Exhibit No.:	
Issues:	Other
Witness:	Martin R. Cohen
Sponsoring Party:	State of Missouri
Type of Exhibit:	Surrebuttal Testimony
Case No.:	ER-2008-0318

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

SURREBUTTAL TESTIMONY OF

MARTIN R. COHEN

ON BEHALF OF

STATE OF MISSOURI

November 5, 2008

NP

1 **Q. Please state your name.**

2 A. I am Martin R. Cohen.

3 **Q. Are you the same Martin R. Cohen who submitted direct testimony on behalf of**
4 **the State of Missouri earlier in this proceeding?**

5 A. Yes.

6 **Q. What is the purpose of your surrebuttal testimony?**

7 A. My purpose is to respond to portions of the testimony of certain witnesses regarding
8 the issue of AmerenUE's request for approval of a fuel adjustment clause, including
9 AmerenUE witnesses Martin J. Lyons, Jr., Ajay K. Arora, Robert K. Neff, and Scott
10 A. Glaeser; Staff witnesses Lena M. Mantle and Michael S. Proctor; Office of the
11 Public Counsel witness Ryan Kind; Noranda Aluminum witness Donald Johnstone;
12 and Missouri Industrial Energy Consumers witness Maurice Brubaker.

13 **Q. After reviewing the rebuttal testimony have you changed your view that a fuel**
14 **adjustment clause is not necessary for AmerenUE at this time?**

15 A. No. The ability of the company to reasonably manage its net fuel costs under ratebase
16 rate of return regulation has not fundamentally changed since the Commission
17 declined to implement an FAC for AmerenUE in docket ER-2007-0002. Automatic
18 adjustment of rates without scrutiny of the overall balance of income and expense
19 over a test period would remove the Company's primary incentive for maximizing its
20 efficient purchase and use of fuel and maximizing its off-system sales of power.
21 Therefore, imposition of a FAC should be avoided unless clearly necessary to the
22 financial health of the utility. As the Commission wrote in its order last year, "A fuel

1 adjustment clause is a powerful regulatory tool to be used with careful consideration.
2 If a fuel adjustment clause is allowed in an inappropriate situation, the customers who
3 pay for utility service can be forced to pay rates that are higher than they should be."
4 (P. 17)

5 **Q. Mr. Lyons states that you are "philosophically opposed to any kind of rate**
6 **adjustment mechanism." Is this an accurate description of your position?**

7 A. No. Rate riders may sometimes be necessary, but they should be employed with
8 caution and meet a high standard because of the risks they transfer to customers and
9 their potentially negative consequences on utility decision making and ultimate cost
10 of service. The statute (Section 386.266 RSMO) recognizes this by giving the
11 Commission discretion to consider Rate Adjustment Mechanisms on a case by case
12 basis but no directive to employ them at all. After assessing the different facts and
13 circumstances of the three applications for FACs that have come before it, the
14 Commission has not come to the same conclusion in all of these cases. My view of
15 this case is based on the particular circumstances of AmerenUE at this time.

16 **Q. Mr. Lyons criticizes your support of traditional regulatory test year principles.**
17 **Have these ideas become obsolete and "outside the mainstream" as he suggests?**

18 A. No. In fact the Commission articulated a view in support of traditional regulatory
19 principles in ER-2007-0002:

20 A fuel adjustment clause should be used cautiously because it runs contrary to
21 some of the basic principles of traditional regulation. One such principle is the
22 matching of expenses and revenues. Over time, certain expenses incurred by

1 the utility may go up. For example, the wages the electric utility pays its
2 linemen may increase, or a major industrial customer may close, causing a loss
3 of income. At the same time, perhaps the utility saves money when the interest
4 rate it must pay to borrow money goes down, or it adds revenue by serving
5 new customers. The increase costs or decreased income in one area may be
6 balanced by decreased costs or increased revenue in another area.
7
8 In a traditional rate case, without a fuel adjustment clause, the Commission
9 examines all the revenue and costs of the utility during a particular period
10 known as a test year. The commission then matches the revenue and costs,
11 arriving at an amount the utility needs to recover from its ratepayers if it is to
12 earn a reasonable return on investment. If a fuel adjustment clause, or other
13 tracking mechanism, is established, then the utility would be able to pass on
14 increased costs in one area, in this case fuel and purchased power, without an
15 examination of all the other areas in which its costs may have decreased or its
16 revenues increased. As a result, ratepayers could be required to pay increased
17 rates while the company enjoys increased profits. (Pp. 17-18)
18 Traditional cost of service regulatory principles are not out of the mainstream. On the
19 contrary, they are used in every state with public utility regulation. Expense tracking
20 measures are exceptions to the rule and must be justified with substantial evidence
21 that they are necessary.

