's customers enjoy low rates that, during alternative regulation, have decreased faster than the average rates of other utilities in the region.

To analyze how alternative regulation has specifically affected UE's overall efficiency and productivity, the Company has retained Dr. Mark Lowry. Dr. Lowry is a noted authority on performance benchmarking and productivity research. The analyses presented in his rebuttal testimony clearly document how UE's efficiency has improved while operating under the EARPs. Dr. Lowry finds that the Company exhibited superior performance relative to the industry during the EARP years. Dr. Lowry specifically finds that, during the 1995-2000 EARP years, UE's total costs have grown at a pace far slower than those of other utilities.

Dr. Lowry finds that UE's higher performance gains during alternative regulation resulted in significant benefits. His analysis shows that UE's costs have grown 1.68% more slowly than costs of other utilities. After six years of operating under the EARPs, this advantage in performance growth means that UE's total annual costs would exceed the Company's current cost of service by an additional $200 million (or approximately 10%) had it not been for the higher performance gains that the Company was able to achieve under the EARPs. As a result, without the additional efficiencies gained during the EARPs, UE would likely have had significant rate increases. Any claims that the Company achieved "excess earnings" under the EARP or that such earnings have come at the expense of customers are, thus, entirely unfounded. The Staff's failure to undertake a meaningful assessment of the Company's performance under the EARPs in its rate complaint is a significant omission. The rebuttal testimony of Professor Weisman discusses many of these points in greater detail.

C. UE's Performance Benefits The State as a Whole

Q. How does UE's performance more broadly benefit the State's economy?

A. UE's performance has offered important benefits for Missouri's economy as a whole. Stable low rates, reliable service, and a modern energy infrastructure directly benefit UE's existing customers and, in addition, help attract new companies and customers to the State. Both customer growth and UE's significant spending on energy infrastructure fuel the State's economic growth and create jobs. UE's financial health not only has allowed the Company to make timely and cost effective infrastructure investment, but has also helped maintain jobs, and benefited the Company's many shareholders who reside in Missouri. The testimonies of Messrs. Beishir, Datillo, Giljum, McVey and Peterson underline this link between fair rates, a financially healthy company, and local employment.

In conclusion, the higher performance gains that the Company has achieved under the EARPs have brought significant benefits to UE's customers and to the

State's economy as a whole. These results clearly document that the stronger performance incentives provided by the EARPs have worked well, to the benefit of all stakeholders, including the State of Missouri.

V. STAFF'S RATE PROPOSAL IS FINANCIALLY PUNITIVE AND INCONSISTENT WITH GOOD PUBLIC POLICY

Q. You noted that the Staff's rate reduction proposal is financially punitive. What would be the financial consequences of the Staff's proposed rate reduction?

A. If the Staff's rate proposal was implemented, the result would not only be significant harm to investors, but it also would result in significantly higher longer-term costs to UE's customers, its investors, other utilities in the State, and the State's economy as a whole.

The Staff's proposed revenue reduction would significantly reduce UE's operating cash flows. This reduction in cash flows will yield some very disturbing results. First, UE will be required to finance significantly more of its infrastructure investments from external sources of capital. At the same time, the costs of external capital will significantly increase as UE's credit ratings would fall if the Staff's rate proposal were adopted. Further, the access to the capital markets that would be required to finance the Company's infrastructure investments would be much more limited due to the Company's worsened financial condition and unfavorable credit ratings. The consequences of this financial quandary are that infrastructure investments, at the very best, would be less timely and more expensive—the costs of which are ultimately borne by UE's customers and the State as a whole. The financial consequences, however, do not end there. UE's financial flexibility to bear increases in operating costs, due to changing economic conditions generally in the nation and particularly in the energy business, will be very limited. Requests for rate increases would therefore be more likely in the near term. Finally, implementation of the Staff's proposal would greatly harm the Company's debt and equity holders, many of whom are Missouri residents.

A. AS A RESULT OF STAFF'S RATE PROPOSAL, CREDIT RATING AGENCIES HAVE ALREADY DOWNGRADED UE'S FINANCIAL OUTLOOK

Q. How have credit rating agencies reacted to the Staff's complaint filing?

A. Financial analysts at the country's three most highly regarded credit rating agencies—Fitch, Moody's, and Standard & Poor's—have already reacted to the regulatory uncertainty associated with the Staff's rate complaint by downgrading the Company's financial outlook. The credit rating agencies made it quite clear that implementation of the Staff's rate proposal would result in the immediate downgrade of UE's and Ameren's credit rating.

Mr. Fetter's rebuttal testimony documents the adverse impact that implementation of the Staff's proposal would have from the perspective of Fitch. Fitch already noted in a recent report for Ameren and UE:

> The Rating Outlook is changed to Negative from Stable. Ameren Corporation is a holding company that derives its credit strength from the cash flow of its regulated utility subsidiaries AmerenUE and AmerenCIPS.... <u>The Negative Rating Outlook for both [UE and Ameren Corp.] reflects the potential rate reduction at AmerenUE</u>, which is Ameren's largest subsidiary and accounts for roughly 70% of operating

> income.... It would be difficult for AmerenUE to offset any rate reduction, since the company has already substantially reduced expenses. (Fitch Rates Ameren Notes 'A+'; Rating Outlook Negative for Ameren and AmerenUE, December 07, 2001 [emphasis added]).

Moody's Investors Service, which downgraded UE's long-term outlook only 10 days after the July 2001 filing of the Staff's complaint, made it clear that the result of implementing the Staff's proposal would greatly reduce the Company's financial flexibility and impair UE's ability to fund its interest obligations, dividend payments, and infrastructure investment needs. Moody's observation below applies even more emphatically in light of the Staff's current recommendation to reduce rates by $245 million to $285 million:

> Moody's Investors Service assigned negative outlooks to its long term ratings of Union Electric Company (AmerenUE) and Ameren Corporation ... in response to the Missouri Public Service Commission's (MPSC) July 2nd staff filing which, if implemented, could reduce AmerenUE's annual revenues between $214 million and $250 million. ...
>
> A $214 million to $250 million annual revenue reduction will considerably reduce AmerenUE's financial flexibility. In 2000, the company's ... funds from operations minus capital expenditures was only $292 million. A $214 million to $250 million revenue reduction in 2000 ... would therefore have significantly reduced the company's free cash flow for any additional working capital and capital expenditure needs. Moody's believes the reduction would, to the same significant extent, affect the company's cash flows going forward. ...
>
> Moody's projects that a $214 million to $250 million AmerenUE revenue reduction [would] impair Ameren Corporation's ability to cover both its interest and dividend payments at their current levels. ("Moody's Assigns Negative Outlooks to AmerenUE and Ameren Corporation," Moody's Investor Service, *Global Credit Research*, July 12, 2001, [emphasis added].)

Similarly, Standard & Poor's stressed the significant financial implications of the Staff's proposed rate reduction in the context of the Company's infrastructure investment needs, increasing operating expenses, and changed wholesale market conditions. The credit rating agency specifically noted that:

> Standard & Poor's revised its credit outlook for Ameren Corp. ... and its Subsidiaries ... to negative from stable. The outlook change reflects the company's eroding consolidated financial profile that just last year was robust for current ratings. Potentially significant electric rate reductions at UE, lower forward energy prices, additional financing requirements for installation of a block of combustion turbines, and higher operating expenses will pressure cash flow, earnings protection measures, and capital structure." ("Ameren Corp. Outlook Revised to Negative," Standard & Poor's, *Credit Profile*, Oct. 5, 2001 [emphasis added]).

However, while the credit rating agencies clearly are concerned about the financial impact that the Staff's rate proposal would have on the Company and its creditors, the agencies also hope that the Commission will reject the Staff's recommendation. For example, S&P's November 2001 report notes that the agency "believes that the MPSC will ultimately be more supportive of the company and will order a rate reduction that is manageable."

B. IMPACT OF STAFF'S RATE PROPOSAL ON THE COMPANY'S INVESTORS AND FINANCING COSTS

Q. What are the implications that adoption of the Staff's rate proposal would have on the Company's debt holders and UE's cost of debt?

A. **

Q.

NP

A.

Q.

NP

A. [redacted]

Q. [redacted]

A. [redacted]

Q.

A.

**

NP

C. The Staff's Financially Punitive Rate Proposal Would Limit Financing of Infrastructure Investment Requirements and Produce Results Contrary to the Long Term Interests of UE, its Customers, and the State of Missouri

Q. What implications would the adoption of the Staff's rate proposal have for the financing of infrastructure investment requirements?

A. Sharply lower cash flows would mean that much of UE's new financing would have to be raised through the issuance of new capital. This infrastructure financing "gap" under the Staff's rate proposal is clearly visible in Schedule 7 of Mr. Stout's testimony, showing that the Staff proposes substantial cuts in depreciation-related cash flows just when the Company faces significant additional infrastructure investment requirements.

Compared to the use of internally-generated funds, higher transaction costs would be incurred to issue the additional debt or equity required to finance the new infrastructure plant. Importantly, acceptance of the Staff's proposal would lead to lower share prices, reduced financial flexibility, higher cost of debt and equity, continued regulatory risk, and inability to earn an adequate return on investment. This would limit UE's access to capital markets and, as the unavoidable consequence, would leave UE with few options but to delay or limit infrastructure investments as much as can be justified under prudent operating practices. In some cases, certain investments may have to be delayed indefinitely.

While the Staff, through Dr. Proctor's testimony, now appears to endorse a "build rather than buy" strategy to UE's resource planning, implementation of the Staff's rate proposal would likely *force* the Company to attempt to ensure reliable supply through increased reliance on power purchases, rather than expansion of our own generation infrastructure. However, such purchases might not be feasible if insufficient generation capacity or transmission capacity were to exist in the region. But even if available, certain suppliers may be unwilling to enter into contracts with UE, or may require a credit premium, due to UE's then poor financial health. While I would hope that the Company could maintain reliable supply even in these circumstances and avoid problems similar to those experienced in California, the Northeastern U.S., and Chicago, such "involuntary" reliance on purchased power would, again, lead to higher costs for UE's customers in the years ahead.

Q. You noted that power purchases, as an alternative to the expansion of UE's generation capacity, might not be feasible if insufficient generation or transmission capacity were to exist in the region. Is there any risk that this might actually be the case?

A. Yes. As Mr. Randolph notes in his rebuttal testimony, Missouri itself has moved from an environment in which it had sufficient in-State generation to meet its customers' demand, to one which requires the import of generation to meet these demands. In fact, as Dr. Fox-Penner notes in his rebuttal testimony, significant generation and transmission investments also are necessary throughout the Midwest. Consequently, UE's ability to purchase power would be highly contingent on the success of others' infrastructure investments. However, the recent developments in the power industry make it clear that sufficient investment by others is not a given. For example, a recent Wall Street Journal article (attached as Schedule 2 to Dr. Fox Penner's rebuttal testimony) notes:

> Now with the power industry hovering uneasily between regulation and deregulation, it faces the prospect of a market that combines the worst features of both: a return to government restrictions, mixed with volatility and price spikes as companies struggle to meet the nation's further energy needs. Investors and lenders, spooked by the twin specters of California and Enron, have become less likely to commit capital to building new power plants, transmission lines and natural-gas pipelines. The U.S. will require big additions to its power production and distribution capacity when it emerges from the current recession – but for now, at least, the nations capital markets are reluctant to cough up the necessary funds. ... The root of the problem is a lack of capital and earnings. [emphasis added]

The power industry's currently limited access to capital is also discussed in a December 18, 2001 article, *Tight Capital Could Threaten U.S. Power Projects* by Reuters:

> 'This market is in a panic,' Jeff Wolinsky, a New York-based analyst at Standard & Poor's, said. 'Right now, those companies, especially those in power generation, that don't have financing in place are going to be under severe constraints,' he said. ... With investors bolting for the exits, capital markets have been effectively closed down to many power companies, Merrill Lynch said. Adding to the Enron-induced panic, current low energy prices are hurting earnings, making debt servicing more difficult and giving capital owners another reason to be cautious about lending to the power sector. While several companies have long-term credit lines in place to fund power plants, projects could be delayed or scrapped altogether if market conditions remain unfavorable. [emphasis added]

Q. How do you sum up the financial and investment implications of Staff's rate proposal?

A. The Staff's cost of service rate proposal is financially punitive, would severely constrain UE's financial flexibility and ability to fund the Company's substantial infrastructure investment requirements and would result in higher long-term costs for customers in the future.

