

Exhibit No.:  
Issues: Evaluation of Staff's  
Rate Proposal and the  
Proposed Alt Rcg Plan  
Witness: Suedeem G. Kelly  
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**

**SUEDEEN G. KELLY**

**ON**

**BEHALF OF**

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

**St. Louis, Missouri  
May, 2002**



## TABLE OF CONTENTS

I.	INTRODUCTION .....	1
II.	PURPOSE AND SUMMARY OF TESTIMONY .....	3
III.	SETTING JUST AND REASONABLE RATES AND CONDITIONS OF SERVICE AS A MATTER OF LAW AND REGULATORY POLICY .....	8
A.	Setting Rates And Conditions Of Service As A Matter Of Law .....	9
1.	Missouri Law: Three Legal Obligations .....	9
2.	Federal Statutory Law .....	15
3.	Federal Constitutional Law .....	17
B.	Setting Rates And Conditions Of Service As A Matter Of Regulatory Policy .....	19
IV.	STAFF'S PROPOSAL DOES NOT COMPLY WITH LAW .....	22
A.	Staff Has Not Met Its Burden Of Proof .....	22
B.	Staff's Proposal Does Not Comply With Missouri Law .....	24
1.	Staff Has Not Proven "Excess Earnings" .....	25
2.	Staff's Proposed Rates Are Not Just And Reasonable .....	26
3.	Staff's Proposal Is Not Supported By Competent And Substantial Evidence .....	28
4.	Staff's Proposal Does Not Include All The Facts Necessary For The Commission To Meaningfully Consider It .....	33
5.	Staff's Proposed Rates Are Arrived At By Arbitrarily Excluding Costs Associated With Prudent Business Practices .....	35
C.	Staff's Proposal Does Not Comply With Federal Law .....	37
D.	Staff's Proposal Does Not Comply With Federal Constitutional Law .....	39

V.	STAFF'S PROPOSAL IS INCONSISTENT WITH GOOD PUBLIC POLICY AND WILL ADVERSELY IMPACT THE INTERESTS OF UE'S CUSTOMERS AND SHAREHOLDERS AS WELL AS THE MISSOURI PUBLIC .....	48
VI.	UE'S PROPOSED ALTERNATIVE REGULATION PLAN IS THE BEST RATESETTING CHOICE FROM A POLICY-MAKING PERSPECTIVE: IT WILL CONTINUE TO ENCOURAGE SUPERIOR PERFORMANCE AT LOW RATES WITH ATTENDANT BENEFITS TO CUSTOMERS, SHAREHOLDERS AND THE PUBLIC .....	53
VII.	UE'S COST OF SERVICE PROPOSAL WILL PRODUCE JUST AND REASONABLE RATES CONSISTENT WITH GOOD PUBLIC POLICY .....	58
	A. UE's Cost of Service Will Produce Just and Reasonable Rates.....	58

1 REBUTTAL TESTIMONY

2 OF

3 SUEDEEN G. KELLY

4 CASE NO. EC-2002-1

5 I. INTRODUCTION

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

8 A. My name is Suedeem G. Kelly. My business address is 1117 Stanford NE,  
9 Albuquerque, New Mexico, 87131.

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

11 A. I am a Professor of Law at the University of New Mexico School of Law.  
12 This semester I have a leave from the law school, and I am working as an attorney with  
13 Modrall, Sperling, Roehl, Harris & Sisk.

14 Q. Please describe the University of New Mexico School of Law and  
15 Modrall, Sperling, Roehl, Harris and Sisk.

16 A. The University of New Mexico School of Law is a public educational  
17 institution that offers its students a full-time, three-year legal education culminating in a  
18 Juris Doctor (J.D.) degree. It is accredited by the Association of American Law Schools  
19 (AALS) and maintains a membership in the AALS.

20 Modrall, Sperling, Roehl, Harris & Sisk is a New Mexico law firm.

21 Q. Please describe your education.

22 A. I received my J.D. *cum laude* from the Cornell Law School in 1976. I  
23 received my B.A. *with distinction* in Chemistry from the University of Rochester in 1973.

24 Q. Please describe your work experience.

1           A.     I have practiced regulatory law since 1976; first in Washington, D.C. with  
2     the law firm of Ruckelshaus, Beveridge, Fairbanks & Diamond, then with the Natural  
3     Resources Defense Council. In 1978 I moved to New Mexico and practiced law with the  
4     firm of Luebben, Hughes & Kelly until 1982. Representing Energy Consumers of New  
5     Mexico, Inc. before the New Mexico Public Service Commission was a significant  
6     portion of my practice.

7                     From September 1982 until January 1983, I was an attorney in the Public  
8     Utilities Division of the New Mexico Office of the Attorney General. In January 1983,  
9     the Governor of New Mexico appointed me a Commissioner of the New Mexico Public  
10    Service Commission. In 1984, I became Chair of the Commission. The Commission had  
11    regulatory jurisdiction over New Mexico's electric, gas, and water utilities. In August  
12    1986, I left the Commission to join the faculty of the University of New Mexico School  
13    of Law.

14                    At the law school I teach Public Utility Regulation, Energy Law,  
15    Electricity Law, Administrative Law and Legislative Process. I research, write, and  
16    speak primarily in the areas of public utility and energy law. My publications are listed  
17    in Schedule 1 to this testimony.

18                    My speaking experiences are listed in Schedule 2 to this testimony.

19                    I have also served in professional organizations concerned with utility and  
20    energy law and policy. For example, I served on the Research Advisory Board of the  
21    National Regulatory Research Institute (NRRI) from 1988 through 1992. From 1994  
22    through 2000, I served as Editor-in-Chief of the Natural Resources Journal, which  
23    includes articles related to public utility regulation in its publications. I have served as

1 Chair of the Energy Industry Restructuring, Financing, Mergers and Acquisitions  
2 Committee of the Section of Environment, Energy and Resources of the ABA. I  
3 currently serve on the Governing Council of the ABA's Section of Environment, Energy  
4 and Resources.

5 During a sabbatical from the law school during the academic year 1999-  
6 2000, I was a Fellow with the U.S. Senate Energy and Natural Resources Committee  
7 (Fall 1999). During the spring and summer semesters of 2000 I worked as a regulatory  
8 attorney with the California Independent System Operator. In addition to teaching, I  
9 have continued to practice utility law and, from time to time, have served as an expert  
10 witness in utility proceedings, testified before the New Mexico legislature regarding  
11 utility matters, and drafted legislation for the New Mexico legislature on public utility  
12 regulation. I also worked for the New Mexico Public Utilities Commission (formerly, the  
13 New Mexico Public Service Commission) in 1997 to mediate a proceeding among all the  
14 stakeholders in New Mexico's electric industry to consider restructuring the industry.

15

16 **II. PURPOSE AND SUMMARY OF TESTIMONY**

17

18 **Q. What is the purpose of your testimony?**

19 A. The purpose of my testimony is to: (1) discuss what it means to set just  
20 and reasonable rates and conditions of service as a matter of law and as a matter of  
21 regulatory policy; (2) explain how the Staff's proposal fails to comply with Missouri law,  
22 federal law and the U.S. Constitution; (3) discuss the policy implications of Staff's  
23 proposal; (4) discuss the policy implications of UE's proposed new Alternative

1 Regulation Plan (Alt Reg Plan); and (5) explain the legal basis for UE's cost of service  
2 filing. An **Executive Summary** of my testimony is attached as Appendix A.

3 **Q. Please provide an overview of your testimony.**

4 A. This is a momentous case in the development of state and federal  
5 regulatory law, in the implementation of Missouri regulatory policy, and for the future of  
6 UE, its customers and Missouri's economic standing in the country. This is so for several  
7 reasons.

8 First, the enormity of Staff's proposed rate adjustment in dollars and as a  
9 percentage of UE's annual revenues makes this an historic case for Missouri as well as  
10 the country. The eyes of other regulators, other utilities, Ameren's shareholders and the  
11 country's financial community are on this case just because of the amount of money put  
12 at issue by the Staff.

13 Second, methodologies used by Staff to support its proposed rate  
14 adjustment raise issues of Missouri law, federal statutory law and federal constitutional  
15 law that rarely present themselves in utility rate cases.

16 Third, this case asks the Commission to make a sharp break with its six  
17 year old regulatory policy of using performance incentives successfully to lower rates,  
18 increase efficiency, enhance customer service, stimulate innovation and ensure reliable  
19 service.

20 Finally, this case requires the Commission to choose between two starkly  
21 different visions of the future for UE, its customers and Missouri itself. UE envisions a  
22 Missouri that fosters a growing, thriving, competitive wholesale electricity market served  
23 by an expanded, better integrated, less congested transmission network. Bringing such a



1 marketplace to Missouri will provide its citizens, including UE's customers, with  
2 increased opportunities for trade in electricity and concomitant expansion of Missouri's  
3 economy, with lower electricity rates, with lower transmission costs, and with increased  
4 reliability of service. UE wants to help bring this marketplace to Missouri and is  
5 presently positioned to do so because its current regulatory regime gives it the financial  
6 flexibility and incentive to make this vision of the future a reality while at the same time  
7 keeping UE's rates low and its service quality high. The Staff gives no evidence that it  
8 sees a changing electric industry. Rather it seems to envision a Missouri with an  
9 electricity marketplace like that of seven years ago—before the 1996 implementation of  
10 the electric-industry-changing policies of the Energy Policy Act—a state with several  
11 traditional, fully-integrated utility monopolies experiencing little growth and no change.  
12 The problem with this picture is that it just does not exist anymore. Staff's proposed rate  
13 adjustment, which would strip any financial flexibility from UE, would consign UE to  
14 being a hobbled utility unable to compete in, and benefit from the advantages of, the new  
15 marketplace.

16           In light of these four defining characteristics of this case, my testimony  
17 has several goals. The first is to present to the Commission my legal and professional  
18 view of its duty to set just and reasonable rates, including a description of the legal  
19 principles and guidelines that define this responsibility. Second, I discuss the policy-  
20 making aspect of ratesetting. I then use these principles to provide the Commission with  
21 a legal and policy analysis of Staff's proposal in this case. Next, I explain why UE's Alt  
22 Reg Plan is the best ratesetting proposal. Finally, I show that UE's cost of service will  
23 produce just and reasonable rates and is consistent with good public policy.

1           **Q.     Please summarize the conclusions of your testimony.**

2           A.     In Section III, on the subject of ratesetting as a matter of law, I explain the  
3     legal and policy framework that underlies utility ratesetting both in Missouri and  
4     nationwide. In doing so, I show that I disagree fundamentally with the bulk of the legal  
5     basis for ratesetting as apparently understood by the Staff, which is mostly set out in the  
6     testimony of Staff witness Ronald Bible. I explain that Missouri law is more  
7     comprehensive than Staff's exposition of it. I also explain that Missouri rate proposals  
8     must be consistent with federal law and the federal Constitution. I show where Staff  
9     misapprehends constitutional law. Finally, I discuss the Commission's obligation to  
10    elevate ratesetting to a policy-making endeavor and observe that Staff has presented no  
11    policy analysis in its direct case.