1 **Q. Under Mr. Lyons' interpretation of the standards for judging a FAC application,**
2 **articulated by the Commission most recently in its Empire order (ER-2008-0093,**
3 **P. 37), are there circumstances under which approval could be denied?**
4 A. Apparently not. Under Mr. Lyon's formulation, passing the three-pronged test would
5 be virtually automatic for any integrated investor-owned public utility seeking an
6 FAC. The first standard, that the costs are substantial enough to have a material
7 impact on financial performance, would always be satisfied because fuel is always a
8 significant cost for utilities that own power plants. The second standard, that these
9 costs are beyond the control of management, would always be satisfied because
10 utilities "cannot control coal, gas nuclear fuel and power markets." (Lyons, P. 20) The
11 third standard, volatility, also would pose no obstacle because market driven prices of
12 all commodities fluctuate over time and "hedging mitigates some volatility and
13 uncertainty but it doesn't come close to eliminating it." (Lyons at p. 30, line 7). Under
14 Mr. Lyons interpretation of the standards, there would be no need for the Commission
15 to have discretion over any application for a fuel adjustment clause because there
16 would be no circumstances under which approval could reasonably be denied.
17 **Q. Mr. Lyons testifies with regard to the volatility standard that "even with the**
18 **robust hedging programs AmerenUE has in place, substantial uncertainty**
19 **remains." (Lyons at P. 29) Is uncertainty the same thing as volatility?**
20 A. No. The company continues to conflate the two concepts, but they are far from
21 identical and "uncertainty" does not appear among the FAC standards articulated by
22 the Commission. A significant degree of uncertainty about future conditions always

1 exists, and as Staff witness Mr. Proctor explains, it is a "fact that uncertainty is greater
2 the further away the forecast is from real time." (Proctor, P. 27) The meaning of
3 volatility is expressed in the standard as "causing significant swings in income and
4 cash flows if not tracked."

5 **Q. Do the Company's witnesses argue that it needs an FAC because of significant**
6 **swings in income and cash flows?**

7 A. No. They argue that the Company has not been achieving its authorized rate of return
8 because of a rising cost environment, and that an FAC is therefore justifiable under
9 the statute regardless of what additional standards the Commission may use to judge
10 its necessity. However, the Commission's view on this point was succinctly stated in
11 its ER-2007-0002 order: ". . . rising, but known fuel costs are the worst reason to
12 implement a fuel adjustment clause." (P.23)
13
14 Failure to earn its authorized rate of return in a historical period is not justification for
15 an FAC. Underearning, if it occurs, is an appropriate basis for filing a rate case. As
16 the Commission concluded, "A future rate case, not a fuel adjustment clause, is the
17 proper means by which AmerenUE should recover its rising fuel costs." (p. 26)

18 **Q. Doesn't the Company experience swings in income and cash flows?**

19 A. While of course there are changes in income and cash flows caused by changes in net
20 fuel costs over time, the question is whether they are "significant" enough to
21 necessitate an FAC. Staff witness Ms. Mantle's analysis shows that the Company's

1 hedges have locked in near-term costs sufficiently to reduce changes to levels that
2 allow the Company an opportunity to achieve a fair rate of return.