The Governor's Energy Policy Task Force noted that "[t]he wise use of [the Commission's] powers over the last two decades has produced financially healthy utilities whose rates are generally average to below-average when compared with national cost figures." Indeed, UE rates have been well below average while the Company has performed financially in line with industry averages and has been financially healthy up to this point. However, the Staff's rate proposal clearly would not allow Ameren to maintain its current financial health. Financing costs would rise and the ability to access financial markets to fund new infrastructure would be hampered.

The ripples that implementation of the Staff's rate proposal would send through the financial markets with respect to investor expectations about regulatory risks and inadequate returns in Missouri would almost certainly also affect the other utilities in the State as investors would demand an additional regulatory risk premium and rating agencies would incorporate these new risks in their ratings. The end result of this would be the undoing of the benefits that two decades of "wise" State regulatory policy have conferred on customers, utilities, and the State's economy as a whole. Finally, with poor financial health and depressed stock prices, Ameren would face a substantially-increased risk of being taken over by other U.S. and foreign utilities.

I sincerely believe that the current combination of low rates and a financially healthy Company is in the long-term interest of customers and is the best way to support the State's economic growth. In contrast, I find that the Staff's proposal is short-sighted, focused solely on reducing rates without regard to other objectives—and with an apparent lack of interest in the financial health of UE and the long-term interests of the Company, its customers, and the State's economy as a whole. Implementation of the Staff's proposal ultimately will cost customers more than they save through the Staff's rate reduction in the short term. In addition to the simply demoralizing effect on UE and its employees of being punished for having performed well, these higher long-term costs will come in the form of higher financing costs, higher risks, higher operating costs, and the Company's handicapped ability to make infrastructure investment timely and effectively.

Given the importance of robust energy markets, a sound infrastructure, financially-sound utilities, and a reliable power supply to the local economy, I again strongly recommend that the Commission reject Staff's rate proposal.

VI. <u>THE STAFF'S RATE PROPOSAL IS FUNDAMENTALLY FLAWED</u>

Q. Please summarize the problems the Company has identified in the Staff's complaint filing.

A. The Staff's rate proposal is technically based on a determination of the company's cost of service. However, their analysis employs idiosyncratic approaches to established methodologies, or relies on previously unheard of adjustments, all of which are inconsistent with sound regulatory policies. Further, their analysis contains a number of technical flaws which serve to overstate the Company's revenues while understating its total cost of service. As a result, the Staff's recommendations are unreasonable and its proposed rate reduction is greatly overstated and inconsistent with just and reasonable ratemaking. test-year For example, the Staff's recommendation suffers from the following serious problems:

- <u>The Staff's proposed return on equity (ROE) is unreasonable, financially confiscatory, and based on erroneous standards and opportunistic applications of methodology.</u> The Staff's ROE recommendation alone serves to understate UE's Missouri annual electric cost of service by approximately $120 million. As Professor Morin and Ms. McShane show in their rebuttal testimonies, the Staff's return on equity recommendation is based on highly inappropriate application of financial methods and standards, falls substantially short of investors' required rate of return, and is also entirely unreasonable compared to the returns on equity that utilities have been allowed to earn in other states. I will further summarize some of these problems in subsection VI.A below.

- <u>Staff's recommendation relies on an irresponsible depreciation proposal that does not take into account UE's substantial infrastructure investment requirements.</u> As explained in Mr. Stout's testimony, and as further summarized in Section VI.B below, Staff's recommended depreciation expenses are unreasonably low, violate sound ratemaking principles, are inconsistent with the treatment afforded by virtually every other regulatory agency in the country, are inconsistent with the depreciation treatment applied by the Commission to St. Louis County Water Company, and undermine the Company's ability to make needed infrastructure investments in a timely and cost-effective manner. The Staff's depreciation proposal understates UE's current cost of service by approximately $110 million per year by deferring these costs to the detriment of future customers.

- <u>The Staff's cost of service proposal contains numerous inappropriate adjustments, unsubstantiated assumptions, and the effective disallowance of prudently-incurred expenses.</u> The Staff's cost-of-service adjustments would result in the effective disallowance of prudently-incurred operating expenses without any attempt to show imprudence or poor business judgement. For example, the Staff's normalization of test-year expenses reduces actual, incurred costs even though there is clear evidence that future costs will not be below test-year expenses. Further, the Staff eliminates one-time costs in their entirety and provides the Company with no hope of recovering these prudently incurred costs. Moreover, the Staff reduces test-year expenses by inappropriately eliminating incentive compensation expenses, burdening future customers with higher pension and other post-retirement employee benefits ("OPEB") costs, double-counting tax benefits already received by customers, relying on unreliable computer simulations to determine the Company's fuel and purchased power costs, and opportunistically switching from accrual to cash basis accounting. I further discuss many of these examples in section VI.C below.

- <u>The Staff's proposed rate reduction is based on overstated normalized test-year revenues.</u> As explained in the rebuttal testimonies of Mr. Voytas and Mr. Kovach, Staff's weather normalization and adjustments for customer growth, are unreasonable and inappropriate. The combined effect of these errors is to overstate test-year revenues by $30 million.

- As discussed by Mr. Whiteley, the Staff's treatment of unbundled transmission revenues, due to the Staff's inadequate ROE proposal, infringes on Federal Energy Regulatory Commission (FERC) jurisdiction by preventing the Company from earning FERC-accepted returns on any of the Company's transmission assets.

- Finally, the Staff's rate proposal does not comply with Commission Rule 4 CSR 240-10.020. This is a serious flaw because the Staff does not apply the Commission rule that governs the treatment of accumulated depreciation when calculating the return component of a utility's revenue requirement. I will return to this point in Section VI.D below.

A. STAFF'S RATE OF RETURN PROPOSAL IS UNREASONABLE, FINANCIALLY CONFISCATORY, AND BASED ON ERRONEOUS STANDARDS AND OPPORTUNISTIC APPLICATION OF METHODOLOGIES

Q. Please summarize why the Staff's proposed ROE is unreasonable, financially confiscatory, and based on erroneous standards and opportunistic applications of methodologies.

A. As Professor Morin and Ms. McShane show in their rebuttal testimonies, the Staff's ROE recommendation is based on highly inappropriate applications of financial methods and standards. Staff witness Mr. Bible calculates his "cost of equity" based on methodologies and data which authoritative experts in finance have identified as highly unreliable, inappropriate, and even "naive." Professor Morin, who Staff considers to be an authority in the field, explains further that the Staff's ROE recommendation is not based on competent analysis and informed judgement.

Mr. Bible rejected higher ROE results in his own testimonies simply because, in his own words, these results were not "twice as high" as his recommendation. If this were a meaningful standard, however, it would logically also follow that ROEs would be reasonable as long as they are less than twice Mr. Bible's recommendation—*i.e.*, less than 18.82%. Under this standard, of course, the Staff has no basis for its complaint regarding UE's current rates and return.

Schedule 17 to Ms. McShane's testimony (also attached to my Executive Summary) shows clearly that the Staff's midpoint recommendation of 9.41% for UE's allowed return of equity, based on test-year and update period data, is unreasonable. It is almost 200 basis points below the 11.27% return on equity that the country's State regulatory commissions have allowed on average for electric utilities during the test-year and update period. The discrepancy is even more striking between the 9.91 % upper end of the Staff's ROE recommendation and the 12.9 maximum % of the ROEs that other State commissions have allowed during the test-year. That ROEs of 12.0 % and above are reasonable for utilities in the Midwest has also been established in the recent FERC Order and Initial Order concerning the Midwest ISO. The FERC Order set temporary rates based on an ROE of 13%; the subsequent Initial Order found an ROE of 12.38 % to be appropriate for setting permanent rates based on a sample of nine comparable utilities—two of which the Staff also find to be comparable to Ameren and UE. Finally, Ms. McShane's Schedule 17 also shows how, over the past several years, the Staff's rate of return recommendations have become increasingly unreasonable and out of touch with the rest of the Nation.

In short, the Staff's proposed return is inadequate to the point of being confiscatory. Their proposed return simply would not allow UE to maintain its financial integrity.

B. THE STAFF'S DEPRECIATION METHODOLOGY SIGNIFICANTLY UNDERSTATES UE'S COST OF SERVICE, PARTICULARLY IN LIGHT OF THE COMPANY'S INFRASTRUCTURE REQUIREMENTS

Q. Please elaborate on the problems you have identified with the Staff's proposed depreciation expenses.

A. The Staff's depreciation proposal is a highly inappropriate and irresponsible recommendation because: (1) it would result in depreciation expenses that are significantly below those that regulators have allowed for other utilities in the country; (2) it would be highly inequitable by deferring substantial costs to future customers; (3) it would increase the volatility of rates; (4) it relies on a treatment of net salvage costs that is inconsistent with the treatment afforded by virtually every other regulatory agency in the country; (5) it is inconsistent with the Commission's own precedent, given UE's significant infrastructure investment needs; and (6) it would make the financing of UE's infrastructure needs significantly more expensive.

The Staff's unreasonable treatment of net salvage costs and its reliance on unreasonably low depreciation rates understates the Company's cost of service by approximately $110 million a year. Importantly, the Staff achieves this reduction to the Company's cost of service only by deferring these costs to the detriment of future customers. As a result, implementing the Staff's depreciation proposal would simply be an example of "robbing Peter to pay Paul"—lowering today's rates only at the cost of higher future rates. As a result, Staff's depreciation proposal not only violates basic ratemaking and accounting principles, but is also inconsistent with good regulatory policy.

Q. How do Staff's proposed depreciation expenses compare to those that regulators have allowed for other utilities in the country?

A. As Mr. Stout shows in his testimony, the level of Staff's recommended depreciation expenses is significantly below the levels that regulators have allowed for other utilities in the country. Schedule 13 of Mr. Stout's testimony compares UE's current, Staff's proposed, and UE's proposed average depreciation rates to the range of average depreciation rates for U.S. investor-owned utilities. His Schedule 13-1 (also attached to my Executive Summary) makes this comparison on the basis of total plant and depreciation expenses. The chart shows that (1) UE's current average depreciation rate are already below the industry median rates; (2) Staff's proposed depreciation rates are *substantially* below the reasonable range of average depreciation rates for other U.S. utilities; and (3) UE's proposed new depreciation expenses reasonably reflect industry average levels. Mr. Stout's Schedules 13-2 through 13-4 show that the same is true for individual categories of plants—in particular distribution assets. As these charts vividly illustrate, Staff's recommended substantial reduction in depreciation expenses clearly is out of line with the rest of the country.

Q. Why does the Staff's proposal lead to increased rate volatility?

A. There is a considerable risk of sharp rate increases whenever plant is retired. Under the Staff's proposal, the customers who are being served at that time would face both the costs associated with retiring the plant as well as the cost of the new plant needed to replace the retired plant.

Q. Considering these factors, how should net salvage costs be recovered in rates?

A. The cost of plant retirement (*i.e.*, the plant's net salvage costs) should be collected ratably over the life of the plant from customers actually served by the plant. The depreciation methodology which collects net salvage costs ratably over the life of the plant is called the "whole life method." The whole life method is used by virtually every regulatory agency and depreciation professional. And both UE's test-year depreciation expenses and proposed depreciation expenses are based on the whole life method.

Nevertheless, the whole life method has been rejected by the Staff in favor of expensing net salvage costs as they occur. Except for Pennsylvania (which is required by an early 1960's decision of the Pa. Superior Court to treat net salvage as an expense) and in certain instances this Commission, no regulatory body is known to use the Staff's proposed treatment of net salvage costs.

Q. The Commission has been concerned about the uncertainty associated with estimating when and at what cost a utility's plant would be retired. Would UE reap a windfall gain if a plant would be retired later than planned or if actual net salvage costs turned out to be less than the forecast costs?

A. No. The only costs that customers ultimately will pay are the actual net salvage costs. First, estimates of net salvage costs and retirement dates are updated as new information becomes available. But more importantly, any net salvage costs recovered through depreciation are reflected in the depreciation reserve and, consequently, serve to reduce the Company's rate base and its allowed return. Any inadvertent overcollection of net salvage would simply benefit future customers through a lower cost of service. As a result, because of this rate base accounting treatment, uncertainties associated with retirement dates and net salvage costs would create neither windfall gains nor windfall losses for the Company.