12                 In Section IV of my testimony, I demonstrate specifically how the Staff's  
13    proposal violates principles of Missouri ratemaking law, federal statutory law and federal  
14    constitutional law. In particular, I show that Staff has misleadingly characterized UE's  
15    earnings under the EARP as "excess" and that UE's earnings were no more than the  
16    earnings authorized by the Commission. I show also that Staff's proposed rates are not  
17    just and reasonable because:

- 18           • They violate the standards of Missouri ratemaking law.
- 19           • They do not balance the interests of UE, its customers, its shareholders and  
20           the public. Rather they seek only to depress earnings.
- 21           • They will render UE unable to keep pace with its future need to supply  
22           reliable power at a low cost.
- 23           • They are not supported by competent and substantial evidence.

- 1           • They do not include all the facts necessary for the Commission to
- 2           meaningfully consider Staff's proposal.
- 3           • They arbitrarily exclude costs associated with prudent business practices.
- 4           • They are inconsistent with federal statutory law.
- 5           • They run contrary to several provisions of the U.S. Constitution.

6           Section V of my testimony takes up the policy implications of the Staff's  
7   proposal. I first explain that Staff has provided no policy analysis of its proposal. I then  
8   show that Staff's proposal does not focus on ratesetting but rather on profit regulation. I  
9   conclude that if Staff's proposal were to be implemented UE's superior performance will  
10   erode, UE's customers' rates will increase, UE's ability to attract capital will decrease,  
11   and the public's interest in a thriving electricity market served by an efficient  
12   transmission network will be compromised.

13           In Section VI of my testimony, I conclude that UE's Alt Reg Plan is the  
14   best ratesetting plan from a public policy perspective. UE's six year track record of  
15   superior performance under the EARP shows that it has the management in place to  
16   successfully run a utility under performance based regulation. Performance based  
17   regulation is the best approach to UE's regulation given its past experience and the  
18   challenges it faces over the next three years in a demanding marketplace. The changes  
19   proposed by UE in the Alt Reg Plan will enhance customer benefits and regulatory  
20   efficiency and thus make it desirable from a public policy perspective. The Alt Reg Plan  
21   eliminates a number of perverse incentives associated with traditional cost of service,  
22   including the incentive to hold back cost-lowering innovations and to "gold plate"

1 infrastructure to increase rate base. It also caps possible earnings for the utility. These  
2 features add to its superiority for UE over cost of service regulation.

3 In Section VII of my testimony, I show that, should the Commission not  
4 adopt UE's Alt Reg Plan, UE's cost of service will produce just and reasonable rates and  
5 is consistent with good public policy.

6

7 **III. SETTING JUST AND REASONABLE RATES AND**  
8 **CONDITIONS OF SERVICE AS A MATTER OF LAW**  
9 **AND REGULATORY POLICY**

10

11 **Q. Why are you testifying as to what it means to set just and reasonable**  
12 **rates and conditions of service as a matter of law and as a matter of regulatory**  
13 **policy?**

14 **A.** As I know from personal experience, both as a ratesetter, an academic and  
15 a practitioner, any effective regulatory process must begin with a clear understanding of  
16 the law and policy underpinning the ratesetting process. For this Commission to  
17 effectively discharge its mandate, it needs rate proposals that are properly crafted as a  
18 matter of law and of good public policy.

19 The fact is that Staff's case is not so constructed. This is demonstrated  
20 most clearly in the testimony of Mr. Ronald Bible, who sets out the Staff's position on  
21 the Commission's legal mandate. In my testimony I explain the difficulties I have both  
22 with things Mr. Bible says as well as with things he never discusses. In summary, Mr.  
23 Bible's exposition on state and federal law is incomplete and in error, and he fails to give  
24 the Commission any policy analysis of Staff's proposal. No other Staff witness provides  
25 any policy analysis to support Staff's proposal either. Additionally, neither Mr. Bible nor

1 any other Staff witness provides any analysis behind Staff's lack of support for the  
2 EARP.

3 Accordingly, in this portion of my testimony I address the following  
4 points:

- 5 • What it means to set just and reasonable rates and conditions of service as a  
6 matter of law. I include discussion of the fundamental principles of Missouri  
7 law, federal statutory law and federal constitutional law.
- 8 • What it means to set rates and conditions of service as a matter of policy. I  
9 explain that this is an analysis designed to answer the questions (1) what kind  
10 of utility behavior is desired, and (2) what is the best ratesetting plan to  
11 achieve it.

12

13 **A. SETTING RATES AND CONDITIONS OF SERVICE AS A MATTER OF LAW**

14 **Q. What does it mean to set rates and conditions of service as a matter of**  
15 **law?**

16 **A.** As a matter of law, both the process of setting rates and conditions of  
17 service and the rates themselves must comply with Missouri and federal statutory law and  
18 the federal Constitution.

19 **1. Missouri Law: Three Legal Obligations**

20 **Q. What does it mean to set rates and conditions of service as a matter of**  
21 **Missouri law?**

22 **A.** Setting rates in Missouri comprises three legal obligations: determining  
23 rates that are (1) just and reasonable in themselves, (2) based on competent and

1 substantial evidence and (3) determined through a process that meaningfully considers all  
2 relevant facts.

3 **Q. What does it mean to have rates that are just and reasonable in**  
4 **themselves?**

5 A. Rates that are just and reasonable in themselves (1) balance the interests of  
6 all affected parties, i.e., customers, the utility, its shareholders, and the public,<sup>1</sup> and (2)  
7 are otherwise lawful. As discussed in the next two subsections of my testimony, to be  
8 lawful these rates must also comport with federal law and meet minimum federal  
9 constitutional requirements.

10 **Q. What does it mean to balance the interests of all affected parties?**

11 A. The customers, the utility, the shareholders, and the public form a  
12 community of interests affected by the business of providing utility service. Because  
13 they depend on each other for the success of this venture, the interests of each group need  
14 to be balanced against the interests of the others. The interests of these parties are  
15 satisfied by setting rates that encourage desirable behavior by each group. For the *utility*,  
16 this generally means lowering costs, improving service and increasing efficiency while  
17 pursuing innovations and maintaining financial stability. For *customers*, this means  
18 rational consumption of electricity (neither overconsumption nor underconsumption).  
19 For *shareholders*, this means receiving a return that is commensurate with the risk of  
20 their investment and that will justify continued investment in the utility. For the *public*,  
21 this means, at a minimum, maintaining confidence that reliable, reasonably-priced

---

<sup>1</sup> *State ex rel. Valley Sewage Co. v. PSC*, 519 S.W.2d 845, 851 (Mo. App. 1974) (“[T]he quintessence of a just and reasonable utility rate is that it be just and reasonable to both the utility and its customers.”).

1 electric service will be available for the foreseeable future, including that the  
2 infrastructure that is necessary to provide that service will be put in place.

3 **Q. Is there a precise calculation for the determination of just and**  
4 **reasonable rates?**

5 A. The calculation of just and reasonable rates is not precise in the sense that  
6 there is not a single magic number that constitutes a just and reasonable rate. Rather, the  
7 law recognizes a range of rates that would be just and reasonable, the so-called zone of  
8 reasonableness. This is not to say that the range of reasonable rates is an arbitrary one.  
9 An economist would say that the zone of reasonable rates centers around the rate that a  
10 competitive market would set for the service.<sup>2</sup> This is based on the principle that  
11 regulation is a substitute for competition, and that in a perfectly competitive marketplace,  
12 a firm will expand production and price its product at the long-run incremental cost, i.e.,  
13 the market price. Likewise, the law teaches that the range of reasonableness is an amount  
14 that covers the utility's operating costs and its cost of capital.<sup>3</sup>

15 A corollary to the proposition that there is a range of just and reasonable  
16 rates is that there are legal limits on the range, beyond which the Commission cannot  
17 lawfully venture.<sup>4</sup> The range is bounded by an upper limit; a price that is "too high"  
18 unjustly provides the utility's shareholders with too much profit at the expense of  
19 customers and leads to inadequate consumption of the product. A price that is "too low"

---

<sup>2</sup> See Justice Stephen G. Breyer, *Regulation and Its Reform* (1982).

<sup>3</sup> *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

<sup>4</sup> *Farmer's Union Cent Exchange, Inc. v. Federal Energy Regulatory Comm'n*, 734 F.2d 1486 (D.C. Cir 1984)

1 unjustly lowers the cost to customers at the expense of the shareholders and leads to over-  
2 consumption of the product and, eventually, to financial distress of the utility.

3 Missouri law is actually more precise than that of most states in locating a  
4 rate within the zone of reasonableness. The Commission's organic statute charges it with  
5 allowing a Company a "reasonable average return upon capital actually expended."<sup>5</sup> By  
6 using both the terms "reasonable" and "average", the statute creates an obligation to place  
7 the return towards the center of the zone of reasonableness.

8 **Q. You said earlier that Missouri law also requires rates to be based on**  
9 **competent and substantial evidence. What do you mean by this?**

10 A. Competent evidence is that evidence which is required due to the nature of  
11 the matter to be proven; and it includes testimony given only by witnesses who are  
12 qualified to testify on the subject matter. The substantial evidence requirement means  
13 that the rate ultimately decided upon must be supported by a substantial amount of  
14 competent evidence, which was in fact admitted into the record of the case.

15 **Q. You said earlier that Missouri law also includes an obligation to**  
16 **determine rates through a process that meaningfully considers all relevant facts**  
17 **What do you mean by this?**

18 A. Setting just and reasonable rates as a matter of Missouri law means  
19 determining rates through a regulatory process that provides for meaningful consideration  
20 of all facts that have a material bearing upon the establishment of just and reasonable

---

<sup>5</sup> R.S.M. § 393.270(4).



1 rates.<sup>6</sup> Failure to consider a probative fact during the ratemaking process renders the rate  
2 decision illegal.<sup>7</sup>

3 **Q. Did Staff's witness Mr. Ronald Bible discuss this aspect of Missouri**  
4 **law in his testimony?**

5 A. No. Mr. Bible ignores this prong of Missouri law in his testimony. In  
6 fact, Mr. Bible miscited a case discussing federal statutory law, i.e., *Federal Power*  
7 *Commission v. Natural Gas Pipeline Co.*, for a proposition of Missouri law that, "If the  
8 Commission's order, as applied to the facts before it and viewed in its entirety, produces  
9 no arbitrary result, our inquiry is at an end." While this is an accurate statement of the  
10 federal law that governs interstate transmission under FERC jurisdiction, it is not the  
11 relevant Missouri law.<sup>8</sup> Rather, in Missouri, it is not enough that the rate "produces no  
12 arbitrary result." In Missouri, the rate must also be arrived at through a process that  
13 includes "*all . . . facts that have a material bearing on the establishment of 'just and*  
14 *reasonable' rates* as contemplated by [Missouri] statutes and decisions."<sup>9</sup> Indeed, the  
15 Missouri Supreme Court has expressly rejected the federal *Hope* test, in favor of an  
16 approach that combines the substantive *and* the procedural. In *State ex rel. Missouri*  
17 *Water Co. v. PSC*, 308 S.W.2d 704 (Mo. 1957), the Commission had refused to consider  
18 a probative element and the appellate court concluded that the order of the Commission  
19 was "neither authorized by law nor supported by competent and substantial evidence

---

<sup>6</sup> *State ex rel. Missouri Water Co. v. PSC*, 308 S.W.2d 704 (Mo. 1957).

<sup>7</sup> *Id.*

<sup>8</sup> In his deposition, Mr. Bible explained that he has not read any Missouri Supreme Court cases.. *Bible*  
*November 2001 Dep.* at 35.

<sup>9</sup> *State ex rel. Missouri Water Co.*, *supra*, at 719 (emphasis added).