3 **Q. Mr. Aurora characterizes certain conclusions in your direct testimony as "simply**
4 **wrong" and reflecting "an apparent misunderstanding of" his analysis. Are**
5 **these characterizations accurate?**

6 A. No. Mr. Aurora has apparently misunderstood my testimony. A part of the analysis
7 in his direct testimony purports to show that the modeled uncertainty in net fuel costs
8 (coal in the example used in my direct testimony) is far less than the actual observed
9 historical uncertainty. He compares the standard deviation to the average annual
10 prices from 1999-2007 to measure historical uncertainty. If he is using an appropriate
11 method of measuring historic uncertainty, his testimony demonstrates that the RTSim
12 model predicts future coal prices that are only about 35% as uncertain as historic
13 experience (11%/31%). Mr. Arora deduces from this information that the model is
14 probably underestimating forward-looking uncertainty. However, that is not the only
15 possible conclusion to draw from this information. Based upon his comparison, my
16 direct testimony observed that without an FAC, Ameren adequately managed its fuel
17 costs despite the historically greater level of uncertainty.
18

19 Moreover, as I have already testified, uncertainty is not a factor that has been used by
20 the Commission to judge the need for a fuel adjustment clause.

21 **Q. Mr. Lyons testifies that denial of its request for a fuel adjustment clause would**
22 **"penalize AmerenUE for its good performance" in successfully managing its fuel**

1 **costs in recent years (Lyons at P.31, line 14). How do you respond to that**
2 **assertion?**
3 A. AmerenUE has an obligation to manage its business as efficiently as possible so that
4 its cost of service and resulting rates paid by customers are as low as possible. An
5 FAC is an optional tool to be used with discretion by the Commission. It is certainly
6 not a penalty for the Commission to deny approval of an FAC because the evidence
7 shows that a company can manage its fuel costs without one. A public utility simply
8 does not have the option of choosing to provide other than good performance of all its
9 functions, including its management of fuel costs. As Chairman Davis put it in his
10 concurring opinion in ER-2007-0004 (P.7):

11 If Aquila fails to adopt a proper hedging strategy, fails to follow its hedging
12 strategy or abuses the discretion given to it by this commission in any other way,
13 this commissioner will not hesitate to modify or reject Aquila's FAC application .
14 . . .

15 Mr. Lyon's contention that rejection of the Company's FAC proposal would unfairly
16 penalize it underscores (inadvertently) my argument against the imposition of an FAC
17 under circumstances when it is not necessary: When the lion's share of risk is
18 transferred to customers and its own money is no longer significantly at stake, a
19 utility's most powerful incentive for good performance is eliminated.
20 **Q. Does the Company suggest that the standards used by the Commission to judge**
21 **FAC requests might result in the Company employing a sub-optimal fuel**
22 **procurement strategy in the future?**

1 A. Yes. Mr. Neff testifies that the hurdle posed by the volatility test "suggests the
2 existence of a perverse incentive to reduce hedging, or to perhaps hedge coal with un-
3 priced, or index contracts, to increase volatility." He echoes Mr. Lyon's claim that the
4 company is being discriminated against "because of the good job" it has done, and
5 asserts that application of the FAC criteria "discourage[s] well-structured and prudent
6 hedging programs." He implies that employment of a procurement strategy designed
7 to increase volatility would be an option for AmerenUE should the Commission
8 determine that current levels of volatility are manageable and do not necessitate an
9 FAC at this time.

10 **Q. Would a strategy by AmerenUE of intentionally increasing its exposure of to**
11 **market volatility be appropriate?**

12 A. No, it would be deplorable. Such a strategy would be imprudent in the extreme and
13 would expose the company to disallowance of costs in a subsequent rate case if the
14 Commission were able to detect it. Such a strategy also might prove to be costly to the
15 utility if exposure to more volatility without an FAC resulted in higher net fuel costs.
16 While intentionally increasing its exposure to market volatility in order to influence a
17 regulatory decision would appear to be a risky and likely self-defeating move, it is
18 unusual and inappropriate for the Company to even suggest that it might consider it.
19 A public utility has a responsibility to minimize its costs and to act in the best
20 interests of its customers and there are no circumstances that justify doing otherwise.