Q. You noted that the Staff's depreciation treatment is inconsistent with the Commission's own precedent, given UE's significant infrastructure investment requirements. Please explain.

A. As explained in the rebuttal testimony of Mr. Stout, UE's need for substantial infrastructure investments is exactly the situation confronted by the Commission in the most recent St. Louis County Water Company rate case. In that case, the Commission continued to treat net salvage costs as an element of the company's depreciation calculation to ensure that the company had adequate cash flows to finance needed investment in infrastructure. In the current case, it is every bit as critical to UE, our customers, and the State of Missouri, that the Company be afforded the means to make the necessary infrastructure investments. Consequently, the Commission should continue to include an appropriate amount of net salvage costs in the Company's depreciation rates. If deemed necessary, UE would be willing to set aside some portion of depreciation-related cash flows in an account ear-marked for infrastructure improvements similar to St. Louis County Water.

Q. Aside from its improper treatment of net salvage costs, are there any other problems with the Staff's calculation of depreciation rates?

A. Yes. As also explained in the rebuttal testimony of Mr. Stout, the service lives for various classes of property developed by Staff witness Jolie Mathis are highly unreasonable, because they are based on rigid adherence to the results of a computer model, rather than the informed judgment of a depreciation professional. This results in lives for many accounts that are unrealistically long and, as a consequence, depreciation rates that are too low.

Moreover, the Staff has proposed that UE refund, by amortizing over 40 years, close to $1 billion of depreciation expenses that the Company has already recovered through Commission-approved rates in the past. As explained in the rebuttal testimony of Ms. Kelly, the Staff's fundamental change in depreciation ratemaking methodology and the proposed refund of these already collected depreciation expenses constitutes retroactive ratemaking. The amortization of these already collected amounts alone would inappropriately reduce the Company's revenue requirement by approximately $25 million per year.

Q. Please explain why the Staff's depreciation proposal is inappropriate given the Company's infrastructure investment requirement.

A. As shown graphically in Mr. Stout's Schedule 7-1 (also attached to my Executive Summary), UE's need for infrastructure investments are substantial and significantly in excess of the level of such infrastructure investments in recent years. The Staff's proposed sharp reduction of depreciation expense reduces the Company's internal cash flows and, as a result, impairs the Company's ability to make these infrastructure investments in a timely and cost efficient manner.

C. THE STAFF'S COST OF SERVICE PROPOSAL CONTAINS NUMEROUS INAPPROPRIATE ADJUSTMENTS TO TEST-YEAR COSTS

Q. You noted that the Staff's cost of service proposal contains numerous inappropriate adjustments, is based on unsubstantiated assumptions, and results in the effective disallowance of prudently-incurred expenses. Please discuss examples for such inappropriate adjustments.

A. Certainly. The following cost of service adjustments by the Staff are good examples of such inappropriate cost of service adjustments.

Tree Trimming Expenses

The Staff's cost of service study eliminates over $4 million in annual tree trimming expenses. This reduction was the result of a 4 year averaging technique based on historical costs. As Mr. Voss explains in his testimony, the Staff reduces these costs despite the fact that there has been a clear upward trend of these costs due to increasing labor costs and the Company's increasing effort to control vegetation in order to maintain and increase system reliability. Staff is well aware of these cost trends and the fact that expected future costs are no lower than test-year expenditures. From a regulatory policy perspective, the elimination of these prudently incurred expenses flies in the face of one of the Company's main objectives—the provision of reliable service to its customers.

Non-Recurring" Costs

The Staff arbitrarily throws out costs by labeling them as "one-time, non-recurring." It thus fails to recognize that (1) the truly "non-recurring" costs were prudently incurred and should be recovered in some fashion from ratepayers; and (2) there is, in fact, a "recurring" level of "non-recurring" costs that should be factored into a test-year. The Company faces unique new challenges and associated costs all the time. There's nothing unusual or abnormal about that—its simply part of doing business in an uncertain world. For example, it would be impossible for a family to balance its checkbook if certain expenses—be it for medical treatment, a car repair, or a needed replacement of a major household item—were left out of the ledger simply because they are infrequent or non-recurring. Yet this is exactly the situation that UE will find itself in, if the Staff prevents recovery of prudently incurred costs that benefit customers merely because those precise events and costs do not arise every year. The Staff has not provided any evidence that the test-year costs reflect "non-recurring" costs that are above normal levels. It would be impossible for the Company's rates to be just and reasonable under such a systematic under-compensation of its services. If the Commission were to disallow such costs, the Company would not be able to recover in its rates this "normal" cost of providing its services.

Midwest ISO Exit Fees

It is unrefuted that the $12.5 million exit fee paid by UE to withdraw from the Midwest ISO was prudently incurred, and Staff witness Proctor concedes that reimbursement of the exit fee is uncertain. Yet, the Staff recommends that the fee be disallowed, based on the speculation that it will be refunded at some point in the future. But the only way the fee can be refunded to UE is if the Company rejoins that Midwest ISO, which will subject the Company to approximately $6 million per year in ISO administrative charges. These charges far exceed the test year expense associated with UE's proposed amortization of the exit fee and are ignored by the Staff. The Staff cannot have it both ways—either the recovery of the exit fee and the imposition of the $6 million in administrative charges must both be recognized, or amortization of the exit fee must be allowed as an expense.

<u>Switching from Accrual to Cash-Basis Accounting</u>

The Staff goes so far as to reject the well-established and universally-recognized accrual basis of accounting in favor of its own *ad hoc*, standardless version of cash-basis accounting—thereby eliminating more than $10 million of test-year costs. As Mr. Lyons explains in his testimony, accrual accounting calls for the recording of costs when obligations have been incurred and the amount of funds required to satisfy them are estimable and likely to be paid. It is particularly suited for the ratemaking process, as it is designed to accurately match revenues with the costs incurred to produce those revenues. The accrual method of accounting allows the recovery of costs (incurred to provide current services) from ratepayers in temporal proximity to the events that give rise to those costs. The cash basis arbitrarily and inconsistently used by the Staff merely permits the recovery of expenses associated with services and liabilities long-since past, bearing no relation to current or future service and subject to all manner of manipulation and gamesmanship. No reason is offered to reject the accumulated wisdom of years of accounting practice embodied in GAAP.

<u>Fuel and Power Purchase Costs</u>

As Mr. Finnell explains in his testimony, the Staff attempted to "normalize" almost $400 million worth of fuel and purchased power costs based on the results of a production cost model that has not been appropriately validated. The Staff uses these results to reduce test-year fuel and power purchase costs by over $40 million.

In addition, the Staff has reduced the cost of service, in effect, by proposing that the Commission unilaterally change certain provisions of the Joint Dispatch Agreement ("JDA"). The JDA has been approved specifically by the FERC and the Illinois Commerce Commission and, as an integral part of the UE-CIPS merger and Ameren Energy Generating Company spin-off, indirectly also by this Commission. As discussed further in the testimonies of Mr. Nelson and Mr. Voytas, this unilateral adjustment to contractual provisions specifying how benefits of Ameren's interchange sales are allocated to UE eliminates approximately $4 million from UE's cost of service.

Similarly, the Staff proposes to disallow part of the costs associated with UE's power purchase contract with Ameren Energy Marketing ("AEM") based on an after-the-fact assessment of the these costs. The Staff now claims that the contract constitutes affiliate abuse even though the Staff was closely involved in the resource planning and competitive bidding effort leading up to this purchase, and despite the fact that FERC has reviewed and approved the contract, specifically finding that the contract is priced appropriately and does not constitute affiliate abuse. Nevertheless, the Staff attempts to disallow part of the AEM contract costs by applying its "affiliate rules" to UE even though these rules do not legally apply to the Company. In addition to this unlawful application of affiliate rules, however, the Staff's adjustment is highly inappropriate because of its application of an erroneously understated "normalized" cost standard. Mr. Voytas and Mr. Nelson address these matters further in their testimony.

<u>Pension and OPEB Expenses</u>

Staff has proposed to eliminate over $7 million in UE's test-year costs by applying a new methodology to account for expenses associated with UE's pension plans and OPEBs. As explained in the testimony of Mr. McGilligan, however, the Staff's new methodology achieves this adjustment to test-year costs only by increasing the volatility of these expenses and by deferring from current to future customers more of the expenses associated with UE's increasing pension and OPEB plans. As Mr. McGilligan also shows in his testimony, the Staff's proposed methodology almost *triples* the volatility of pension and OPEB expenditures as compared to UE's current method and causes a substantial run-up of these expenditures whenever financial markets perform poorly, such as in a weak economy. In fact, Mr. McGilligan shows that the Staff's methodology would lead to an average $25 million in increased pension expenses over the next 5 years, based on the known and measurably poor asset returns of 2000 and 2001. The Staff's methodology, which also is inconsistent with GAAP, is highly opportunistic because its reduction of test-year costs is driven solely by the fact that financial markets have performed well in the several years prior to the test-year. For the Staff to recommend this change in methodology is simply poor regulatory policy.

Incentive Compensation

The Staff proposes to disallow over $6 million in costs associated with three incentive compensation programs for UE's employees despite the fact that these incentive compensation plans: (1) contain clearly ascertainable goals to improve performance to the direct benefit of UE's Missouri electric customers; (2) are based on challenging "stretch goals" that reward employees' performance at levels beyond their ordinary duties; (3) resulted in clearly visible benefits; and (4) are needed to provide UE's employees with compensation levels equal to industry average levels. The testimonies of Mr. Lindgren and Mr. Cross discuss these matters in more detail. test-year

UE's incentive compensation plans are funded only if the Company achieves certain pre-determined levels of earnings per share (EPS). For purposes of this calculation, EPS may be adjusted to reflect refunds, one-time charges, and other unusual events. This adjustment is necessary in order to avoid punishing or rewarding employees for uncontrollable events, as well as for certain short-term effects of sound business decisions with long-term positive effects, such as cost effective contract buyouts and employee separation programs. It also avoids creating a moral hazard for managers charged with making such decisions, whose incentive compensation might be jeopardized. These adjustments may either increase or decrease the EPS levels against which funding of the incentive compensation plans is determined. For 2001, for example, reported EPS levels were adjusted downwards for incentive compensation purposes.

The amount of funds made available under each plan depends on whether the Company achieves the threshold, target, or maximum pre-determined level of such earnings. However, as Mr. Lindgren explains in more detail, funding of the plans does not mean that incentive compensation payments are actually made. Rather, the large proportion of incentive compensation payments under each plan depends on the attainment of clearly-defined, pre-determined performance indicators targeted to produce tangible benefits to UE and its customers. For example, these performance indicators set three levels of increasingly challenging targets (in other words, base and stretch targets) to motivate employees to decrease power plant production costs, increase plant availability, increase distribution system reliability, reduce delivery service cost per customer, increase customer satisfaction ratings, reduce employee accident rates and lost work days, streamline administrative processes, increase new business revenue, increase employee training, and improve call center efficiency, among others. These payments create strong performance incentives at individual, group, and company levels whose results are clearly visible through examples, such as the Sioux Plant employees' recent feat to set the world record for the longest continued operation of that plant type.

The benefits to Missouri customers of such performance increases are readily identifiable. In addition, the plans also directly benefit UE's customers: (1) through the earnings sharing provided under UE's alternative rate plans; (2) through strong incentives to make operations more effective and efficient; and (3) through the Company's ability to attract and retain more talented employees and managers. In the long run, customers will pay lower rates and receive better service quality as a result of these plans.

The funding of these incentive plans and a small portion of payout do depend on earnings per share, but they create more than a shareholder benefit. Ameren's incentive compensation plans are structured specifically to align the interests of the Company's employees, customers, and shareholders. The plans create incentives to lower costs, increase earnings, and improve service—all of which benefit both shareholders and customers. This is particularly true for UE's past EARPs and the proposed new Alt Reg Plan which share earnings directly between customers and shareholders. By tying the funding of incentive compensation to earnings, employees will see benefits if their performance also benefits customers and shareholders. I further discuss in section VIII.A how alternative regulation in conjunction with these incentives has changed the Company to the benefit of all stakeholders.