1 upon the whole record.”<sup>10</sup> Thus, in determining just and reasonable rates the  
2 Commission must consider all relevant facts and may only reject a relevant fact based on  
3 substantial evidence and not in an arbitrary or capricious manner.<sup>11</sup>

4 **Q. Has Missouri law further defined the term “relevant facts”?**

5 A. Yes, it has. For example, the courts have explained that the Commission  
6 may not exclude from a utility’s revenue requirement any cost incurred by the utility  
7 pursuant to a utility business practice or utility management decision without a finding  
8 that the decision or practice constituted an abuse of discretion or was imprudent at the  
9 time it was made. I bring this example up because, as I discuss later in Section IV of my  
10 testimony, Staff proposes numerous adjustments to UE’s actual expenses without  
11 providing any discussion of why the business practice giving rise to the expense is  
12 imprudent or an abuse of discretion. Such unsubstantiated departures from utility  
13 business practices (e.g., accepted accounting standards) cannot lawfully be accepted by  
14 the Commission.

15 This business judgment rule recognizes that utilities should not be  
16 penalized after-the-fact for a particular management decision unless the decision was an  
17 abuse of discretion at the time it was made. To do otherwise, and upset a decision that  
18 was reasonable, would make management operate in an unstable and unpredictable  
19 environment. This would make management of a utility immeasurably difficult and risky  
20 and increase the cost of capital without adding any significant benefits to customers or

---

<sup>10</sup> *Id.* at 720.

<sup>11</sup> *State ex rel. Joplin Water Works Co. v. PSC*, 495 S.W.2d 443 (Mo. 1973).

1 the public. The U.S. Supreme Court called this presumption of management competence  
2 “the business judgment rule” in a case originating in Missouri.<sup>12</sup> This rule has been  
3 applied in subsequent cases.<sup>13</sup>

4                   **2. Federal Statutory Law**

5           **Q. How is ratesetting in Missouri constrained by federal law?**

6           A. Three areas of federal statutory law are relevant to this case. A state  
7 regulatory commission cannot exercise its authority to set utility rates and conditions of  
8 service in a manner that effectively preempts rates set, and certain decisions made by the  
9 Federal Energy Regulatory Commission (FERC), or rules set by the Internal Revenue  
10 Service (IRS) or pension regulations enacted under the Employee Retirement Income  
11 Security Act (ERISA).

12                   For example, the U.S. Supreme Court ruled in *Nantahala Power & Light*  
13 *Co. v. Thornburg*,<sup>14</sup> that a rate set by FERC is entitled to deference under the U.S.  
14 Constitution’s Supremacy Clause and cannot be changed or modified by a state agency.  
15 In that case the Utilities Commission of North Carolina found that a FERC-approved  
16 agreement that a North Carolina utility, Nantahala Power & Light Co., had entered into

---

<sup>12</sup> *State ex rel. Southwestern Bell Telephone Co. v. PSC*, 262 U.S. 276, 289 (1923) (“It must never be forgotten that, while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and is not clothed with the general power of management incident to ownership”).

<sup>13</sup> See, e.g., *Citizen’s Gas Co. of Hannibal v PSC*, 8 F.2d 632, 634 (W.D. Mo. 1925) (“The commission is not the financial management of the corporation, and is not empowered to substitute its own judgment for that of the directors of the corporation . . . [if] [t]here is no evidence of abuse of discretion”); *State ex rel. City of St. Joseph v. PSC*, 30 S.W.2d 8, 14 (Mo. 1930) (“The company has a lawful right to manage its own affairs and conduct its business in any way it may choose, provided that in doing so it does not injuriously affect the public”); *State ex rel. Harline v. PSC*, 343 S.W.2d 177, 182 (Mo. Ct. App. 1960) (“The utility retains the lawful right to manage its own affairs and conduct its business as it may choose, as long as it performs its legal duty, complies with lawful regulation and does no harm to public welfare.”)

<sup>14</sup> 476 U.S. 953, 106 S.Ct. 2349, 90 L.Ed.2d 943 (1986).

1 an agreement with other utilities, which allocated generation produced by their  
2 hydroelectric plants and set a wholesale rate for this generation, was unfair. The Utilities  
3 Commission calculated a different allocation (that had the effect of lowering for  
4 ratemaking purposes Nantahala's actual wholesale power expenses) for its purpose of  
5 setting Nantahala's retail rates. The Court held that the retail rates set by the Utilities  
6 Commission violated the Supremacy Clause, and that the Commission had to reset the  
7 rates to give full effect to FERC's decision approving the allocation and wholesale rate.

8           Likewise, in *Mississippi Power & Light Co. v. Mississippi*,<sup>15</sup> the U.S.  
9 Supreme Court ruled that under the Supremacy Clause the reasonableness of rates and  
10 agreements regulated by FERC may not be collaterally attacked in state or other federal  
11 proceedings and that states may not bar regulated utilities from passing through to retail  
12 customers FERC-mandated wholesale rates. In that case, the Mississippi Public Service  
13 Commission had rolled into retail rates the costs that a Mississippi utility, Mississippi  
14 Power & Light Co, was going to incur with respect to wholesale power purchases from a  
15 nuclear power plant pursuant to a FERC decision approving an allocation agreement and  
16 wholesale rate. The Attorney General of Mississippi challenged this decision, arguing  
17 that the Commission could not pass on these costs without first reviewing the prudence of  
18 the utility's decision to enter into the agreement ultimately approved by FERC. The U.S.  
19 Supreme Court rejected this argument, holding, as explained above, that FERC's decision  
20 could not be collaterally attacked, in this case through the vehicle of a prudence review.

21           As discussed in Section IV, the Staff's proposal contains recommendations that  
22 would violate these principles of federal law.

---

<sup>15</sup> 487 U.S. 354, 108 S.Ct. 2428, 101 L.Ed.2d 322 (1989).

3. Federal Constitutional Law

Q. What impact does the federal Constitution have on the determination of rates and conditions of service in Missouri?

A. Determinations of rates and conditions of service by state regulatory commissions must be consistent with the federal Constitution. Staff's proposal implicates no less than six constitutional doctrines:

- Prohibition against opportunistic shifting of ratesetting methodologies;<sup>16</sup>
- Prohibition against retroactive ratemaking;<sup>17</sup>
- Placement of an undue burden on interstate commerce in violation of the Commerce Clause;
- Procedural due process guaranteed by the 14<sup>th</sup> Amendment;
- Impairment of contracts as protected by the Contracts Clause;
- Federal preemption of state regulatory action;

<sup>16</sup> The U.S. Supreme Court explained in *Duquesne v. Barasch*, 488 U.S. 299, 315 (1989) that "serious constitutional questions" are raised by a "State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others."

<sup>17</sup> A regulator cannot impose a retroactive rate alteration and may not order reparations. The U.S. Supreme Court has stated that "[d]eficits in the past do not afford a legal basis for invalidating rates, otherwise compensatory, any more than past profits can be used to sustain confiscatory rates for the future." *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*, 289 U.S. 287, 313 (1933)(citing *Board of Commissioners v. New York Telephone Co.*, 271 U.S. 23, 31-32 (1926))("Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory). See also, *Bluefield Water Works & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 694 (1923)("The company may not insist as a matter of constitutional right that past losses be made up by rates to be applied in the present and future."). *New Jersey Power & Light Co. v. State Dept. of Public Utilities, Board of Public Utility Com'rs*, 104 A.2d 1, 4-5 (N.J. 1954)(noting that this rule has become so well established as to be stated summarily in *Wisconsin Telephone Co. v. Public Service Commission*, 287 N.W. 122, 137 (Wis. 1939)("As already pointed out, the cases hold that in establishing a rate for the future and in the absence of statutory authorization therefore, the Commission may not amortize a loss or make a rate sufficiently low to recapture the excesses.); and noting that the rule works both ways—neither may past losses be made up nor may past excesses be recaptured). See also, *State ex rel. Utilities Commissions v. Edmisten*, 232 S.E.2d 184, 195 (N.C. 1977)("Such rate making throws the burden of such past expense upon different customers who use the service for different purposes than did the customers for whose service the expense was incurred").

1           **Q.     Mr. Bible described some federal and state Supreme Court decisions**  
2 **in his testimony. Were his descriptions correct?**

3           A.     No, they were not. In fact, the descriptions of two cases Mr. Bible  
4 provides as the legal underpinning for Staff's case that are quite flatly wrong.

5                     At page 6, lines 9 and 10 of his direct testimony, Mr. Bible states, "The  
6 Supreme Court also noted in this case [*Hope Natural Gas Co.*] that regulation does not  
7 guarantee profits to a utility company." Mr. Bible thus implies that the Supreme Court  
8 has sanctioned the withholding of profits to a utility company by a regulator. This is  
9 incorrect. Rather, the Supreme Court required regulators to set rates that provide a utility  
10 with the opportunity to earn a fair rate of return, although, having done so, a regulator  
11 does not guarantee that the utility will actually *earn* such a return.<sup>18</sup>

12                     Also, on page 6, lines 30 to 32 of his direct testimony, citing *Pennsylvania*  
13 *Electric Co.*<sup>19</sup>, Mr. Bible states, "[I]n the case of poor [utility] management, I do not  
14 believe it would always be appropriate for a regulatory agency to provide sufficient funds  
15 to continue operations no matter what the costs are to the ratepayers." By this statement,  
16 Mr. Bible implies that the Supreme Court of Pennsylvania has sanctioned the punitive  
17 bankrupting of a utility by a regulator if the utility has "poor management." The dicta  
18 cited by Mr. Bible in *Pennsylvania Electric* is not so sweeping and clearly does not  
19 sanction punitive regulatory measures. Rather, the *Pennsylvania Electric* court found  
20 that any *actual costs* caused by poor management need not be passed on to customers.<sup>20</sup>

---

<sup>18</sup> *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944).

<sup>19</sup> *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*, 502 A.2d 130 (1985), *cert. den.*,  
476 U.S. 1137 (1986).

<sup>20</sup> *Id.* at 330-31.

1 The court did not find that costs unrelated to poor management could be excluded from  
2 rates.

3 **B. SETTING RATES AND CONDITIONS OF SERVICE**  
4 **AS A MATTER OF REGULATORY POLICY**  
5

6 **Q. What does it mean to say that setting rates and conditions of service is**  
7 **a policy-making endeavor?**

8 **A.** Regulators face the unenviable task of not only crunching the numbers and  
9 arriving at a ratesetting conclusion that is analytically sound, but also weighing that  
10 conclusion subjectively in light of a host of policy considerations. These latter  
11 considerations shape today's ratesetting process in light of tomorrow's needs --  
12 tomorrow's needs for a broad range of interested parties. Unfortunately, the seriousness  
13 and complexity of this task too often prevents ratesetting from ever becoming a policy-  
14 making endeavor. Too often we never rise above the mechanical tasks that usually  
15 precede ratesetting, i.e., determining what the utility's costs are and what return is  
16 allowable. Although cost accounting is a valuable first step in determining future rates, a  
17 preoccupation with mechanical accounting techniques and historical costs often distracts  
18 us from reaching what is truly the ultimate goal of economic regulation. The central  
19 purpose of regulation is to achieve desirable utility behavior. Deciding what is desirable  
20 utility behavior and, even more challenging, how it can best be achieved is the policy-  
21 making aspect of economic regulation. It is analytical and future-oriented. In order to  
22 properly discharge that duty, the Commission must be presented with rate proposals that  
23 properly consider these vital elements. Unfortunately, to date, Staff has submitted no  
24 policy analysis in this case.