21 **Q. Mr. Neff asserts that, under the Company's proposed 95/5 split of deviations**
22 **from net base fuel costs, AmerenUE could annually absorb an average of**

1 **[redacted]** based on its current budgeted coal cost increases for the next four

2 years, an amount he argues would be sufficient incentive for the company to

3 minimize its costs. Do you agree?**

4 A. Because of likely intervening rate cases, the budgeted, ratebased, and actual amounts

5 are likely to change several times before the end of 2012. What we do know, as I

6 mentioned in my direct testimony, is that the Company's anticipates that its delivered

7 cost of coal will increase by **[redacted]** in 2009 over the test year, which limits the

8 Company's exposure under the FAC as proposed to **[redacted]**, a relatively tiny

9 amount for a company the size of AmerenUE, providing insufficient incentive for

10 optimal procurement practices. That's why I recommend that, in the event the

11 Commission determines that an FAC is appropriate, the sharing of risk between

12 customers and the Company be more balanced than the Company's 95/5 proposal.

13 **Q. Are there other options that would more equitably share risk and provide

14 greater incentive to minimize net fuel costs?**

15 A. Yes. While the exact sharing ratio would be a judgment call of the Commission, a

16 ratio lower than 95/5 would better align the interests of the Company and its

17 customers and could meet the statutory standard that the FAC be "reasonably

18 designed to provide the utility with a sufficient opportunity to earn a fair return on

19 equity." Mr. Kind recommends a 50/50 split, which would not be an unreasonable

20 place to start, and would cut the Company's present exposure in half. Mr. Brubaker

21 and I both recommend a split of 80/20 in our direct testimony. I've not found any

22 testimony citing an evidentiary basis for the 95/5 sharing proposed by the Company,

1 other than the fact that this ratio would be identical to what the Commission found
2 reasonable for Aquila and Empire in earlier proceedings. Mr. Brubaker demonstrates
3 that there are significant differences between AmerenUE and these smaller companies
4 with regard to their relative levels of fuel costs and the effects of changes in net fuel
5 costs on earnings, which support different treatment.

6 **Q. Several Company witnesses cite the prospect of periodic prudence reviews as a**
7 **key reason why the Company would continue to have ample incentive to**
8 **minimize fuel costs and maximize off-system sales, even if the net costs were**
9 **largely passed on to consumers through the FAC. Mr. Glaeser, for example,**
10 **states that "reconciliation reviews are very intensive and thorough." (Glaeser**
11 **P.18) Do you believe that prudence reviews can be relied on to ensure that the**
12 **Company's decisions are in line with its customers' interests?**

13 A. No. Despite the best intentions and hard work of staff, they can't review every
14 decision made and every action taken by the Company and their effects on costs. And
15 it may be impossible to assess the actions *not* taken or to detect (much less quantify)
16 the effects of changes in management priorities or distortions in investment decisions
17 that might occur under a FAC.
18
19 By way of illustration, consider the following hypothetical example: An investment
20 in newly available technology would add $200,000 in annual costs and would
21 improve availability and performance at a generating unit such that net fuel costs
22 would shrink by $1 million per year. Without an FAC, the Company would leap to

1 make such an investment because it would see an immediate annual net benefit of
2 $800,000, which it would retain until the next general rate case, after which it would
3 receive a regulated return on the investment. Under the operation of the FAC as
4 proposed by the Company, in such a situation customers would receive a $950,000
5 reduction in fuel costs and the company would keep $50,000. Return of and on the
6 invested capital and recovery of other new costs would be deferred until the next rate
7 case. Therefore, the Company would have an incentive not to undertake the
8 investment, particularly if the next rate case were not imminent. There is little risk to
9 the Company that the failure to make such an investment could or would be raised
10 successfully as an imprudent counterfactual issue in a prudence review. In this
11 hypothetical, foregoing the investment would be the rational and optimal choice for
12 the company under the incentives of the 95/5 split. If, however, the split were 80/20,
13 the company would realize $200K in immediate annual benefit, equaling the annual
14 costs of the investment and eliminating the disincentive.
15
16 This hypothetical example illustrates a point made by the Commission in its Empire
17 order (P.44), "an after-the-fact prudence review is not a substitute for an appropriate
18 financial incentive."
19 **Q. Mr. Lyons characterizes any asymmetry as "patently unfair." Would the**
20 **asymmetrical FAC you propose be fair to AmerenUE?**
21 A. Absolutely. An FAC would protect the Company by transferring the lion's share of its
22 market risk to customers. If those markets over which the Company has no control