Finally, I would like to stress again that the incentive compensation plans represent an important investment in Ameren's human capital. A utility such as Ameren must not only train but also retain skilled managers and employees. Just as the Company must maintain its power lines and physical plant in order to provide quality service, so it must encourage and maintain a quality workforce and management.

If incentive compensation were to be disallowed, UE would not be able to recover in rates, reasonable, market-based labor expenses. This is because, without the opportunities provided by the incentive compensation plans, employees' total salaries would be below market levels. By disallowing incentive compensation, the Commission would send a strong signal to reduce incentive payments in exchange for higher base compensation in the future. This action may be required simply to retain and attract skilled managers and employees, but would sharply reduce the performance incentives of UE's employees which, in conjunction with alternative regulation, have demonstrably created sizeable benefits for UE's customers. This is not a policy that should be followed.

D. STAFF'S RATE PROPOSAL DOES NOT COMPLY WITH COMMISSION RULES

Q. Does the Staff's rate proposal contain any other flaws?

A. Yes. Counsel advises me that the Staff's rate proposal contains a serious flaw that by itself renders the Staff's recommendation unlawful. This flaw is the Staff's failure to comply with 4 CSR 240-10.020, the Commission's rule that governs the treatment of accumulated depreciation when calculating the return component of a utility's revenue requirement. That rule requires the Commission to calculate the return component of a utility's revenue requirement by multiplying the gross rate base (original cost without subtracting accumulated depreciation) by the authorized rate of return. The revenue requirement must then be reduced to reflect an imputed income of 3% per year on accumulated depreciation.[1]

UE recognizes that the Commission has in recent cases simply failed to follow this rule and, instead, determined the return component of revenue requirement by multiplying *net* rate base (original cost less accumulated depreciation) by the authorized rate of return.[2] I also understand the Commission has not rescinded or in any way amended 4 CSR 240-10.020 through the appropriate procedures under Missouri law. I have been informed by counsel that under the law, and as Ms. Kelly discusses in her testimony, the Commission is not free to simply ignore one of its duly promulgated rules, but must apply a rule, according to its terms, until it is properly rescinded or amended. As Mr. Weiss shows in Schedule 20 of his testimony, had the Staff complied with 4 CSR 240-10.020 without changing any of its other current calculations (ignoring that those calculations are flawed in many respects), their rate proposal would reflect a rate increase of $42 million. Accordingly, even if the Commission were to disagree with the Company's rebuttal testimony and affirmative cost of service determination and conclude that the Staff's cost of service calculations were in all respects accurate and proper, UE would still be entitled under the law to have 4 CSR 240-10.020 applied to Staff's calculations, yielding a rate increase here of $42 million.

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[1] The following formulas reflect this treatment:
(Original Cost of Rate Base) x (Rate of Return) = Gross Return
(Accumulated Depreciation) x 3% = Credit for Income on Accumulated Depreciation
(Gross Return) – Credit = Allowed Return

VII. UE-MISSOURI'S COST OF SERVICE WOULD JUSTIFY A RATE INCREASE

Q. Has UE prepared its own cost-of-service study for the purpose of determining just and reasonable rates for the Company's Missouri electric retail service?

A. Yes. UE has prepared its own cost of service study to determine the appropriate level of the Company's Missouri electric retail rates. This affirmative cost of service study is presented in the rebuttal testimony of Mr. Weiss. In addition, the testimony of Mr. Kovach presents the Company's class cost of service study which supports a rate structure that aligned more closely with the costs the Company incurs to serve each rate class.

Q. What changes would be necessary to UE's Missouri electric rates based on the Company's cost of study?

A. As Mr. Weiss shows in his testimony, the combination of appropriately test-year costs and revenues, updated depreciation rates, and a reasonable rate of return would necessitate a *rate increase* of approximately $148 million.

Q. What are some of the key factors on which the Company's cost of service study is based?

A. The Company's cost of service determination is based on "per book" values for the test-year ending June 30, 2001 updated through September 30, 2001 (as

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[2] [(Original Cost of Rate Base) – (Accumulated Depreciation)] x (Rate of Return) = Allowed Return

approved by the Commission). As discussed in Mr. Weiss's rebuttal testimony, the cost of service study also reflects the following adjustments to the test-year book values:

- Normalization of UE-Missouri for weather, unbilled sales, and lost customers (as discussed in the testimonies of Mr. Voytas and Mr. Weiss) and UE-Missouri's associated fuel and purchased power costs (as discussed in the rebuttal testimony of Mr. Finnell);
- A 12.5 % return on equity, which is based on the recommendation of UE's cost of capital witness, Ms. McShane, is well within the range of ROEs that other commissions have approved since the beginning of the test-year period;
- Revised depreciation rates as discussed in the rebuttal testimony of Mr. Stout and net salvage values based on the necessary funding of fossil generation plant retirements, as discussed in the rebuttal testimony of Mr. LaGuardia;
- Annualization of 2001 payroll increases as discussed in the testimony of Mr. Weiss;
- A 4-year amortization of Midwest ISO exit fees as discussed in the rebuttal testimony of Mr. Whiteley;
- Normalization of the expenses associated with the Callaway refueling outage; and
- Reduction of Missouri advertising expenses of $1 million; and
- Revised jurisdictional allocation factors (as discussed in the rebuttal testimonies of Mr. Weiss and Mr. Kovach).

As one can see, the number of adjustments that were made to test-year expenses are very modest. Simply put, aside from the standard normalization of certain revenues and expenses, our cost of service largely reflects our actual costs incurred by the Company during the test-year.

Q. **How can the significant difference between the Staff's proposed $246 million to $285 million rate reduction be reconciled with your affirmative cost of service determination, indicating that current rates collect approximately $148 million *less* than UE-Missouri's cost of service?**

A. The difference between Staff's filed complaint and the Company's cost of service determination is driven primarily by:

- The difference between the Company's proposed ROE and Staff's return recommendation;
- The difference between the Company's depreciation expense proposal and Staff's depreciation proposal;
- Differences between the Company's and Staff's weather normalized revenues and fuel and power purchase costs;
- Staff's inappropriate adjustments to or provisions for expenses such as tree trimming and rate case costs;
- Staff's elimination of certain expenses, including Venice fire expenses, Midwest ISO exit fees, and adjustments to the costs of capacity purchases;
- Differences in the treatment of pension and OPEB expenditures; and
- Staff's application of cash accounting instead of accrual accounting.

Q. **Does the Company propose new rates based on your affirmative cost of service results?**

A. No. The Company proposes that the Commission confirm that a continuation of alternative regulation is in the public interest and approve the Company's proposed Alt Reg Plan attached as Schedule 1 of my testimony. If, however, the Commission should decide that a return to the traditional regulatory model is warranted, then the Company proposes that rates be set based on the Company's affirmative cost of service determination. Either way, the Company will file compliance tariffs to implement the Commission's order. Under the traditional regulatory model, these compliance tariffs will also reflect the Commission's decision on the Company's customer class cost of service study and rate structure proposal as presented in the testimony of Mr. Kovach.

Q. Would the Company be legally entitled to rates in excess of the rates that the Company would propose under the traditional regulatory model?

A. Yes. If 4 CSR 240-10.020 were applied to the Company's affirmative cost of service determination, the necessary rate increase would be $524 million. However, though it is the Company's position that UE AmerenUE is legally entitled to a rate increase of up to that amount, the Company is willing to forego this rate increase under that rule, provided that the Commission adopt either the new Alt Reg Plan or set reasonable rates under the traditional regulatory model to which UE could agree.

VIII. THE COMMISSION SHOULD IMPLEMENT THE COMPANY'S PROPOSED NEW ALTERNATIVE REGULATION PLAN

A. CONTINUATION OF SETTING UE'S RATES BASED ON ALTERNATIVE REGULATION IS IN THE PUBLIC INTEREST

Q. Why do you recommend that the Commission should continue to set just and reasonable rates based on alternative regulation?

A. I recommend that the Commission continue to set UE's rates based on alternative regulation for several important reasons. First, UE's previous EARPs have successfully resulted in lower costs, lower rates, high customer satisfaction, important infrastructure investments made on a timely basis, and a financially healthy company. This is also addressed in the testimonies of Professor Weisman and Dr. Lowry, as well as Section IV of my testimony above. Second, alternative regulation recognizes that the utility industry no longer operates in a static environment. Alternative regulation provides utilities with the flexibility to operate efficiently and effectively in today's marketplace. Third, alternative regulation simply provides better incentives and the prospect of significant gains for all stakeholders. As I noted in Section III of my testimony, industry and regulatory experts recognize the importance of strong performance incentives, particularly given today's rapidly-changing market place. Putting aside the problems with the Staff's cost of service presentation, the traditional regulatory model as applied by the Commission's Staff provides extremely limited performance incentives—and is particularly ill-suited to regulate utilities in today's dynamic market place.

The Company's proposed Alt Reg Plan provides for a continuation of the performance incentives under which UE has successfully operated under the EARPs. The Alt Reg Plan also builds on the experience gained from the previous plans, and includes a variety of modifications that are designed: to increase customer benefits through additional customer credits and rate reductions; to enable UE to make specific, significant infrastructure investments; to monitor service quality; to greatly accelerate the payment of customer credits; to reduce the likelihood of disputes; and to fund low income customer assistance and economic development programs in UE's service territory. I will discuss these improvements and features of the new Alt Reg Plan in greater detail below.

Q. Why does UE need stronger performance incentives than those provided by the traditional regulatory model? Doesn't the Company have the *obligation* to operate efficiently?

A. The Company has always taken very seriously its obligation to operate efficiently. However, based on my own experience with competitive markets, providing strong performance incentives gives companies and their employees that extra "edge" to run operations more efficiently, capitalize on new opportunities to control costs, and improve other aspects of overall performance. As seen in the rise of this country and the more recent decline of centrally-planned nations, stronger performance incentives will make a huge difference in the long run. Professor Weisman, whose testimony discusses this subject in greater detail, also points out that the achievement of superior performance under incentives, such as those provided by competitive markets, is a discovery process in which efficient operating practices and innovations are only discovered over time due to better incentives. In our economy, such discoveries are not the result of obligations, but are achieved as a result of explicit incentives.

The Governor's Energy Policy Task Force recognized the importance of providing incentives and rewarding performance even in regard to Missouri state agencies. For example, in the context of providing better incentives to improve state agencies' energy efficiency, the Task Force report recognized that "*agencies may be reluctant to become more efficient if those efficiencies result in a dollar-for-dollar reduction in their budget*" (Task Force report, p. 19, emphasis added). To overcome this reluctance and provide improved incentives for state agencies to improve efficiency, the Task Force recommended that "*State agencies that achieve savings from energy efficiency measures should retain a portion of those savings to advance their mission.*" (*Id.*, emphasis original). This insight about limited efficiency incentives of state agencies almost literally applies also to the limited performance incentives utilities face under cost-of-service regulation as practiced by the Staff. Similarly, the Task Force's recommendation that state agencies should retain a portion of their savings from improved efficiency to advance the mission, is a strong endorsement of the type of shared savings plans that the Commission has approved twice for Union Electric.

Q. How have the alternative regulation plans specifically changed UE's operations?

A. I have been with Union Electric since the first year of the first EARP and have known UE's operations as an outside consultant for many years before that. This gives me a good perspective on how the previous alternative regulation plans have changed UE's operations and its entire perspective on performance. How the EARPs have changed the Company's employees' perspective on performance has been expressed eloquently by my predecessor, Donald E. Brandt:

> There are a couple items I think are very critical to the issue at hand. The most important has been the use of this [EARP] agreement, the two agreements in helping to change the culture of the Company.... [I]t's my job to beat on people about cost.... [But employees] said, every time we reduce costs, the Commission comes and takes it away. [T]hat's the way the cost-of-service model rate base regulation works,...that's a disincentive. And when we got this plan in place, I made speech after speech... Here's your opportunity, folks. This is as close to competition I can get you right now, but you make a dollar and we get to keep half of it. It goes to the bottom line. And again, regardless of whether I'm talking to a vice president or a pipefitter in one of our power plants, that's had an effect, and I've seen that effect... It's good for the shareholders and it's good for customers. I know that sounds trite, but that rings a bell when it comes to employees. (Transcript of Proceeding, Case No. EO-96-14, pp. 266-67.)