25 **Q. What is desirable utility behavior?**

1           A.     Desirable utility behavior is superior performance at low cost. Superior  
2 performance generally includes lowering costs, improving service, increasing efficiency,  
3 pursuing innovation, enhancing customer satisfaction, enhancing reliability of service,  
4 providing environmental protection, providing reasonably stable rates, and maintaining  
5 financial stability by ensuring revenues that both cover the costs of producing service and  
6 encourage continued shareholder investment in the utility.

7           **Q.     How does a regulator go about determining what set of rates and**  
8 **conditions of service will achieve this behavior?**

9           A.     The rate case must include sufficient economic analysis of the likely  
10 future impacts of the proposed rates and conditions of service to enable the regulator to  
11 make an informed judgment about the expected consequences of any rate proposal on the  
12 utility and on its customers and shareholders and the public. UE's witness, Mr. Warner  
13 Baxter, has submitted this analysis in this case for both Staff's proposal and UE's new  
14 proposed Alt Reg Plan.

15          **Q.     What impact will policy-oriented ratesetting have on UE's customers,**  
16 **shareholders and the public?**

17          A.     Rates should also promote desirable outcomes for these parties. For  
18 *customers*, this usually means rates that encourage rational consumption of electricity  
19 (neither overconsumption nor underconsumption). For *shareholders*, this usually means  
20 rates that provide them with a return that is commensurate with the risk of their  
21 investment and that will justify their continued investment in the utility. For the *public*,  
22 this usually means rates that maintain public confidence that reliable, reasonably-priced  
23 electric service will be available for the foreseeable future, including assurance that the



1 infrastructure that is necessary to provide that service will be put in place reliably and  
2 securely.<sup>21</sup> It also means rates that ensure public resources, such as the environment and  
3 the public's safety, are appropriately protected.

4       **Q. By way of a summary, what is the principal conclusion of this portion**  
5 **of your testimony?**

6       A. My principal conclusion is that the Commission's task of determining just  
7 and reasonable rates for UE in this case entails the obligations to ensure that both the  
8 process of setting rates, and the rates themselves, *comply with Missouri law, with federal*  
9 *law and with the federal Constitution.* Additionally, the Commission should *make the*  
10 *policy determination* that the *rates* that are set are the ones *best calculated to promote*  
11 *superior performance* by UE at a low cost.

12       1. Complying with Missouri law means determining rates that are *just and*  
13 *reasonable in themselves, based on competent and substantial evidence* and determined  
14 through a process that *meaningfully considers all relevant facts.*

15               a. Rates that are *just and reasonable in themselves* are rates that  
16 balance the interests of all affected parties, i.e., customers, the utility, the shareholders,  
17 and the public, are not otherwise unlawful.

18               b. Rates based on *competent and substantial evidence* means that the  
19 rate ultimately decided upon must be supported by a substantial amount of competent  
20 evidence, which was in fact admitted into the record of the case.

21               c. Determining rates through a process that provides for *meaningful*  
22 *consideration of all relevant facts* means that failure to consider a probative fact during

---

<sup>21</sup> Final Report of the Missouri Energy Policy Task Force 33 (Northwest Missouri State University: Oct. 16, 2001).

1 the ratemaking process renders the rate decision illegal. This principle encompasses the  
2 business judgment doctrine which holds that the test year costs that are a product of a  
3 utility management decision or business practice cannot be excluded from revenue  
4 requirements unless there is a finding that the decision or practice was an abuse of  
5 discretion or imprudent at the time it was made.

6 2. Complying with federal law in this case means ensuring that Staff's  
7 recommendations that violate principles of federal law are not adopted.

8 3. Complying with the federal Constitution means ensuring that Staff's  
9 recommendations that would violate constitutional law are not adopted.

10 4. The obligation to *elevate ratesetting to a policy-making endeavor* is a  
11 weighty one that should be taken on by the Commission in this case because ratesetting is  
12 the primary tool that the Commission has to achieve the overall objective of economic  
13 regulation: to have Missouri utilities *achieve superior performance at a low cost*.

#### 14 IV. STAFF'S PROPOSAL DOES NOT COMPLY WITH LAW

##### 15 A. Staff Has Not Met Its Burden Of Proof

17 Q. Who bears the burden of proof in this case?

18 A. This is an unusual rate case because Staff is the complainant. Staff,  
19 therefore, has the burden of proof.<sup>22</sup> Since Staff proposes to change the status quo, Staff  
20 bears the burden of proving that existing rates are not just and reasonable and that its  
21 proposed rates are just and reasonable.<sup>23</sup> This burden is heavy.

---

<sup>22</sup> *In re Associated Natural Gas Company's Tariff Revisions*, 1999 Mo.PSC LEXIS 2, at \*10 (Jan. 26, 1999).

<sup>23</sup> *In re Missouri Public Service*, 1998 Mo.PSC LEXIS 21, at \*19 (Apr. 16, 1998).

1           **Q.     What, specifically, must Staff prove and how must it prove it?**

2           A.     Staff must prove its allegation that UE's current rates produce excessive  
3 earnings and that Staff's proposed rates are just and reasonable. As I explained in  
4 Section III of my testimony, Staff must prove this through competent and substantial  
5 evidence upon the whole record,<sup>24</sup> and, in attempting to prove its case, Staff must provide  
6 the Commission with all the relevant facts having a bearing upon the adoption of the  
7 proposed adjustments.

8           **Q.     In your opinion, has Staff overcome these hurdles?**

9           A.     No. As I detail below in my testimony, Staff has not overcome these  
10 hurdles. Staff has not proven that UE's rates under the Experimental Alternative  
11 Regulatory Plan (EARP) produced excessive earnings. Staff has neither shown that its  
12 proposed rates are just and reasonable nor that they provide a reasonable balance of the  
13 interests of the affected parties. And Staff has failed to provide the Commission all the  
14 facts that are necessary and relevant to consideration of its proposed adjustments to UE's  
15 rates. Therefore, as a matter of Missouri law, Staff's proposal cannot be adopted by the  
16 Commission. Beyond failing to satisfy its own obligations under Missouri law, Staff has  
17 proposed a case that violates not only federal statutory law, but also the federal  
18 Constitution.

19           **Q.     What is the practical effect of Staff's failure to meet its burden of**  
20 **proof?**

21           A.     When the complainant in a case fails to meet its burden of proof, the  
22 complaint is dismissed and the status quo prevails. This rule as applied to this case

---

<sup>24</sup> *State ex rel. Hotel Continental v. Burton*, 334 S.W.2d 75, 78 (Mo. 1960).

1 means that UE's existing rates would remain in place. However, in this case UE has  
2 voluntarily proposed two alternative rate structures to the status quo. So, as a practical  
3 matter, the Commission could adopt either of those.

4 **B. STAFF'S PROPOSAL DOES NOT COMPLY WITH MISSOURI LAW**

5  
6 **Q. What is the basis for your conclusion that the Staff's proposal does**  
7 **not comply with Missouri law?**

8 A. I base my conclusion on numerous flaws in the proposed rate adjustments  
9 and the process followed by Staff in making the proposal, which I describe in detail  
10 below. In summary, Staff's proposal does not balance the interests of UE, its customers,  
11 shareholders and the public and, therefore, will not produce rates that are just and  
12 reasonable.

13 Staff's proposal must be backed by competent, substantial evidence, and  
14 Staff has failed to meet this requirement. As I discuss below, Staff often relies on  
15 testimony by witnesses who have admitted they have no basis for their opinions or who  
16 have performed no analyses to support their opinions. Additionally, some witnesses base  
17 their opinions on the alleged opinions of others who are no longer with the Commission  
18 and not available for cross-examination.

19 Staff's proposal must include consideration of all the facts relevant to its  
20 potential adoption by the Commission, and yet Staff has not provided those facts. For  
21 example, Staff has failed to analyze a number of issues crucial to the adoption of its  
22 proposal. Staff has provided no economic or policy analysis of the implications of its  
23 proposal for UE, its customers, its shareholders and the public. Staff has often omitted  
24 from its testimony any discussion of the witnesses' bases for the opinions they offer in

1 their testimony. Depositions of some of these witnesses have revealed that they often do  
2 not even have a basis for their opinion. These are serious deficiencies in any rate case,  
3 but here, where Staff's proposed rate adjustment is huge, it leaves the Commission  
4 without an adequate record to consider in any meaningful way the Staff's remarkable  
5 proposal.

6           Indeed, the proposed rates are based in part on Staff's arbitrary exclusion  
7 from allowable expenses many costs that have benefited ratepayers, and that have been  
8 actually incurred by UE as a result of prudent management decisions and standard  
9 business practices. As I discuss below, these types of costs cannot just be ignored. Staff  
10 must prove that they were incurred imprudently, and Staff has failed to do that.

11           **1. Staff Has Not Proven "Excess Earnings"**

12           **Q. Why do you conclude that Staff has not proven that UE had excess**  
13 **earnings under the EARP?**

14           A. Staff initiated this complaint proceeding because it found that UE had  
15 "excess earnings"<sup>25</sup> under the EARP, and that UE's rates therefore needed a drastic  
16 overhaul. Characterizing UE's earnings in this way is misleading to the public and is  
17 unfair to UE and its customers. The EARP was designed to effect profit sharing with  
18 UE's customers such that UE's Missouri electric retail earnings *could not exceed* 13.5%,  
19 and this maximum earnings rate of 13.5% was approved by the Commission. Thus, UE  
20 is unable to accrue "excess" earnings under the EARP. To the extent UE did achieve  
21 *pre-sharing* earnings beyond the 13.5% cap, its earnings were distributed to the  
22 customers--so that it actually earned no more than this cap. Thus, any earnings

---

<sup>25</sup> See Staff's Excess Earnings Complaint against Union Electric Co., Case No. EC-2002-1, filed July 2, 2001, at p. 7.

1 AmerenUE has realized could not be, and in fact are not, “excess.” Indeed, the fact that  
2 performance based regulation can be designed to cap earnings is one of the desirable  
3 hallmarks of such regulation.<sup>26</sup>

4                   **2. STAFF’S PROPOSED RATES ARE NOT JUST AND REASONABLE**

5           **Q. Why does Staff’s proposal not produce just and reasonable rates?**

6           A. As I explained in Section III of my testimony, just and reasonable rates are  
7 rates that comply with all applicable laws and appropriately balance the interests of the  
8 utility, its customers , its shareholders and the public. Staff’s proposal does not produce  
9 just and reasonable rates because it contains violations of substantive Missouri law, and  
10 numerous violations of federal statutory and federal constitutional law, which I discuss in  
11 more detail below, and it fails to balance the interests of the affected parties.

12           Three instances where Staff’s proposal would violate Missouri law include:

- 13           • *Failure to Comply with 4 CSR 240-10.020*

14           Commission rule 4 CSR 240-10.020 governs the treatment of accumulated  
15 depreciation when calculating the return component of a utility’s revenue  
16 requirement. The rule requires the Commission to calculate the return  
17 component of a utility’s revenue requirement by multiplying the gross rate  
18 base (original cost without subtracting accumulated depreciation) by the

---

<sup>26</sup> This contrasts with what can happen with rates based on traditional cost of service. Under cost of service based regulation, a particular return on equity is authorized but if the utility’s costs fall significantly, the utility could earn significantly more than the authorized return. This possibility was eliminated by the terms of AmerenUE’s EARP. The EARP and AmerenUE’s performance under it are described in detail in the rebuttal testimony of Warner Baxter, and evaluated in “White Paper On Incentive Regulation: Assessing Union Electric’s Experimental Alternative Regulation Plan” Prepared for Ameren Corporation by The Brattle Group and Professor David E. M. Sappington, February 1, 2001, and attached to the rebuttal testimony of Warner Baxter.