1 produce lower fuel prices and/or higher off-system sales margins than anticipated, it is
2 certainly fair to limit the benefit flowing to the Company to a relatively small amount.
3 This is particularly so in light of the dramatic difference in the cost of money between
4 the Company and the vast majority of its customers, which I cited in my direct
5 testimony. The only rationale for designing an FAC to allow the company any
6 earnings boost due to falling fuel costs is to provide it some incentive to drive net fuel
7 costs down below base levels. While the idea of "symmetry" in FAC design may have
8 superficial appeal, an asymmetric sharing mechanism would lead to just and
9 reasonable rates if fuel costs decline. What would be patently unfair is an opportunity
10 for the Company to receive an undeserved windfall in such an event.

11 **Q. What is your response to Mr. Johnstone's testimony regarding his concern over**
12 **the treatment of replacement power under the proposed FAC in case of**
13 **generating unit outages?**

14 A. Mr. Johnstone's concern is well-founded. The FAC as proposed would flow through
15 to customers all deviations in net fuel costs, regardless of cause. If a generator were to
16 fail, or be shut down for extended maintenance, or reduce its output for any reason,
17 customers would pay through the FAC for purchased replacement power or dispatch
18 of less cost-effective plants. The FAC would also rise if the outage reduced off-
19 system sales or decreased their margins. The potential amount of money at stake in
20 such a situation is large, particularly in the case of an extended outage of a baseload
21 plant. Customers would not be reimbursed for extra costs until either insurance
22 proceeds were paid to the Company (if the Company were insured against such costs)

1 or the Commission were to disallow costs and order an FAC adjustment after finding
2 in a subsequent review that imprudent actions led to the outage. Either course of
3 action would be time consuming and of uncertain outcome, and neither would make
4 consumers whole because of the disparity between the statutory interest rate, which is
5 set at the utility's cost of short-term debt, and the actual cost of money to customers,
6 which is far higher, as I noted in my direct testimony. Mr. Johnstone points out also
7 that initially higher rates followed by eventual lower rates would cause an undesirable
8 "yo-yo effect" on rates. In the event of an extended period of litigation before
9 resolution of issues (an eventuality more likely the greater the stakes), an additional
10 problem of inequity could arise, as some of those who paid the higher FAC leave the
11 utility's customer base.
12
13 I agree with Mr. Johnstone that the Company cannot reasonably claim that operation
14 of its generating fleet is outside its control. Therefore, if the Commission approves a
15 FAC it should include a generation floor for each type of existing power plant –
16 nuclear, coal and natural gas. Such floors should be set based on the average
17 availability and output of the Company's generating units in recent years, adjusted for
18 scheduled outages. Costs for replacement power in the event of unplanned or
19 extended outages that cause output to fall below a floor should not be flowed through
20 the FAC.
21 **Q. Mr. Lyons suggests that the issue raised by Mr. Johnstone is unimportant**
22 **because over the last 20 years AmerenUE has recovered a total of only**

1 **approximately $14 million in replacement power insurance payments. Is this a**

2 **good reason to ignore this issue?**

3 A. No. If the company is confident it can continue to reliably operate its generation fleet,

4 it should not object to standards being put in place to ensure that customers are not

5 harmed in the event that its performance diminishes in the future under an FAC.

6 **Q. Mr. Cohen, does this conclude your surrebuttal testimony?**

7 A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service	)))	**Case No. ER-2008-0318** Tariff Nos. YE-2008-0605

AFFIDAVIT OF MARTIN COHEN

STATE OF ILLINOIS))ss COUNTY OF COOK)

Martin R. Cohen, of lawful age, on his oath states: that he has participated in the preparation of the above Surrebuttal Testimony in question and answer form, consisting of 25 pages of Surrebuttal Testimony to be presented in the above case, that the answers in the above Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true to the best of his knowledge and belief.

Martin R. Cohen

Subscribed and sworn to before me this 4th day of November, 2008.

Notary Public

My commission expires 04-02-2012

OFFICIAL SEAL
DAVID ADAN
NOTARY PUBLIC - STATE OF ILLINOIS
MY COMMISSION EXPIRES:04/02/12