Simply put, incentives drive performance leadership. Performance leadership, a key cornerstone of our Company's strategy, controls costs, increases our focus on our customers' needs, and sharpens investment decisions. The result is a win-win proposition for all stakeholders in the form of lower rates, high customer satisfaction, a strong energy infrastructure, and strong overall returns to investors.

For example, the incentives provided by the previous two EARPs encouraged the aggressive management of our employee headcount. In 1998, the Company implemented a targeted separation plan that resulted in savings of approximately $16 million per year at an overall up-front cost of $18 million. Under traditional regulation, these up-front costs would have been a significant concern since a rate complaint could have followed immediately after the plan was implemented. In that case, the Company would not have been able to recover its up-front costs through savings and associated profits in the subsequent years. In contrast, the EARP provided the

Company with the opportunity not only to recover these costs, but also to share in the net savings directly and immediately with our customers.

Further, the EARP focused management on analyzing sound investments in the infrastructure of its system. For example, investments in the form of plant additions and targeted maintenance significantly improved the availability of UE's generating plants. As a result, UE's plants were on line and operating efficiently during one of the most volatile energy price periods in the history of the industry. This served to reduce costs to our customers who now enjoy some of the lowest production costs in the country. Without these investments our costs would be significantly higher today.

We also sharpened our focus on the transmission side of our business. Our strategic location in the center of the country, coupled with the incentives to make incremental investments and optimize these assets, allowed us to capitalize on the opportunity to increase wheeling revenues from wholesale transmission service, almost all of which is paid by out-of-state entities. As Mr. Whiteley shows in his testimony, this resulted in revenue benefits of over $160 million and associated earnings which were shared with customers as well.

Recognizing the importance of service quality to successful utility operations in general and to a successful outcome under the EARPs, the Company has also expended significant efforts to maintain service reliability and customer satisfaction while controlling costs. In its continuing efforts to deliver high service quality and reliability, UE also made significant investments in new call center infrastructure and positioned itself as a national leader in network-wide automated meter reading and outage reporting. In addition, the Company continued its focus on good, old-fashioned tree trimming. As a result, the Company's customer satisfaction is among the best in the country. Mr. Voss, the Senior Vice President of Customer Services, discusses these activities further in his testimony.

The Company's innovations in environmental technologies have greatly reduced the environmental impact of its power plants while, at the same time, drastically reducing, by a factor of ten, the cost of environmental compliance. As noted above, the success of the Company's environmental innovation has earned the Missouri Governor's Pollution Prevention Award twice during the EARPs and has resulted in UE's major power plants ranking at the very top of the nation's electric utility plants in terms of environmental performance. Most recently, due to the outstanding team work of our employees at the Sioux plant, UE set a new world record for longest continued operation of that plant type.

These benefits are just a few examples of what we have achieved during the last 6 years under the EARPs. It is not a coincidence. Recognizing the benefits of the EARP and its incentives, the Company realigned its incentive compensation program to focus and reward employees for the achievement of certain targets, the key performance indicators. While the incentive compensation plans are discussed in more detail in Mr. Lindgren's testimony, I was the leader of the overall "Performance Management" program. The concept is quite simple: senior management establishes a set of challenging targets for certain key performance indicators that are aligned with the Company strategic initiatives and customer benefits. Important performance targets, such as power plant availability and plant costs apply specifically to UE's operations. Further, since approximately 70% of our business is represented by electric retail operations in

Missouri, it goes without saying that achievement of performance indicator targets which appear to apply to Ameren as a whole, also directly benefit our regulated Missouri operations.

Under this incentive compensation program, the results were clear: performance improved, many of the most challenging targets were achieved, and shareholders, customers, and employees benefited. The success of this program could not have been achieved absent the incentives and flexibility provided by the EARPs. In short, incentive regulation works and produces tangible results with clear benefits to all stakeholders.

B. SUMMARY OF FEATURES AND BENEFITS OF THE PROPOSED NEW ALTERNATIVE REGULATION PLAN

Q. Please summarize the main elements of the proposed new Alternative Regulation Plan.

A. The proposed new Alt Reg Plan has been structured to enhance the principles underlying the previous EARPs, based on the experience gained over the last 6 years. New features have also been added to the plan that recognize the energy market environment in which we operate today. The proposed new Alt Reg Plan is presented in Schedule 1 of my testimony and includes the following basic features:

- The Alt Reg Plan's proposed <u>3 year term</u> from July 1, 2002 through June 30, 2005 provides for a desirable continuation of UE's operation under alternative regulation.
- A <u>permanent rate reduction</u> of $15 million will be implemented with an effective date of April 1, 2002.

- A one-time customer credit of $15 million will be paid in the first billing period after the Alt Reg Plan is implemented.
- The Alt Reg Plan sets out specific commitments to make significant new infrastructure investments in UE's generation, transmission, and distribution operations for the purpose of supporting adequate generation supply, transmission import capability, and service reliability.
- The Alt Reg Plan will implement a low income customer assistance program and an economic development program for the benefit of Missouri customers in UE's service territory. These programs will be initially funded through a combined one-time payment of $10 million ($5 million each). The Company proposes to administer these funds through two independently governed programs, but is open to the Commission's further guidance. Under this proposal, the low income customer assistance program would be administered through the Company's existing "Dollar More" program, and the economic development program would be administered through a new Ameren Community Development Corporation. The testimony of Company witness Mr. Richard Mark discusses these two programs in further detail.
- The Alt Reg Plan provides for annual Performance Dividends (i.e., additional customer benefits) to share a portion of UE's earnings for the benefit of the Company's Missouri electric retail customers, UE's low-income customers, and economic development needs in UE's service territory. After each sharing period, beginning with the year starting July 1, 2002, this Performance Dividend will provide specifically: (1) annual Sharing Credits to customers'

bills, and (2) additional annual funding for the low income and economic development programs.

- As specified in the plan's sharing grid, an annual Sharing Credit of $15 million will be provided automatically if the pre-sharing ROE for the Company's UE Missouri electric operations is equal to or above 10.5%. For a pre-sharing ROE at or above 10.5% the Company will also provide a combined annual $2 million funding of the low income and economic development programs ($1 million each).
- In addition to these $17 million of baseline Performance Dividends, the Company will also share 55% of earnings between an ROE of 12.5% and 15.0% with its customers in the form of increased Sharing Credits (50% of earnings) and increased funding of the low income customer assistance and economic development programs (5% of earnings split between the two programs).
- Based on the proposed sharing grid, the Company would also share an additional 90% of earnings between an ROE of 15 and 16%, and 100% of any earnings above a 16% ROE. As a result, UE's Missouri maximum earnings (after sharing) are limited to an ROE of approximately 13.3%. This limit on earnings will ensure that UE-Missouri's earnings remain well within a reasonable range during the term of the Alt Reg Plan. Of course, in order for UE to achieve the maximum ROE, very high levels of financial performance would be required given rising costs and significant infrastructure investment.

- The $17 million baseline Performance Dividend in the 10.5% to 12.5% sharing band is specifically designed as a fixed amount within this wide band to minimize future disputes over earnings calculations and to incentivize UE to achieve strong levels of performance.
- The new Alt Reg Plan will provide for greatly accelerated payment of the Performance Dividends through the immediate payment of undisputed amounts of any Performance Dividends (*i.e.*, sharing credits and funding of the low income customer assistance program and the economic development program funding) approximately 2 months after the conclusion of each sharing period. Upon the resolution of any disputes, any outstanding amounts will be paid with interest.
- Based on the experience with the Company's experimental alternative regulation plans, the proposed Alt Reg Plan contains added specificity and clarified language. This should further reduce the likelihood of disputes over the meaning of certain provisions.
- The proposed Alt Reg Plan provides for improved performance monitoring, including the monitoring of service quality such as call center and distribution system reliability measures.
- Finally, the Company will not be able to file a rate increase case unless earnings fall below a 9.5% ROE for a 12 month period or unless UE is adversely affected by major events beyond its control.

Q. Please summarize the main benefits and improvements that the new Alt Reg Plan provides.

A. The new Alt Reg Plan contains a number of important benefits and improvements. First, the proposed plan provides for a continuation of alternative regulation. Over the 3-year term of the new plan, its up-front rate reduction, one-time customer credit, and payments of Performance Dividends (i.e., customer sharing credits and funding of the low income economic assistance and economic development programs) provide at least $121 million in expected benefits that would not be available to Missouri customers under a fairly-applied, traditional regulatory model.

Second, the Alt Reg Plan sets out the Company's commitment to undertake commercially reasonable efforts to make a minimum of $1.5 billion to $1.75 billion of new infrastructure investments from January 1, 2002 through June 30, 2005. This commitment includes infrastructure investments in generation, transmission, and distribution, such as: 700 MW of new regulated generation capacity; upgrades to existing plants which will ultimately result in 270 MW of additional generating capacity; new transmission lines or transmission upgrades that will increase transmission import capability by 1,300 MW; and various projects in transmission and distribution upgrades to improve the overall reliability of UE's energy delivery system. Similar to a provision that the Iowa Utilities Board recently approved in an alternative regulation plan for MidAmerican Energy Company, this commitment provides additional assurance that UE's customers will continue to enjoy a reliable energy infrastructure. UE's infrastructure investment requirement also is consistent with the precedent this Commission established in the St. Louis County Water Company case.

Third, as already noted above, the new plan greatly accelerates customers' receipt of Performance Dividends by paying the undisputed amount of such dividends immediately after the Company completes its earnings calculation for the preceding sharing period and stakeholders had the opportunity to review those calculations. In addition, the new plan also requires that the Company complete its earnings calculations by August 15, approximately 6 weeks faster than under the previous EARPs. To the extent that a portion of the Performance Dividends should be delayed because of further disputes, the new plan will hold customers harmless by accruing interest on the disputed amounts.

Fourth, this plan recognizes the importance of providing monies to help those in need during tough economic times, but also is forward looking by providing sorely needed economic development funds to help bring new employers and jobs into Missouri.

Fifth, the new plan provides for payment of $17 million in "baseline" Performance Dividends to UE's Missouri customers. This baseline Performance Dividend is paid as soon as UE's Missouri electric ROE reaches 10.5%. Due to this "baseline" Performance Dividend mechanism, the Company will share its earnings with its customers at a much lower ROE than the previous EARPs. For example, should UE's earnings for any given year result in an ROE of 12.5%, UE would effectively share 22% of its earnings above 10.5% under this plan, which in turn would also result in an effective return of only about 12.1% after sharing. If UE's actual ROE is 11.5% in any given year, then its earnings sharing percentage would be over 40% of the earnings above 10.5%. At the same time, this mechanism continues to drive UE to attain high levels of performance in its operations.

In other words, under the proposed Alternative Regulation Plan, the Company starts sharing a significant portion of earnings at a threshold of 10.5%. As pre-sharing earnings exceed a 12.5% ROE (equivalent to an earned ROE of only 12.1%), an additional 55% of earnings are shared in the form of higher Performance Dividends. By comparison, under the previous EARPs, UE did not begin any sharing of its earnings until it achieved a 12.6% ROE. In addition, because much of the Company's realized earnings before sharing are expected to fall within the 10.5% to 12.5% range, the provision of the fixed $17 million annual Performance Dividend will serve to minimize disputes associated with the calculation of earnings. As long as all stakeholders are reasonably certain that realized earnings fall within this 10.5% to 12.5% ROE range, there will be no need to pursue any potential disagreements over how earnings should have been calculated.

Sixth, the new plan specifically provides for the monitoring of service quality and distribution system reliability. This provision is similar to the service quality monitoring requirement which this Commission has imposed as a condition for the approval of UtiliCorp's merger with SJPL, except that it applies here for the entire duration of the Alt Reg Plan.

Seventh, the continuation of alternative regulation through June 30, 2005 provides customers with more stable, predictable rates than under the traditional regulatory model. At the same, the plan also provides UE with a more predictable regulatory environment and clearly-defined, broad-based performance measures. This gives the Company the flexibility needed to adjust to changing economic and energy market conditions, and allows it to shift its attention from dealing with the administrative burden of cost of service regulation back to focusing on increasing its performance and customer satisfaction. The Commission and its Staff will similarly benefit from the substantially streamlined regulatory process and reduced administrative burden provided by the plan.