1 authorized rate of return. The revenue requirement must then be reduced to  
2 reflect an imputed income of 3% per year on accumulated depreciation.  
3 Staff's proposal does not comply with this rule. The law is well settled that  
4 administrative agencies are bound by their own rules.<sup>27</sup> Thus, the  
5 Commission cannot adopt Staff's proposal as a just and reasonable rate.<sup>28</sup>

6 • *Adjustments Inconsistent With a Previous Commission Decision*

7 Staff Witness Doyle Gibbs proposes an adjustment to reverse the effects of  
8 various territorial agreements that have been approved by this Commission.  
9 Mr. Gibbs wants to attribute to UE some customers it lost in consummating  
10 each past territorial arrangement. This would have the effect of lowering UE's  
11 revenue requirements. Mr. Gibbs justifies his adjustment with the assertion  
12 that these arrangements are detrimental to the public interest – an argument  
13 that is precluded by the fact the Commission has already found to the  
14 contrary.<sup>29</sup> Mr. Gibbs cannot indirectly undo the Commission's previous  
15 approval of these territorial agreements.

- 16 • *Staff Fails to Apply Statement of Financial Accounting Standard (FAS) No.*  
17 *106 to other post-retirement benefits (OPEBs) as required by Missouri law,*  
18 *Section 386.315 of the Revised Statutes of Missouri. FAS 106 does not allow*  
19 *averaging of gain/loss accounts and does not allow the recording of gains*

---

<sup>27</sup> *Berry v. Moorman Manufacturing Co.*, 675 S.W.2d 131, 134 (Mo. Ct. App. 1984) ("Administrative agencies, just as the general public, are bound by the terms of rules promulgated by them." Citing *Mississippi Valley Barge Line Co. v. United States*, 252 F.Supp. 162, 166 (E.D. Mo. 1966), appeal dismissed, *Pittsburgh Towing Co. v. Mississippi Valley Barge Line Co.*, 385 U.S. 32 (1966). See also *United States v. Nixon*, 418 U.S. 683, 695-96 (1974) (holding that so long as regulations are extant, they have the force of law).

<sup>28</sup> *Mississippi Valley Barge Line Co. v. United States*, 252 F.Supp. 162, 166 (E.D. Mo. 1966), appeal dismissed, *Pittsburgh Towing Co. v. Mississippi Valley Barge Line Co.*, 385 U.S. 32 (1966).

<sup>29</sup> Gibbs November 2001 Dep, at p. 84.

1           when these accounts show losses and vice-versa. The method Staff employs  
2           to account for OPEBs violates both aspects of the rule.

3  
4           Regarding the necessary balance of interests, Staff's case is almost devoid  
5 of any discussion of how the interests of UE, its customers, its shareholders and the  
6 public will be affected by its proposal. As I discuss in Section V of my testimony, I  
7 believe these interests will be adversely affected by Staff's proposal. I also observe that  
8 Staff's proposal suggests it seeks only to depress earnings. No other potential policy  
9 goals or accommodation of interests is evident from Staff's proposal. To the extent one  
10 might be tempted to think that a goal of simply lowering rates is a policy goal, the U.S.  
11 Court of Appeals for the District of Columbia Circuit has told us otherwise. In  
12 *Association of Oil Pipe Lines v. FERC*, the court cautioned FERC not to even consider  
13 adopting a ratemaking principle of "lower is better", calling it merely "an argument that  
14 seems to have no end and little connection to any stated purpose."<sup>30</sup>

15

16                           **3. STAFF'S PROPOSAL IS NOT SUPPORTED BY**  
17                           **COMPETENT AND SUBSTANTIAL EVIDENCE**

18

19           **Q.    Has Staff offered any opinions without providing a basis for the**  
20 **opinion?**

21           **A.    As I explained in Section III of my testimony, the testimony of a witness**  
22 **who gives no basis for his or her opinion is incompetent testimony, which should not be**  
23 **admitted into evidence and cannot be relied upon to support a decision in a case. In this**

---

<sup>30</sup> 281 F.3d 239, 244 (D.C. Cir. 2002)



1 case, a number of Staff's witnesses have provided *no* bases for the opinions they offer or  
2 have failed to perform any analysis:

3 • *Pension and OPEB Expense Adjustment*

4 Staff witness Greg R. Meyer provided no basis for his opinion that UE's  
5 pension and OPEB expenses should be adjusted.<sup>31</sup>

6 • *Rate Case Expense Adjustment*

7 Staff witness Leasha S. Teel provided no basis for her opinion that UE's rate  
8 case expenses should be adjusted.<sup>32</sup>

9 • *Weather Normalization Adjustment*

10 Staff witness Lena Mantle recommends a weather normalization adjustment  
11 that would reduce UE's revenue requirement by \$19 million; however, she  
12 provides no analysis to support her recommended adjustment.<sup>33</sup>

13 • *Depreciation Rate Adjustment*

14 Staff witness Jolie Mathis recommends an adjusted depreciation rate for  
15 approximately half of UE's property accounts and provides no basis for her  
16 recommendation.<sup>34</sup>

17 • *Rate Design Recommendation*

18 Staff witness James Watkins recommends a rate design unsupported by any  
19 analysis as to why this design is appropriate and desirable.<sup>35</sup>

---

<sup>31</sup> Meyer November 2001 *Dep.* at 114, line 19 through 115, line 1.

<sup>32</sup> Teel April 2002 *Dep.*, at 50, line 9-19.

<sup>33</sup> Direct Testimony of Mantle at 3; *see also* Rebuttal Testimony of Richard A. Voytas discussing Ms. Mantle's proposed adjustment.

<sup>34</sup> Mathis April 2002 *Dep.* at 13-14; Ms. Mathis simply adopts depreciation rates used in a UE rate case twenty years ago.

<sup>35</sup> Watkins April 2002 *Dep.* at 14-15. Mr. Watkins simply adopts a rate design from a 1996 non-unanimous stipulation.

1 This testimony cannot be relied on in this case.

2 **Q. Has Staff offered any opinions without having performed an analysis**  
3 **to support them?**

4 A. Yes. Several of Staff's witnesses have offered opinions without having  
5 performed analyses to support them:

6 • *Incentive Compensation Expense Adjustment*

7 Staff witness Doyle Gibbs recommends a \$6 million adjustment to UE's  
8 incentive compensation expenses; however, he admits he has performed no  
9 analysis to support his recommendation.<sup>36</sup>

10 • *Tree Trimming Adjustment*

11 Staff witness Paul Harrison proposes an adjustment to tree trimming expenses  
12 of \$4 million. He recommends that UE's test year expenses be normalized on  
13 the previous four years' expenditures. He makes this recommendation  
14 without performing any analysis of whether normalization is even justified let  
15 alone whether four years is the appropriate time period. At a minimum Mr.  
16 Harrison should have analyzed whether the cost of tree trimming will likely  
17 rise, fall or remain constant, before deciding to recommend normalization.<sup>37</sup>

18 **Q. Has Staff offered any opinions without having adequate analyses to**  
19 **support them?**

---

<sup>36</sup> Gibbs April 2002 Dep. at 43-47. Mr. Gibbs also admitted that he has no experience in the field of incentive compensation and did not understand UE's incentive compensation plan. He also admitted that he did not understand the labor markets in which UE competes and had not considered the effect of the plans on UE's performance.

<sup>37</sup> Harrison April 11 at 92-95; see also November Dep at 93-96.

1           A.     Yes. A number of Staff's witnesses have offered opinions without having  
2 performed analysis adequate to support them. Following are examples of instances of  
3 this.

4           • *Adjustment to Injuries and Damages*

5           Staff witness Doyle Gibbs recommends an adjustment to injuries and damages  
6 without having analyzed UE's bases for its incurred costs.<sup>38</sup>

7           • *Adjustment to Overtime Labor Costs*

8           Staff witness Doyle Gibbs proposes an adjustment to the overtime labor costs  
9 associated with refueling the Callaway plant, without having made any effort  
10 to determine why the costs of the Test Year refueling were higher than prior  
11 refuelings.<sup>39</sup>

12          • *Adjustment to Reverse Territorial Agreements*

13          Staff witness Doyle Gibbs proposes an adjustment to reverse territorial  
14 agreements, without having analyzed whether the exchanges were overall in  
15 the public good, or whether they were prudent.<sup>40</sup>

16          • *Fuel Inventory Adjustment*

17          Staff witness Paul Harrison proposes a fuel inventory adjustment, yet does so  
18 relying on information gleaned from the fifth sharing period, rather than UE's  
19 current fuel inventory policies and without an understanding of how the  
20 Company purchases or transports coal.<sup>41</sup>

---

<sup>38</sup> Gibbs April Dep. at 43-47.

<sup>39</sup> Gibbs April Dep. at p. 32.

<sup>40</sup> Gibbs April 12, 2002 Dep. at p. 66.

<sup>41</sup> Harrison, April 11, 2002 Dep. at 47-49.

1           • *Y2K Cost Amortization Adjustment*

2           Staff witness Paul Harrison proposes that Y2K costs be amortized over six  
3           years, without analyzing how UE purchases software and hardware or  
4           assessing the relevance of the standard amortization treatment for software  
5           expenses.<sup>42</sup>

6           • *Fuel Adjustment*

7           Staff witness John Cassidy proposes a fuel adjustment without having  
8           analyzed UE's fuel contracts, burn rates, the quality or source of fuels,  
9           transportation costs, or any industry developments that may affect fuel  
10          prices.<sup>43</sup>

11          • *MISO Exit Fee*

12          Staff witness John Cassidy proposes a \$12 million dollar adjustment to  
13          eliminate UE's MISO exit fee without analyzing whether UE can otherwise  
14          recover this fee or would incur additional costs if it were to recover this fee.<sup>44</sup>

15          • *Adjustments to Legal Fees and Environmental Expense*

16          Staff witness John Cassidy has proposed adjustments to UE's test year costs  
17          for legal fees and environmental expenses without analyzing the bases upon  
18          which UE incurred its costs or providing any analysis of why his proposed  
19          methodology is appropriate.<sup>45</sup>

---

<sup>42</sup> Harrison April Dep. at 106-07.

<sup>43</sup> See Cassidy April Dep. at 37-38.

<sup>44</sup> Cassidy April Dep. at 50-52.

<sup>45</sup> Cassidy April Dep. at 55; Cassidy November Dep. at 74. See also the Rebuttal Testimony of Martin Lyons explaining his concerns with the accounting practices proposed by Mr. Cassidy).

1           • *Adjustment to Reflect Normalized Energy and Purchase Power Expenses*

2           Staff witness Leon Bender recommends an adjustment to reflect normalized  
3           energy and purchase power expenses based on a production cost model with  
4           flaws that render its results useless.<sup>46</sup>

5           As a legal matter, this testimony constitutes incompetent evidence and  
6           cannot be relied upon in this case.

7           **Q.     Has any testimony been submitted that is based solely on the**  
8           **opinion of a person not available to the Commission?**

9           A.     Yes. Staff witness Greg Meyer submitted testimony based on the  
10          opinion of another person who did not sponsor the testimony. Mr. Meyer testified in his  
11          deposition that another person initially wrote his testimony, and that he does not have  
12          sufficient experience in the subject area of his testimony to be able to answer all the  
13          questions about the implications of his testimony—although he is confident that the  
14          person who did the initial drafting of his testimony did look into those implications.<sup>47</sup> As  
15          a legal matter, this testimony constitutes incompetent evidence and it cannot be relied  
16          upon in this case.

17                   **4.     STAFF'S PROPOSAL DOES NOT INCLUDE ALL THE FACTS**  
18                   **NECESSARY FOR THE COMMISSION TO MEANINGFULLY**  
19                   **CONSIDER IT**  
20

21          **Q.     What are the relevant facts that are missing from Staff's proposal?**

22          A.     Testimony submitted by Staff in support of its proposal is deficient  
23          because it does not include all the facts necessary to allow meaningful consideration of

---

<sup>46</sup> See Rebuttal Testimony of Timothy Finnell at 3. Mr. Finnell lists the serious flaws found in Mr. Bender's initial and subsequent model runs.

<sup>47</sup> Meyer November Dep. at 85, lines 15-16; 116, lines 5-9; Meyer April Dep. at 50, lines 9-19.

1 the overall proposal as well as a number of underlying issues in the case. For example:

- 2 • With respect to Staff's overall proposal that UE's EARP be replaced with  
3 Staff's specific cost of service-based rate structure, Staff has submitted no  
4 evidence on the impact that this change will have on UE, its customers, its  
5 shareholders and the public. Without this information the Commission cannot  
6 meaningfully consider whether the proposed change would constitute a just  
7 and reasonable rate structure for UE.
- 8 • With respect to many of Staff's specific proposals (e.g., those regarding tax  
9 depreciation expense, pensions and OPEBs, net salvage expense, depreciation  
10 reserve expense, UE's appropriate rate of return on equity, revenues  
11 associated with customer growth, payroll taxes, incentive compensation costs,  
12 uncollectible expenses, employee medical costs, costs for injuries and  
13 damages, cash working capital, and jurisdictional allocations, and system  
14 energy losses), several witnesses (e.g., Mr. Rackers, Mr. Meyer, Mr. Bible,  
15 Ms. Teel, Mr. Bax and Mr. Gibbs) have acknowledged that they failed to  
16 consider the impact their proposals would likely have on UE's stock price,  
17 ability to attract capital, ability to invest in infrastructure, or vulnerability to  
18 takeover. Without this information the Commission cannot meaningfully  
19 consider whether the proposed is just and reasonable.<sup>48</sup>
- 20 • With respect to rate design, Mr. Watkins' testimony is based on a class cost of  
21 service study done in 1996 in a UE rate case,<sup>49</sup> even though the parties to that

---

<sup>48</sup> Stephen Rackers November *Dep.* at 10-12; Gregory Meyer November *Dep.* at 24-27; Ron Bible November *Dep.* at 88-91; Doyle Gibbs November *Dep.* at 19, 49, 63; Teel November *Dep.* at 20-21; Teel April *Dep.* at 11-13; Bax November *Dep.* at 12-13; Bax April *Dep.* at 6-7.

<sup>49</sup> James C. Watkins November *Dep.* at 50.

1 case had agreed that that study would only be considered relevant to the 1996  
2 case.<sup>50</sup>

3 • As detailed in the subsection above, the testimony of various witnesses is  
4 missing any basis for the opinions they offer, or is missing any analysis to  
5 support the opinions they offer, or their opinion is based on the opinion of  
6 another person who is not available to sponsor the testimony.

7 As I explained in Section III of my testimony, the Commission cannot  
8 legally adopt a proposal without considering all the probative facts surrounding the  
9 proposal. As a practical matter that means the Commission cannot adopt the Staff's  
10 proposal in this case because it does not have before it all the facts that are relevant to its  
11 consideration.

12 **5. STAFF'S PROPOSED RATES ARE ARRIVED AT BY ARBITRARILY**  
13 **EXCLUDING COSTS ASSOCIATED WITH PRUDENT BUSINESS**  
14 **PRACTICES**  
15

16 **Q. Which UE costs were arbitrarily excluded by Staff in arriving at its**  
17 **proposed rate adjustments?**

18 **A.** Staff has arbitrarily excluded the following costs that UE incurred or  
19 accrued through normal and prudent business practices:

20 • \$7 million Pension and OPEB funding<sup>51</sup>

---

<sup>50</sup> *Id.* at 53.

<sup>51</sup> \$7 million is in approximate number. Because of workpaper errors, this exact figure is not known. *See* Adjustments S-17.7 through S-17.12, Accounting Schedule 10; Meyer April Dep. at 61, line 12 through page 62, line 14.

- |    |  |   |
|----|--|---|
| 1  | • \$13 million   | Costs deemed by Staff to be non-recurring <sup>52</sup> |
| 2  | • \$1 million  | Rate case expense <sup>53</sup>                         |
| 3  | • \$50+ million  | Net salvage   |
| 4  | Conversely Staff has arbitrarily included as a revenue offset: |   |
| 5  | • \$2.2 million  | Double-counting tax deductions for depreciation         |
| 6  |  | have already been taken by UE                           |
| 7  |  |   |
| 8  | TOTAL: \$73.2+ million   | Staff's arbitrary deflation of UE's annual revenue      |
| 9  |  | requirement   |
| 10 |  |   |

11           As I explained in Section III of my testimony, Staff cannot legally exclude  
12 such costs without proving that the business practice and management decisions requiring  
13 these costs were an abuse of discretion or imprudent at the time made. Staff has not even  
14 attempted to proffer such proof in these cases. In fact, Staff does not even seem to think  
15 they are imprudent. Rather, in the case of net salvage, pension and OPEBs and rate case  
16 expense, Staff would just prefer to see these things accounted for in a way that lowers  
17 today's costs -- although it would raise tomorrow's costs.<sup>54</sup> In the case of non-recurring  
18 costs, it seems that Staff has excluded them merely because Staff prefers that they not  
19 exist. This approach to ratesetting is arbitrary and capricious and can only produce  
20 arbitrary and capricious rates.

---

<sup>52</sup> This figure includes \$12.5 million for the MISO exit fee and \$.5 million for automated meter expenses. These are more fully discussed in the rebuttal testimonies of Mr. David A. Whiteley at 15-18, and Mr. Thomas R. Voss at 19, respectively.

<sup>53</sup> The rate case expense amount of \$300,000 is over \$1 million less than the annualized expenses based on the update period. See Teal April Dep. at 44, lines 6-16.

<sup>54</sup> See Harrison April Dep. at 104-05 (a "one-time, non-recurring" does not imply a cost was not prudently incurred or did not benefit ratepayers); Cassidy April Dep. at 42 (same).



1           **C.     STAFF'S PROPOSAL DOES NOT COMPLY WITH FEDERAL LAW**

2           **Q.     What is the basis for your conclusion that the Staff's proposal does**  
3 **not comply with federal law?**

4           A.     Several of Staff's proposed rate adjustments would violate federal law,  
5 specifically previous rates and agreements approved by FERC, rules enacted by the IRS  
6 and pension regulations promulgated under ERISA.

7           **Q.     What adjustments proposed by Staff would violate previous rates and**  
8 **agreements approved by FERC?**

9           A.     As I discussed in Section III of my testimony, the U.S. Supreme Court has  
10 ruled<sup>55</sup> that FERC's lawful determinations regarding utilities must be given full effect in  
11 the states within which these utilities are regulated, and state regulation cannot interfere,  
12 directly or indirectly, with these FERC determinations. In this case, three of Staff's  
13 proposed adjustments to UE's rates would interfere with previous FERC determinations  
14 regarding UE:

- 15           • As detailed in the testimony of UE witness McShane, Staff witness Bible  
16 proposes a stunningly low rate of return. In calculating its proposed rates,  
17 Staff includes in its cost of service analysis all income received by UE from  
18 interstate sales--sales that are regulated by FERC and earn FERC  
19 jurisdictional rates of return. Including those revenues in UE's ledgers for  
20 ratemaking purposes allows Staff to lower the rates charged to Missouri  
21 ratepayers. In effect, Staff uses higher interstate returns to subsidize in-state  
22 rates. In lowering Missouri rates below the level at which they could be set

---

<sup>55</sup> See *Nantahala Power & Light Co. v. Thornburg*, U.S. 953 (1986); *Mississippi Power & Light Co. v. Mississippi*, 487 U.S. 354 (1988).

1 absent higher FERC-approved returns, Staff is effectively preventing UE from  
2 earning FERC approved rates of return on the assets devoted to interstate  
3 sales. Staff's proposal would interfere with FERC-approved rates.

4 • Staff would impute to UE's revenue requirement an additional \$4 million of  
5 revenues associated with its allocation of interchange sales under the Joint  
6 Dispatch Agreement (JDA), approved by FERC as part of the UE-CIPS  
7 merger and Genco spin-off. Staff's proposal would directly interfere with  
8 FERC's decision to approve the JDA.<sup>56</sup> Staff's proposal is closely analogous  
9 to the proposal of the Utilities Commission of North Carolina that was held by  
10 the U.S. Supreme Court in the *Nantahala* case, summarized in Section III of  
11 my testimony, to be barred by the Supremacy Clause of the Constitution.

12 • Staff proposes to disallow part of the costs associated with UE's 2001 power  
13 purchase contract with AEM. This contract has been approved by FERC.  
14 Staff now argues that this contract should be dishonored by this Commission.  
15 Staff's proposal would directly interfere with FERC's decision to approve the  
16 contract.<sup>57</sup> Staff's proposal is closely analogous to the proposal of the  
17 Attorney General of Mississippi that was held by the U.S. Supreme Court in  
18 the *Mississippi Power & Light* case, summarized in Section III of my  
19 testimony, to be barred by the Supremacy Clause of the Constitution.

20 **Q. What adjustments proposed by Staff would be inconsistent with rules**  
21 **enacted by the IRS?**

---

<sup>56</sup> See discussion of this issue in Rebuttal Testimony of Craig D. Nelson.

<sup>57</sup> *Id.*

1           A. As Mr. Warren explains in his rebuttal testimony, Staff calculates tax  
2 depreciation contrary to federal tax law and in a way that results in the double-counting  
3 of tax deductions with a concomitant lowering of UE's revenue requirements by \$2.2  
4 million.

5           **Q. What adjustments proposed by Staff would violate pension**  
6 **regulations promulgated under ERISA?**

7           A. The five-year averaging of pension and OPEB gain/loss accounts  
8 proposed by Mr. Meyer results in a 5-year amortization period, contrary to the 10-year  
9 amortization of assumption changes under ERISA, I.R.C. § 412(b)(2)(B)(v).