Finally, the proposed Alt Reg Plan provides additional up-front benefits to customers in the form of one-time credits, initial funding of low income and economic development programs, and rates that are lower than the Company's normalized test-year cost of service. While this plan will likely result in an overall ROE below the 12.5% ROE that the Company believes to be an appropriate risk-adjusted return under the traditional regulatory model, the Alt Reg Plan does provide the opportunity to earn such a return if UE can achieve additional performance gains during the duration of this plan. At the same time, however, by limited post-sharing ROEs to approximately 13.3%, the plan's sharing grid also assures that the ROEs which the Company realizes from its Missouri electric retail operations remain within a reasonable range during the entire duration of the plan. As shown in Ms. McShane's testimony, this limit on the Company's achievable return is well within the range of reasonable returns.

Q. How has the Company determined that the "sharing bands" of the proposed Alt Reg Plan are reasonable?

A. The Company, in consultation with Ms. McShane, has designed the plan's sharing bands specifically to be consistent with the reasonable range of the return on equity of UE and comparable utilities. The baseline sharing band ranges from a pre-sharing 10.5% to 12.5% ROE with a center point of 11.5% which is approximately equal to a post-sharing ROE range of 10.1% to 12.1% (with a center point of 11.1%). As explained in Ms. McShane's rebuttal testimony, this corresponds to the range of returns that have recently been allowed for utilities by other regulatory commissions. It also corresponds to the sharing grids that other commissions have allowed for similar plans.

The upper end of this baseline sharing band (i.e., 12.5% pre-sharing and 12.1% post sharing) is consistent with Ms. McShane's estimate of UE's cost of equity and the range of recent commission-approved ROEs for other utilities in the Midwest. Finally, the maximum ROE of 13.3% that UE-Missouri can theoretically achieve under the proposed plan (although such an outcome is extremely unlikely) is consistent with the ROE limits approved by the Commission in the previous EARPs and, as Ms. McShane shows, is also well within the range of returns on equity that other well-performing utilities in the Midwest have been able to achieve.

Q. You noted that the Alt Reg Plan's proposed sharing grid is consistent with the sharing grids that other commissions have been allowing for utilities. To which cases are you referring?

A. The Company's proposal to share an additional 55% of earnings above the effective 12.1% threshold (*i.e.*, after payment of $17 million baseline Performance Dividends) and 90% above approximately 14.6% (again after payment of the baseline Performance Dividend) is very similar to the sharing grid of the alternative regulation plan that the Iowa Utility Board recently approved for MidAmerican Energy Company. The sharing grid of that particular plan, provides for 50/50 sharing between 12% and 14% ROE, and 83.3% sharing (to customers) above 14%.

Similarly, the sharing thresholds of UE's proposed Alt Reg Plan are lower than the 13% threshold under which Northern States Power and Otter Tail Power share half of their earnings through alternative regulation plans approved by the North Dakota commission little more than a year ago. The Alt Reg Plan's lower threshold of 10.5%, below which the Company will not be required to pay the $17 million in baseline Performance Dividends, is also lower than the 11% ROE threshold for Northern States Power and Otter Tail, below which the two companies can pass on to their customers half of their earnings shortfalls.

Q. You referred twice to the alternative regulation plan that the Iowa Utilities Board approved for MidAmerican Energy Company, once with respect to UE's commitment to make certain infrastructure investments and the second time with respect to the sharing grid. Did the Iowa Board make any findings that this Commission might find to be relevant in this case?

A. Yes, the Iowa Board made several relevant findings. The MidAmerican plan represents a settlement that will leave rates at current level through 2005. This "rate freeze" follows a dispute in which the Iowa Office of Consumer Advocate filed a rate complaint asking for a $77 million rate decrease while the company filed for a $50 million rate increase. In approving this settlement, the Iowa Board specifically recognized: (1) the substantial benefits of rate stability, predictable revenues, and better efficiency incentives provided by the plan; (2) that this more flexible regulatory model is required in the "hybrid" environment in which utilities need to operate today (*i.e.*, regulated retail with a competitive, volatile wholesale market); (3) that the settlement continues a similar plan under which MidAmerican operated since 1997; and (4) that the Board can find the settlement to be reasonable without a formal full cost of service determination. While the Iowa Utilities Board also noted that the sharing grid is at the high end of what it has been determining as a reasonable range for utilities' allowed ROE, the Board also found the sharing grid to be consistent with the higher risks associated with (1) the plan's multi-year rate freeze; (2) electric operations without a fuel adjustment clause; and (3) the necessity to build new generation. These considerations and risk factors also apply to UE's electric operations in Missouri.

Q. What conclusions do you draw about UE's proposed new Alt Reg Plan?

A. Based on these analyses and comparisons, I truly believe that the Alt Reg Plan that we have proposed in this proceeding balances the interest of all our stakeholders and will clearly result in a win-win situation for our customers, shareholders, employees, and the State of Missouri. I strongly recommend that the Commission approve the Company's proposed new Alternative Regulation Plan as presented in Schedule 1 to my testimony.

Q. Does this conclude your testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission,	)	
Complainant,	)	
	)	
vs.	)	Case No. EC-2002-1
	)	
Union Electric Company, d/b/a AmerenUE,	)	
Respondent.	)	

AFFIDAVIT OF WARNER L. BAXTER

STATE OF MISSOURI)
) ss
CITY OF ST. LOUIS)

Warner L. Baxter, being first duly sworn on his oath, states:

1. My name is Warner L. Baxter. I work in St. Louis, Missouri and I am employed by Ameren Corporation as Senior Vice President-Finance.

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 82 pages, Appendix A and Schedules 1 through 4, all of which have 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.

Warner L. Baxter

Warner L. Baxter

Subscribed and sworn to before me this 9th day of May, 2002.

Mary Hoyt

Notary Public

My commission expires: 4-01-2006

MARY HOYT
Notary Public - Notary Seal
STATE OF MISSOURI
Jefferson County
My Commission Expires: April 1, 2006

EXECUTIVE SUMMARY

Warner L. Baxter

Senior Vice President, Finance, of Ameren Corporation, AmerenUE, and AmerenCIPS

* * * * * * * * * * *

The significance and magnitude of the Staff's complaint case cannot be overstated. Just as a matter of sheer numbers, the Staff's proposed $245 million to $285 million rate cut represents not only the largest rate reduction UE has ever faced but, by some accounts, is the highest-profile, most important, largest complaint case in the history of the Missouri Public Service Commission. Otherwise ignorant of the facts, a reasonable observer—perhaps not schooled in the finer points of ratemaking but having an appreciation for the common-sense of a utility's operations and our State's energy needs—may well think that UE must be a bloated, inefficient utility that has been significantly overcharging its customers.

But those are <u>not</u> the facts.

In fact, UE's customers currently enjoy some of the lowest rates in the country, region and the state. Since UE started operating under Experimental Alternative Regulation Plans (EARPs) in mid 1995, customers have received over $425 million in rate reductions and sharing credits. At the same time, the Company has achieved one of the highest customer satisfaction ratings in the country and has received several commendations for its environmental leadership. As Professor Dennis Weisman's Schedule 2-1 (attached to this Executive Summary) shows, consumers in the St. Louis metropolitan area enjoy the second lowest electricity prices of any of the major metropolitan areas reported by the U.S. Bureau of Labor Statistics. Professor Weisman's Schedule 2-2 (also attached hereto) shows that, while average electricity prices generally increase significantly with the size of metro areas, prices in the major St. Louis metropolitan area have been well below the average prices of both mid-sized and major metro areas in the Midwest and nationwide.

In fact, UE's performance has increased markedly under the EARPs. Professor Weisman shows that UE's customers enjoyed sizeable reductions in effective rates relative to the trend of rates for the other utilities in the Midwest. Dr. Mark Lowry shows that UE's cost of service would be significantly higher today had it not been for the performance gains achieved under alternative regulation. Not surprisingly, credit rating agencies note UE's well-recognized strengths, including: "competitive rates"; "superb nuclear performance"; "extremely efficient fuel management"; "it's position as one of the lowest-cost producers in the Midwest"; "strong transmission ties"; "a strong cost-conscious management team that is committed to credit quality"; and the fact that the "UE/CIPS merger created a bigger, more efficient utility."

In fact, going forward, UE will need, more than ever, such efficient operation and strong performance to come to grips with increasing operating costs and the need to make significant additional investments in its energy infrastructure to meet the growing needs of its customers in an ever more complicated and volatile energy marketplace.

The Staff's extraordinary—and it is fair to say, punitive—rate recommendation seems totally disconnected with these facts. Why should UE's revenues be slashed in response to such superior performance? Why should UE's revenues be slashed when those funds are needed for infrastructure investment? Simply put, the Staff's rate recommendation is without merit, is not supported by the relevant facts, and, perhaps most importantly, fails to consider important energy and regulatory policy matters in its recommendation.

The Staff's Cost of Service Determination is Fundamentally Flawed

The Staff's rate proposal, while supposedly the result of traditional cost of service analyses, does not employ sound cost of service methodologies and is crippled by numerous technical flaws—which only serve to understate the Company's true costs that it incurs today and that it will incur in the future. As such, the Staff has failed to meet their burden of proving that their proposed rates will establish just and reasonable rates which provide an adequate return on and recovery of investment. For example:

- As Professor Roger Morin and Ms. Kathleen McShane show in their rebuttal testimonies, Staff's return on equity (ROE) recommendation is based on an approach that is far removed from the methodologies for estimating ROE that are reasonably relied upon by experts in the field. How grossly the Staff's 9.41% ROE estimate falls outside the mainstream is illustrated by the fact that ROEs authorized in other states for UE's test year and update period ranged from a low of 10.50% to a high of 12.90%. (This data is set out in Ms. McShane's Schedule 17, and is also attached to this Executive Summary.) The Staff's fundamentally unreliable ROE estimate alone serves to understate UE's Missouri annual electric cost of service by approximately $120 million.
- The Staff's rate proposal is based on a highly inappropriate and irresponsible depreciation calculation that understates UE's current cost of service by approximately $110 million per year by inequitably deferring these costs to the

detriment of future customers. The Staff's approach to depreciation also increases the volatility of rates; relies on a treatment of net salvage costs that is inconsistent with the treatment afforded by virtually every other regulatory agency in the country; is inconsistent with the Commission's own precedent; and, because of its impact on UE's cash flow, would make the financing of UE's infrastructure needs significantly more expensive. As with the Staff's ROE estimate, the unreasonableness of their depreciation approach is made evident by the fact that it results in depreciation expenses that are significantly below those that regulators have allowed for other utilities in the country. (This data is set out in Mr. Stout's Schedule 13-1, which is also attached to this Executive Summary.)

- The Staff's cost of service proposal contains numerous inappropriate adjustments and is based on unsubstantiated assumptions. The Staff substantially reduces test year costs: by effectively disallowing prudently-incurred operating expenses without any attempt to show imprudence or poor business judgment; by normalizing test-year expenses even though there is clear evidence that on-going costs will not be below test year expenses; by unreasonably eliminating costs incurred to retain revenues and to participate in regional transmission organizations; by burdening future customers with higher expenses associated with pension and OPEB plans; by double-counting tax benefits already received by customers; by inappropriately eliminating incentive compensation expenses; by relying on unreliable computer simulations to eliminate costs through after-the-fact modifications of the Company's actual plant operations and power purchases; and by opportunistically switching from accrual to cash accounting.

- The Staff's normalized revenues are overstated by approximately $30 million due to erroneous weather normalization and adjustments for customer growth.
- The Staff's treatment of unbundled transmission revenues, due to their inadequate and unsupported ROE proposal, infringes on FERC jurisdiction by preventing the Company from earning FERC-accepted returns on any of the Company's transmission assets.
- Finally, the Staff's rate proposal does not comply with Commission Rule 4 CSR 240-10.020, governing the treatment of accumulated depreciation when calculating the return component of a utility's revenue requirement. Under this rule, UE would be entitled to *a rate increase* of at least $42 million, even if the Commission otherwise adopted all of the Staff's cost of service calculations.