10           **D. STAFF'S PROPOSAL DOES NOT COMPLY WITH FEDERAL**  
11 **CONSTITUTIONAL LAW**

12  
13           **Q. What is the basis for your conclusion that the Staff's proposal does**  
14 **not comply with federal Constitutional law?**

15           A. Several of Staff's proposed rate adjustments would violate the federal  
16 Constitution, including (1) the prohibition against opportunistic shifting of ratesetting  
17 methodologies as described by the U.S. Supreme Court in *Duquesne Light Co. v.*  
18 *Barasch*<sup>58</sup>; (2) the prohibition against retroactive ratemaking in violation of the 5<sup>th</sup>  
19 Amendment's Takings Clause; (3) the placement of an undue burden on interstate  
20 commerce in violation of the Commerce Clause; (4) the deprivation of procedural due  
21 process guaranteed by the 14<sup>th</sup> Amendment's Due Process Clause; (5) the impairment of  
22 contracts in violation of the Contracts Clause; (6) the elevation of state over federal  
23 regulatory action in violation of the Supremacy Clause.

---

<sup>58</sup> 488 U.S. 299 (1989).

1           **Q.     What adjustments proposed by Staff would violate the prohibition on**  
2           **opportunistic shifting or manipulation of ratesetting methodologies?**

3           A.     As I explained in Section III of my testimony, the opportunistic switching  
4           of ratesetting methodologies (i.e., as described by the U.S. Supreme Court in the  
5           *Duquesne* case, arbitrarily switching among methodologies with the result that the  
6           investors are systematically disadvantaged) can rise to a constitutional violation. In a  
7           number of instances in this case, Staff has departed from generally accepted methods for  
8           calculating costs and return on equity, and in each instance the departure has resulted in a  
9           calculation that lowers allowable costs and return on equity. In none of these instances  
10          has Staff been able to provide UE with any reasoned explanation why it has departed  
11          from generally accepted ratesetting methods; in fact, in several instances Staff admitted  
12          that it made adjustments precisely to decrease the revenue requirement it would have to  
13          recommend. These instances include:

14               •   *Mr. Bible's Idiosyncratic Approach to Estimating ROE*

15               Mr. Bible adapts accepted methodologies for estimating ROE in ways so  
16               unique to him that even one of the two scholars he recognizes as an authority  
17               in the field, and whose well-known treatise he cites, Prof. Roger Morin,  
18               criticizes his approach as far out of the mainstream of generally accepted  
19               methodologies and fundamentally unreliable.<sup>59</sup> For example, to estimate  
20               ROE, Mr. Bible relies on a DCF calculation solely for Ameren, and refuses to  
21               question that result if estimates done by other methods do not double his DCF

---

<sup>59</sup> See Rebuttal of Roger A. Morin.

1 result. This approach effectively means that no method other than his DCF  
2 calculation really affects his ROE estimate, a practice – reliance on only one  
3 method to estimate ROE – that all experts in the field reject. Moreover, he  
4 offers no justification or authority for his “double” standard, other than it is  
5 his approach.

6 Yet while this “double” standard is good enough in his eyes to evaluate his  
7 calculations, when it comes to his recommended ROE for UE, he is much less  
8 generous, proposing a range of only +0.5% (50 basis points) around his  
9 midpoint of 9.41%. (In comparison, his “double” standard for checking his  
10 DCF result is a range of +9.41% or 941 basis points. In short, it would take a  
11 result of over 18.8% from another method to cause Mr. Bible to question his  
12 DCF result.) Here again, he offers no justification, other than his  
13 “experience” for the tighter range for his actual ROE recommendation. If the  
14 opportunism here were not apparent enough, I would also note that if he did  
15 use his “double” standard to set a range for his ROE recommendation, UE’s  
16 current ROE would fit comfortably within it, and the Staff’s case would have  
17 no evidence whatsoever to prove that adopting their new ROE had merit.

18 • *Staff’s Treatment of Net Salvage Costs in Calculating Allowable Depreciation*  
19  
20 As discussed in the rebuttal testimony of Mr. Stout, Staff has been unable to  
21 provide UE with any explanation based on reason why it rejects the normal  
22 “whole life” method of calculating net salvage value. Staff’s treatment of net  
23 salvage costs in this case is contrary to that provided for in the Uniform  
24 System of Accounts and is used by no regulatory Commission other than the

1           Pennsylvania Commission, which is required by a decision of its Superior  
2           Court to do so.

3           • *Staff's Estimation of Service Lives for Various Classes of Property in the*  
4           *Calculation of Depreciation Rates*

5           Staff recommends service lives for various categories of property that are on  
6           average unrealistically long and depreciation rates that are unrealistically low.

7           This, in turn, reduces the recommended revenue requirement.

8           • *Staff's Normalization of Test Year Fuel and Power Purchase Costs*

9           Staff uses a production cost model which it knows, and admits, makes a  
10          “normalization adjustment” to factors that are not supposed to be normalized.

11          In particular, this cost model “normalizes” any plant operations and power  
12          purchases that are different from the Staff’s model of these operations and  
13          purchases. Staff does so without first performing any analysis as to the  
14          prudence of UE’s practices. As Mr. Finnell and Mr. Baxter explain in their  
15          rebuttal testimony, employing this arbitrary methodology lowers UE’s  
16          calculated revenue requirement by approximately \$40 million.

17          • *Staff's “Normalization” Adjustment to Tree Trimming Expenses*

18          As explained by Mr. Voss in his rebuttal testimony, Staff proposes to  
19          eliminate over \$4 million in tree trimming expenses by calculating a 4 year  
20          average based on historic costs. As Mr. Voss explains, Staff chooses to  
21          “normalize” these costs in a manner that is inconsistent with historic spending  
22          levels. Indeed, Staff is aware that normalization conditions do not apply given

1           that tree trimming costs are trending decidedly upward due to increasing labor  
2           costs and UE's efforts to control vegetation to increase system reliability.

3           • *Staff's Refusal to Allow Any "Non-Recurring" Costs*

4           Because a company always has a threshold level of "non-recurring" costs each  
5           year, normal accounting and regulatory methodologies provide for a  
6           "normal," although not "extraordinary," amount of non-recurring cost as  
7           allowable costs for ratemaking purposes. Staff proposes to disallow *any*  
8           amount for non-recurring costs.

9           • *Staff's Application of a New Methodology to Account for Expenditures*  
10          *Associated with the Funding of UE's Pension Plans and Other Post-*  
11          *Retirement Benefits (OPEBs)*

12          Staff's methodology, which, as Mr. McGilligan explains in his rebuttal  
13          testimony, is inconsistent with accounting standards, eliminates over \$7  
14          million in UE's test year costs by deferring from current to future customers  
15          the costs and risks associated with UE's future pension liabilities. Because  
16          financial markets performed well in the several years prior to the test year,  
17          Staff's novel methodology in this case drives down revenue requirements well  
18          below those levels required to recover prudently incurred pension and OPEB  
19          costs.

20          • *Staff's Approach to the Test-Year Concept*

21          In a more general vein, Staff witnesses take an opportunistic approach to the  
22          test year, looking outside the test year when doing so will have the effect of  
23          lowering UE's rates, but dogmatically upholding the test year concept when

1 another result might occur. For instance, Mr. Cassidy objects to UE's test  
2 year including certain *accrued* costs, yet he himself proposes to remove a  
3 *current* cost from the test year--a \$12.5 million dollar MISO exit fee. And he  
4 recommends this on the basis of nothing more than another Staff witness'  
5 speculation that UE may rejoin the MISO. In recommending this reduction to  
6 the test year expenses, he does not add to them the \$6 million annual  
7 administrative charge that UE would have to pay to belong to the MISO. On  
8 the other hand, Staff witness Harrison applies an accrual-like accounting  
9 rationale to the Venice plant fire costs, which causes the import of significant  
10 revenues from outside the test year into the test year.

11 **Q. Would Staff's proposed rate regime violate the Takings Clause of the**  
12 **5<sup>th</sup> Amendment?**

13 A. Although it is historically difficult to prevail on a takings claim in the  
14 ratemaking context, Staff's proposal in this case not only raises takings concerns but in  
15 fact appears to contain at least one violation of the Takings Clause:

16 • Staff has proposed to exclude from the ratesetting process any and all  
17 "one-time, non-recurring" costs, wholly without regard to whether they  
18 were prudently incurred, and whether they benefited ratepayers. I have  
19 already noted the problem from a rate-level perspective, in that such costs  
20 occur every year such that artificially removing them will necessarily  
21 result in rates that are too low. But beyond that, Staff's practice  
22 necessarily requires the shareholders to bear the cost of anything that



1 occurs only once. Such a "rule" is hard to describe as anything but a  
2 taking.

3 Staff's proposal also contains a number of flaws that raise takings concerns:

- 4 • Staff proposes to set rates exceedingly low, based on a cost of service  
5 study fraught with opportunistic switching of methodologies that  
6 systematically lower the calculated revenue requirement.
- 7 • Staff's proposed return on equity is pegged exceedingly low, based solely  
8 on a simple, highly-criticized DCF result and in spite of the fact that the  
9 electric industry is becoming riskier.
- 10 • Staff has mischaracterized UE's earnings under the EARP as "excess,"  
11 even though it was impossible for UE to have earned in excess of the  
12 allowed return under the EARP.
- 13 • Staff seems to want to penalize UE for its successful performance under  
14 the EARP, essentially to deprive UE of the benefit of that bargain, even  
15 though UE's customers and shareholders are pleased with its performance.

16 **Q. Does Staff's proposal constitute retroactive ratemaking?**

17 A. Yes, in at least one instance. UE has consistently capitalized the net  
18 salvage costs associated with the retirement of assets and depreciated them over the  
19 useful life of the asset. Staff witness Jolie Mathis has recommended not only that the  
20 practice of capitalizing the net salvage costs be abolished but also that the past  
21 depreciated amounts already recovered by UE through its rates now be credited to UE's  
22 current customers. This would amount to about \$500 million.<sup>60</sup> This is retroactive

---

<sup>60</sup> See Rebuttal Testimony of William M. Stout at 48.

1 ratemaking in one of its clearest forms. In fact, Staff witness Greg Meyer stated in his  
2 deposition that this adjustment represents “the refund of these prior customers paying for  
3 net salvage.”<sup>61</sup>

4 Staff’s rate proposal as a whole can be seen to be retroactive ratemaking.  
5 Staff’s choice of unique cost of service methodologies consistently lowers UE’s  
6 allowable costs for ratemaking purposes so far below its actual costs that it raises the  
7 question whether it isn’t an attempt to recapture UE’s earnings under the EARP –  
8 earnings Staff has already characterized as “excess”.

9 **Q. Would Staff’s proposal violate the Supremacy Clause?**

10 A. Yes. Clearly, the adjustments proposed by Staff that would violate  
11 previous rates and agreements approved by FERC that I discussed in subsection C above  
12 (the JDA and AEM contract-related adjustments) would also violate the Supremacy  
13 Clause. Additionally, Staff’s tax depreciation adjustment (that is inconsistent with IRS  
14 standards) and its pension expense-related adjustments (that are inconsistent with ERISA  
15 standards) may also violate the Supremacy Clause.

16 There are also serious questions about whether at least two other  
17 adjustments proposed by Staff would violate the Supremacy Clause. The Staff’s tax  
18 straight-line depreciation adjustment disallows a portion of UE’s tax expenses merely  
19 because the Staff disagrees with the federal tax law treatment of depreciation. (Staff  
20 would prefer that UE double-count depreciation deductions, or deduct more than 100% of  
21 the original cost of assets.) The Staff’s pension and OPEB expense adjustments are  
22 inconsistent with the amortization methods allowed under ERISA.

23 **Q. Would Staff’s proposal violate the Commerce Clause?**

---

<sup>61</sup> Meyer April 2002 *Dep.* at 30, lines 110-12.