Ramifications of the Staff's Proposal

Moreover, the Commission cannot rely on the Staff's rate recommendation because their proposal is further handicapped by a narrow perspective that essentially reduces rate-setting to an accounting exercise divorced from any broader policy judgment. This approach betrays an almost absolute, and certainly unwarranted, confidence in the numerical estimation that produced the Staff's proposed rate decrease (an estimate that in the end is wrong), and ignores the real-world energy issues that policy makers, such as this Commission, must address.

For example, the Staff's testimony shows no sign that the Staff has taken into account industry trends and non-cost objectives of sound regulation, such as rate stability, the facilitation of infrastructure investments necessary for reliable and adequate service at reasonable costs, and the need to provide a regulatory structure which gives a utility sufficient financial flexibility to operate effectively and efficiently in today's increasingly complex industry environment. Even worse, the Staff's rate proposal actually undermines UE's ability to make needed infrastructure investments in a timely and cost-effective fashion. For example, Mr. Stout's Schedule 7-1 (attached to this Executive Summary) clearly shows that the Staff's proposal would drastically reduce UE's depreciation-related cash flows exactly at a time when these cash flows are needed more than ever to provide part of the capital necessary to finance new energy infrastructure.

By substantially reducing what already are some of the lowest rates in the country, the Staff's rate proposal would significantly curtail the Company's cash flow, sharply lower credit ratings for UE, increase financing requirements as well as financing costs, limit UE's access to capital markets, impair the Company's ability to make necessary infrastructure investments in a timely and efficient fashion, lead to near term rate increases, and ultimately harm our customers and the State as a whole.

Despite their expectation that this Commission will ultimately reject the Staff's proposal and set reasonable rates, the country's credit rating agencies have already reacted to the regulatory uncertainty associated with the Staff's rate complaint by downgrading the Company's financial outlook. The ripples that the actual implementation of the Staff's rate proposal would send through the financial markets with respect to investor expectations about regulatory risks and inadequate returns in Missouri would almost certainly affect the other utilities in the State as investors demand an additional regulatory risk premium and rating agencies incorporate these new risks in their ratings.

In addition to seriously damaging the financial integrity of UE, it would also demoralize the Company's employees, severely and immediately punish our investors (many of whom are Missouri residents), and potentially impair the independence of Ameren as well. Importantly, implementation of the Staff's rate proposal would penalize UE for its achievements and suggest that striving for superior performance is not in the interest of Missouri utilities and their customers. Undoing of the benefits that two decades of wise State regulatory policy have conferred on customers, utilities, and the State's economy in this way is hardly "just and reasonable," and the Staff's case surely does not prove otherwise.

<u>UE's Affirmative Cost of Service Determination</u>

The Company has prepared its own cost of service study to determine the appropriate level of UE's Missouri electric retail rates. As Mr. Gary Weiss shows in his testimony, the combination of appropriate test-year costs and revenues, updated depreciation rates, and a reasonable return on equity would necessitate a *rate increase* of approximately $148 million under the traditional cost of service regulatory model. This is in stark contrast to Staff's proposal and highlights the inherent unreasonableness of Staff's cost of service recommendation.

While it is the Company's position that UE would be legally entitled to an even greater rate increase under Commission rule 4 CSR 240-10.020 (which would add approximately $375 million to our cost of service), the Company is willing to forego this rate increase under that rule, provided that the Commission adopt either reasonable rates to which UE could agree or the Company's proposed Alternative Regulation Plan (the "Alt Reg Plan").

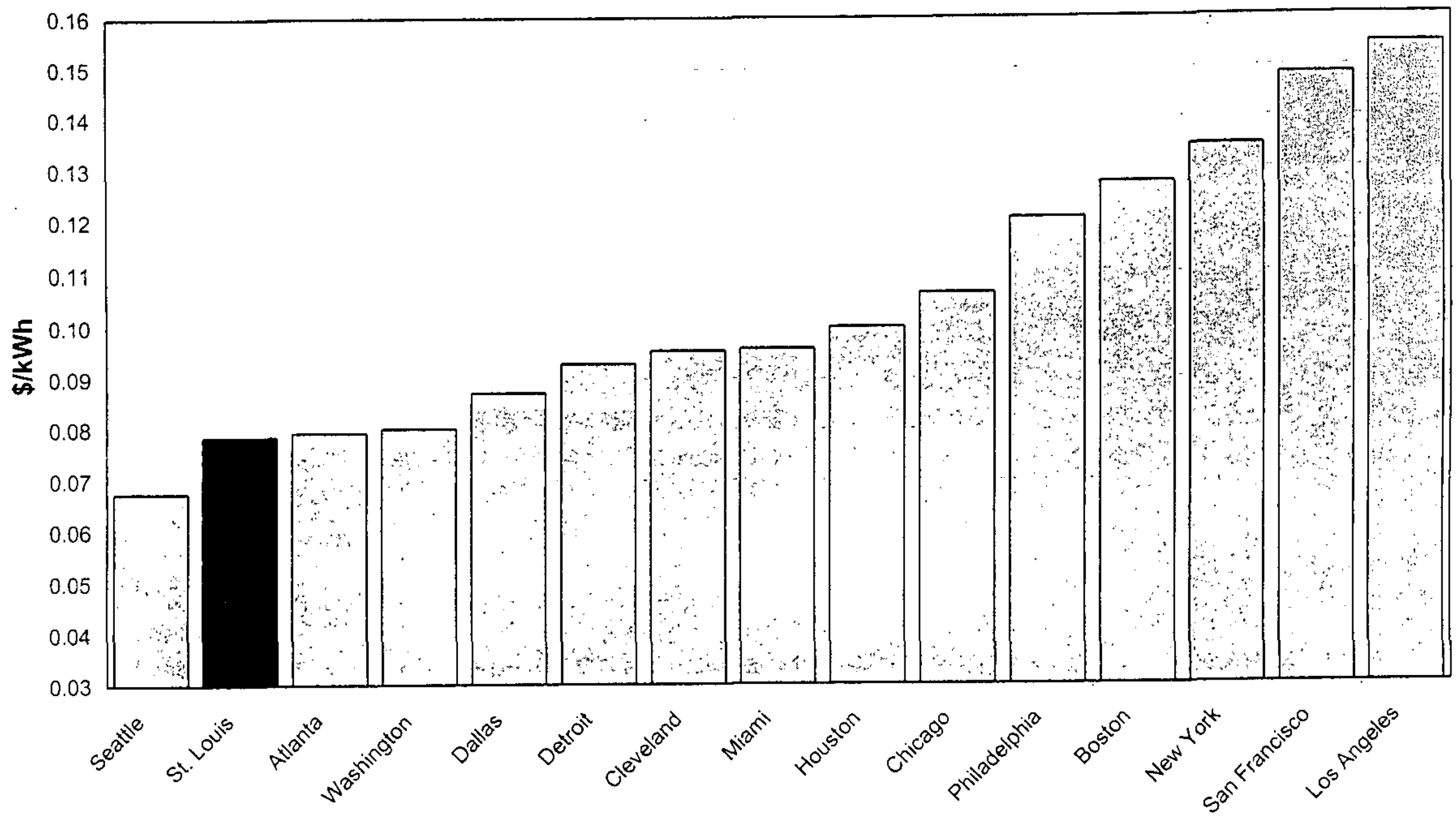
The Proposed New Alternative Regulation Plan

UE proposes for the Commission's approval a new Alt Reg Plan which will take our partnership with the Commission and all of our stakeholders to the next level. The proposed Alt Reg Plan, as presented in Schedule 1 to my testimony, builds upon the experience gained from the prior EARPs and also reflects features and parameters of similar recently-approved plans of other Midwestern utilities, such as MidAmerican Energy Company in Iowa. The EARPs have resulted in superior performance, timely infrastructure investment, low rates, and high quality of service for UE's customers—while also allowing the Company to earn reasonable rates of returns and providing it with the financial flexibility necessary to finance needed infrastructure investment. The EARPs have achieved this by setting out broad but very specific performance targets and standards against which the Company's performance was measured.

The proposed new Alt Reg Plan will provide customers with more stable, predictable rates than the traditional regulatory model, as well as, over its three year term, provide a minimum of $120 million in expected customer benefits from the plan's rate reduction, customer credits, and the funding of low income customer assistance and economic development programs. The Plan specifically includes: (1) an immediate permanent $15 million rate reduction; (2) an immediate one time customer credit of $15 million; (3) an immediate $10 million initial funding of the low income customer assistance and economic development programs ($5 million for each program); (4) a substantial commitment to invest in new generation, transmission, and distribution infrastructure; (5) payment of annual Performance Dividends that, based on a revised sharing grid, include customer sharing credits and additional annual funding of the low income and economic development programs; (6) a revised sharing grid under which a \$17 million Performance Dividend is paid as soon as UE's ROE equals or exceeds 10.5%, and under which these Performance Dividends are increased further through additional sharing of UE's earnings above 12.5% (an additional 55% sharing of earnings above 12.5%, 90% sharing above 15%, and all of UE's earnings above 16%); (7) measures to reduce future disputes over earnings calculations; (8) greatly accelerated payment of Performance Dividends with immediate payment of undisputed amounts and accrual of interest on disputed amounts; and (9) monitoring of service quality and distribution system reliability. The sharing thresholds and ROE levels that the Company can achieve under this plan (which are capped at about 13.3%) are consistent with the reasonable range of investors' required ROE for UE and comparable utilities, with the ROEs that other regulatory commissions have been allowing, and with the sharing thresholds that commissions have set for similar plans in other states.

Based on these analyses and comparisons, I strongly believe that the proposed Alt Reg Plan is the appropriate regulatory framework going forward and that it clearly serves the public interest by creating a win-win proposition for all stakeholders. While UE is willing to operate under a fairly-applied traditional cost of service model, I am convinced that providing broad-based performance incentives through this Alt Reg Plan is a superior approach to regulating utilities in today's industry environment—both from a company and customer perspective. I thus strongly recommend that the Commission use this opportunity to continue the successful regulatory framework that it embraced over six years ago and approve the Company's proposed Alt Reg Plan.

Schedule 2-1: Average Consumer Electricity Prices (2001) for All Major Metropolitan Areas Reported by the Bureau of Labor Statistics

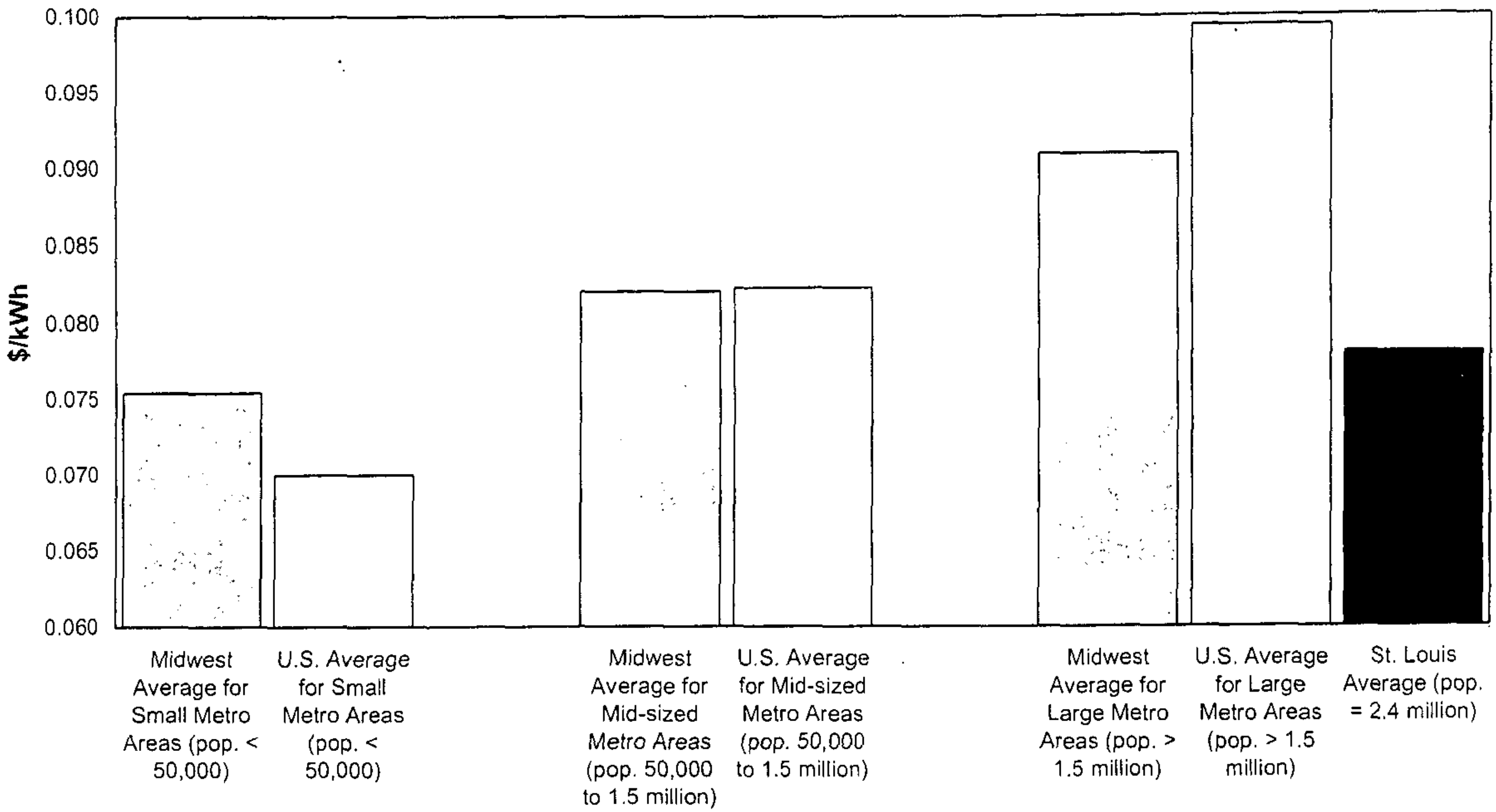


Appendix A-10
Weisman Schedule 2-1

Notes:
1 - BLS data based on monthly surveys of 10 residential electricity bills per metropolitan area.
2 - St. Louis Metro Area includes some counties not served by Ameren. Rates do not include seasonal discounts or EARP sharing credits.
3 - Data for St. Louis for 1998 to 2001 are obtained by extrapolating 1997 data using the annual growth rate of the CPI electricity index for the city of St. Louis.
4 - Source: www.bls.gov/data.

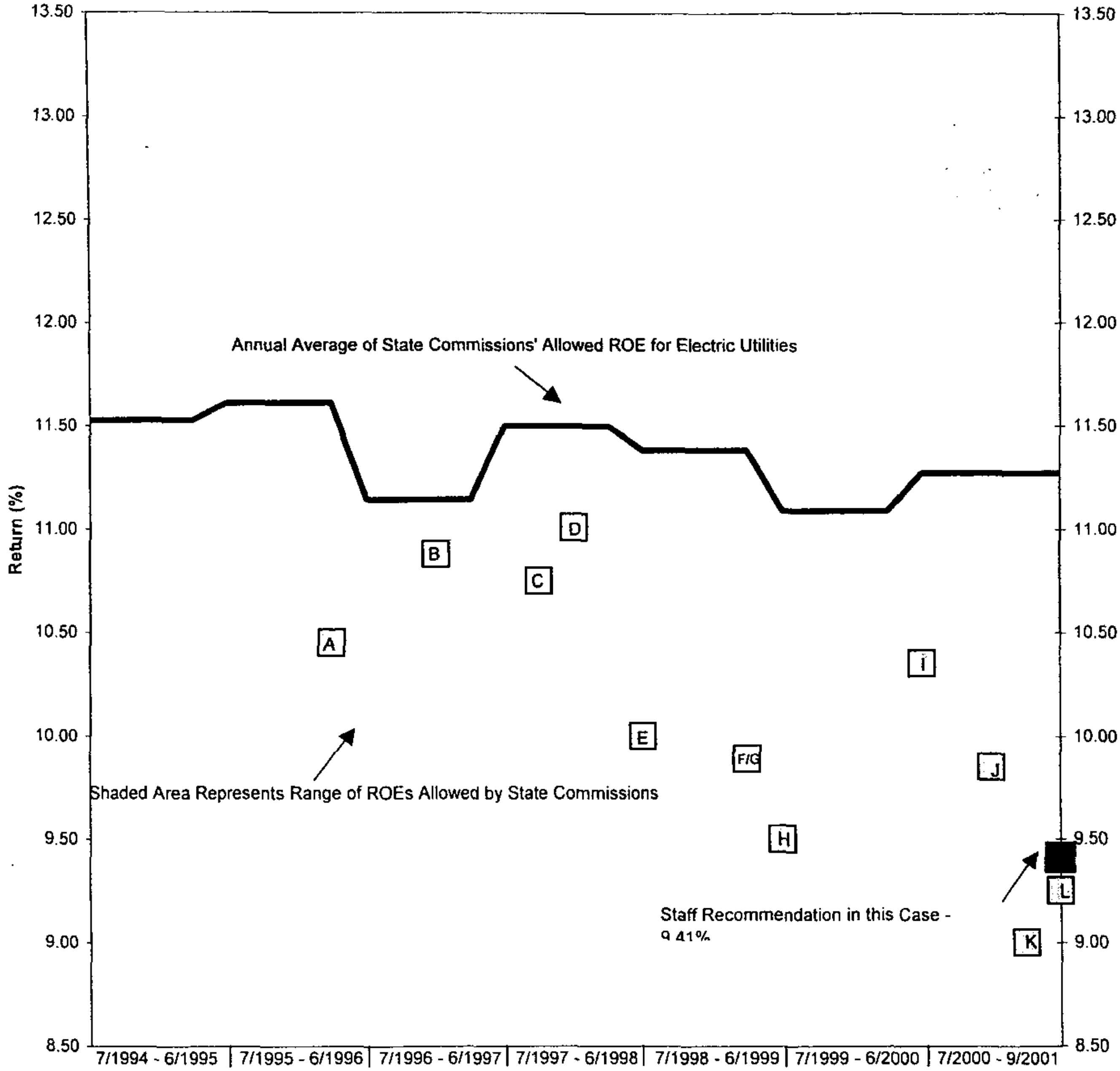
Schedule 2-2: Consumer Electricity Prices by Size of Metro Area -- U.S. and Midwest Averages 1998-2001

(Based on Monthly Consumer Price Surveys Reported by the Bureau of Labor Statistics)



Notes:
1 - BLS data based on monthly surveys of 10 residential electricity bills per metropolitan area.
2 - St. Louis Metro Area includes some counties not served by Ameren. Rates do not include seasonal discounts or EARP sharing credits.
3 - Data for St. Louis for 1998 to 2001 are obtained by extrapolating 1997 data using the annual growth rate of the CPI electricity index for the city of St. Louis.
4 - Source: www.bls.gov/data.

Comparison of Allowed Returns on Equity
(MPSC Staff Recommendations Compared to State Commissions' Orders)



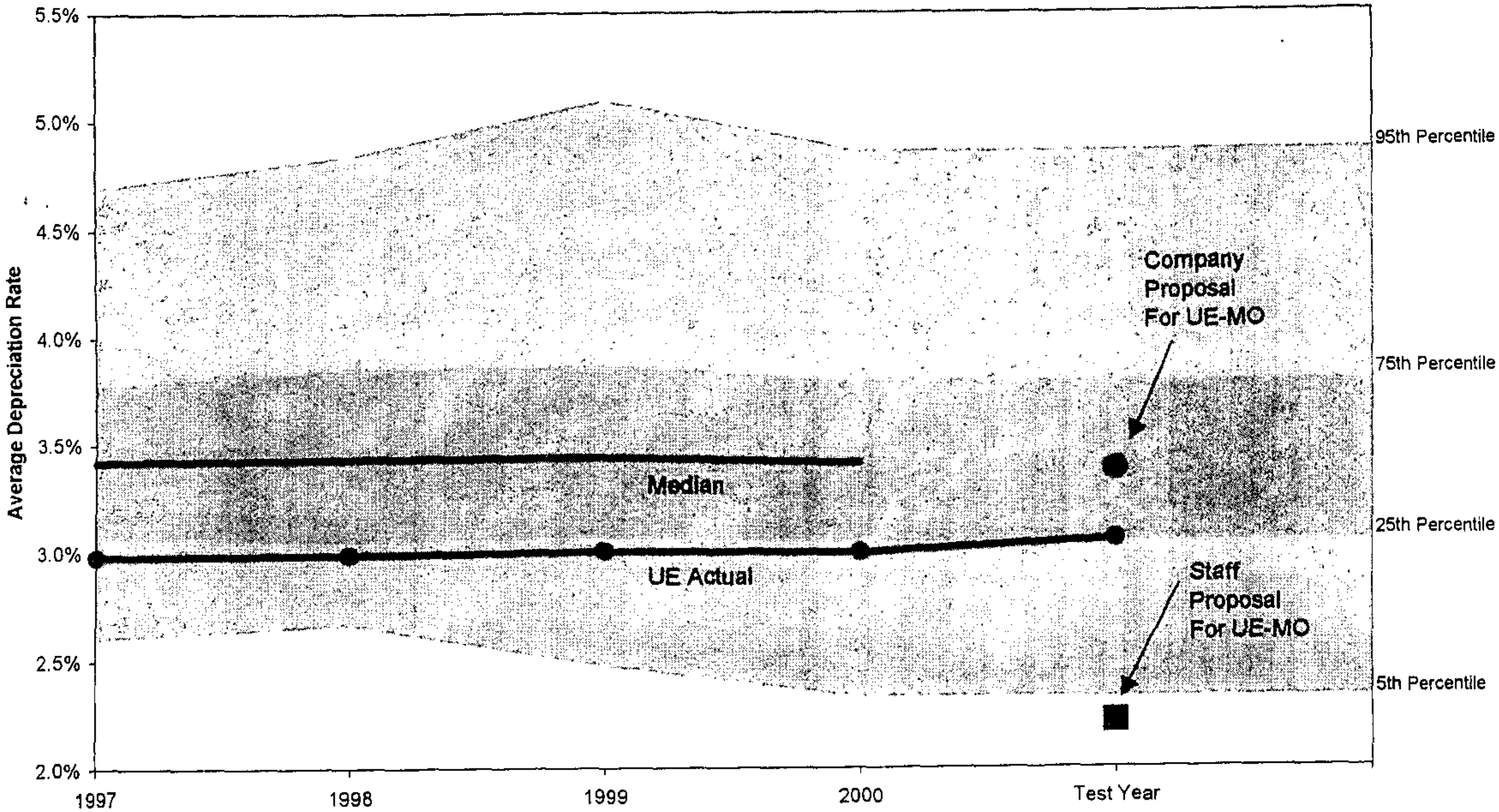
Staff ROE Recommendations

A - Broadwater - GR-96-193 - Laclede (1996) - 10.45%
B - Broadwater - ER-97-81 - EDE (1997) - 10.88%
C - Hill - ER-97-394 - MPS (1997) - 10.75%
D - Bible - GR-98-140 - Missouri Gas (1998) - 11.01%
E - Broadwater - GR-98-374 - Laclede (1998) - 10%
F - Bible - GR-99-246 - SJLP (1999) - 9.89%
G - Bible - ER-99-247 - SJLP (1999) - 9.89%
H - Broadwater - GR-99-315 - Laclede (1999) - 9.5%
I - McKiddy - GR-2000-512 - AmerenUE (2000) - 10.35%
J - Murray - GR-2001-292 - Missouri Gas (2001) - 9.85%
K - McKiddy - ER-2001-299 - EDE (2001) - 9%
L - McKiddy - GR-2001-620 - Laclede (2001) - 9.25%

Note:
Allowed ROE statistics for 2001 do not include MPSC's September 21st decision allowing a 10.00% ROE for Empire District Electric.

Source:
Regulatory Research Associates, Inc., Regulatory Focus, Jan. 2001 and Oct. 10, 2001

Schedule 13-1: Average Depreciation Rate for Investor-Owned Utilities
(Depreciation & Amortization Expense / Gross Plant Value)
Total Plant



Sources:
Median, Percentile, and UE Actual, 1997 - 2000: UDI.
UE Actual Test Year and Company Proposal: AmerenUE.
Staff Proposal: Staff Schedule 5.

Appendix A-13
Stout Schedule 13-1