1           A.     Yes.   Those adjustments of Staff that interfere with the rates and  
2     agreements approved by FERC would also violate the Commerce Clause. Congress gave  
3     FERC regulatory jurisdiction over wholesale sales of electricity in interstate commerce  
4     and the interstate transmission of electricity because the U.S. Supreme Court had ruled in  
5     *Public Utilities Comm'n of Rhode Island v. Attleboro Steam & Elec. Co.*, 273 U.S. 83, 90  
6     (1927), that state attempts to exercise jurisdiction in this area violated the Commerce  
7     clause. It follows that state interference with decisions made by FERC in the lawful  
8     exercise of its jurisdiction also constitutes violation of the Commerce Clause.

9           **Q.     Would Staff's proposal violate the Due Process Clause of the 14<sup>th</sup>**  
10    **Amendment?**

11          A.     Yes.   Several of Staff's proposed adjustments to rates discussed above  
12     would also amount to violations of the Due Process Clause. For example, it would  
13     violate due process for the Commission to rely on testimony that either had no basis for  
14     its conclusions, or that relied on another person who was unavailable for cross-  
15     examination in reaching its decision. A decision without a reviewable basis does not  
16     square with the due process guarantee of a meaningful hearing. Retroactive ratemaking  
17     arguably also amounts to a violation of UE's due process rights.<sup>62</sup>

---

<sup>62</sup> See Justice Kennedy's opinion in *Eastern Enterprises v. Apfel*, 524 U.S. 498, 546-50 (1998) (Kennedy, J., concurring in the judgment).

**V. STAFF'S PROPOSAL IS INCONSISTENT WITH GOOD  
PUBLIC POLICY AND WILL ADVERSELY IMPACT THE  
INTERESTS OF UE'S CUSTOMERS AND SHAREHOLDERS AS  
WELL AS THE MISSOURI PUBLIC**

**Q. What has Staff said about the policy implications of its proposal?**

A. Nothing. Staff has provided no testimony regarding the policy implications of its proposal. Because Staff's proposal is presented in conjunction with its complaint that UE has been earning "excessively" we can fairly conclude that its chief purpose is to decrease UE's earnings. Indeed, I believe that is Staff's only purpose.

**Q. Why do you conclude that lowering earnings is Staff's only purpose in recommending its rate proposal?**

A. I have reviewed UE's performance over the last six years it has operated under the EARP. What I see is that UE and its customers have experienced much beneficial change: UE's rates have decreased; its rates are among the lowest in the country; its service has improved; its customers are highly satisfied with it; its efficiency has improved; its management has improved; its management has been innovative; its management is highly regarded in the industry and by financial analysts; its environmental performance has been applauded by EPA; and it has kept up with its infrastructure investment demands. Because these are the defining features of superior performance, as I discussed in Section III of my testimony, I conclude that the EARP should be viewed as a regulatory success story. Confronted with the fact that Staff does not view it that way, I ask myself why, and the answer seems to be that Staff would like to change the only thing about UE that hasn't changed under the EARP: its earnings. UE has managed to achieve superior performance and lower rates without eroding its earnings. The latter seems to be Staff's problem.

1           **Q.     In your opinion and experience, is lowering earnings the appropriate**  
2 **focus of economic regulation?**

3           A.     No, the focus of economic regulation should be the regulation of rates, not  
4 the regulation of profits. Having said that, it is not unheard of for regulators to lose that  
5 focus. In fact, I recently came upon an article written more than 30 years ago that  
6 discussed this very issue, and in the article the author, Professor Massel, tells an  
7 interesting story about this recurring problem:

8                     In the late 1930's a federal commission decided to lower the profits of a  
9 major company under its jurisdiction. In response to the ensuing rate reduction,  
10 the company adopted some innovations which it had developed experimentally.  
11 These innovations produced such cost savings that profits were even higher than  
12 those which obtained before rates were lowered.

13  
14                     The chief accountant of that commission, an able, conscientious public  
15 servant, was outraged—an emotion which reflected the chagrin of his superiors.  
16 He was shocked because the company earned a higher profit in the face of the  
17 agency's order to reduce rates. He felt that the company's performance was so  
18 dishonest that it verged on fraud. . . .The chagrin of the agency provides a key to  
19 the problem. The regulatory process had not encouraged the company to reduce  
20 costs and to innovate. Instead, it had induced the enterprise to hold back the  
21 innovations as a 'hidden reserve' to protect itself against future rate reductions or  
22 economic depressions. The holding back was a reflection of the [agency's]  
23 preoccupation with profit control rather than rate regulation.<sup>63</sup>  
24

25                     While a preoccupation with profit regulation sometimes occurs, it is not a  
26 desirable development because it displaces the regulatory focus from where it should be  
27 as a matter of good policy: deciding what performance is desirable and how to best get  
28 there. Or, as Professor Massel put it, "This good man [chief accountant] was so imbued

---

<sup>63</sup> Massel, *The Regulatory Process and Public Utility Performance* in *PERFORMANCE UNDER REGULATION* 113-124 (H. Trebing, ed. 1968), reprinted in Richard J. Pierce, Jr., Gary D. Allison, Patrick H. Martin, *ECONOMIC REGULATION: ENERGY, TRANSPORTATION AND UTILITIES* 251 (1980).

1 with the public service tradition of controlling 'monopoly profits' that he overlooked the  
2 broad public issues."<sup>64</sup>

3           The Staff's preoccupation with earnings is particularly misplaced here  
4 where performance based regulation has worked to induce utility innovation and lower  
5 costs. Indeed, UE's performance is a true success story because it has managed to  
6 advance the interests of both its customers (with lower rates) and its shareholders (with  
7 consistent earnings). Customers have no real interest in whether profits are high or not;  
8 their interest is in whether rates are stable and low. Or, as Professor Massel put it,  
9 "Given a choice between low rates and high profits, on the one hand, and high rates with  
10 low profits, on the other, the customer would opt for the low-rate [high-profit]  
11 combination."<sup>65</sup> Significantly, in our case, under both the EARP and UE's proposed Alt  
12 Reg Plan, UE cannot earn an excessive profit because its profit is capped.

13           **Q.     What are the policy implications of Staff's proposal?**

14           A.     There are four policy implications:

- 15                     • UE's superior performance will erode.
- 16                     • Customer rates will increase.
- 17                     • UE's ability to attract capital will deteriorate.
- 18                     • The public's interest in a thriving electricity market served by an  
19                     efficient transmission network will be compromised.

20           **Q.     What do you mean when you say that UE's superior performance will**  
21 **erode under Staff's proposal?**

---

<sup>64</sup> *Id.* at 254.

<sup>65</sup> *Id.*

1           A.     As I discussed in Section III, desirable utility behavior is superior  
2 performance at low cost. Superior performance generally includes:

- 3                 - lowering costs,
- 4                 - improving service,
- 5                 - increasing efficiency,
- 6                 - pursuing innovation,
- 7                 - enhancing customer satisfaction,
- 8                 - enhancing reliability of service,
- 9                 - providing environmental protection,
- 10                - providing reasonably stable rates, and
- 11                - maintaining financial stability.

12                In his rebuttal testimony, Mr. Baxter explains in detail how Staff's  
13 proposal would shrink UE's cash flows and earnings and how this, in turn, will raise  
14 costs and decrease access to capital markets. When cash is short, it is spent only on the  
15 core mission of a business, in this case delivering basic electricity service, and spending  
16 on non-core services (e.g. enhancing customer satisfaction, providing environmental  
17 protection) is reduced or eliminated. Therefore, most, if not all, of the criteria of superior  
18 performance noted above will be adversely impacted by Staff's proposal.

19           **Q.     What do you mean when you say that customer rates will increase?**

20           A.     Clearly, in the short term customer rates will decrease; however, as Mr.  
21 Baxter explains in his rebuttal testimony, UE's costs will increase and, under the  
22 traditional regulatory model, customer rates will have to be increased to cover these  
23 increased costs.

1           **Q.     What do you mean when you say that UE's ability to attract capital**  
2 **will decrease?**

3           A.     The primary consequence to UE of Staff's proposal, i.e less cash flow,  
4 lower credit ratings and lower earnings, will cause a drop in UE's stock prices, reduced  
5 financial flexibility, increased cost of debt and equity, continuing regulatory risk and an  
6 inability to earn an adequate return on investment. This, in turn, will limit UE's access to  
7 capital markets. Mr. Baxter explains this in detail in his rebuttal testimony.

8           **Q.     What do you mean when you say that the public's interest in a**  
9 **thriving electricity market served by an efficient transmission network will be**  
10 **compromised?**

11          A.     Load growth and an increasingly active power market in the Midwest is  
12 demanding substantial investments in new infrastructure, including generation,  
13 transmission and distribution facilities. Decreased cash flows and earnings will make  
14 UE's financing of these facilities more risky, costly, less timely and potentially  
15 impossible. Mr. Baxter explains this in detail in his rebuttal testimony.

16                 Staff's recommendation would consign UE to a future of no growth and no  
17 innovation—a future inconsistent with where the industry is now and where it's moving.  
18 In my opinion, not only would this be sad for UE's customers but also for the people of  
19 Missouri. Because of Missouri's strategic geographic location in the heartland of the  
20 country, it has the potential to be pivotal in the development of the country's new  
21 regional, and eventually national, markets in electricity. It could be a trading center for  
22 electricity moving north, south, east and west, as well as put Missouri's electricity  
23 customers in a place to benefit greatly from the low prices this competition promises to



1 bring. UE understand this and is currently situated to help Missouri accomplish this, but  
2 eroding UE's cash and earnings will rob it of much of its ability to do this. Overall, this  
3 will also be a missed opportunity for the State of Missouri.

4

5 **VI. UE'S PROPOSED ALTERNATIVE REGULATION PLAN IS**  
6 **THE BEST RATESETTING CHOICE FROM A POLICY-MAKING**  
7 **PERSPECTIVE: IT WILL CONTINUE TO ENCOURAGE**  
8 **SUPERIOR PERFORMANCE AT LOW RATES WITH ATTENDANT**  
9 **BENEFITS TO CUSTOMERS, SHAREHOLDERS AND THE**  
10 **PUBLIC**

11

12 **Q. Why do you conclude that UE's proposed Alt Reg Plan is the best**  
13 **ratesetting choice from a policy-making perspective?**

14 **A.** I conclude that UE's proposed Alt Reg Plan is the best ratesetting choice  
15 because I believe it is the plan best calculated to achieve superior performance at low  
16 cost. There are a number of reasons I say this. First, UE has had six years' experience  
17 with performance based regulation, and its performance has been excellent. This is solid  
18 evidence to support continuing performance based regulation for UE. Second,  
19 performance based regulation is more important now than ever before because the  
20 changes in the industry demand new investment and will reward cost reduction,  
21 efficiency and innovation. A ratesetting regime that capitalizes on these conditions is the  
22 best choice for a utility like UE that is otherwise ready to participate in this market.  
23 Third, the Alt Reg Plan makes changes to the EARP that will increase benefits to UE's  
24 customers and the public in general and will add to the assurances that the desired  
25 regulatory goals will be achieved quicker and with less associated cost. Fourth, the Alt  
26 Reg Plan is aligned with the Commission's Mission Statement. Finally, the Alt Reg Plan

1 eliminates some of the regulatory risks associated with traditional cost of service  
2 regulation that current conditions in the industry counsel against incurring.

3 **Q. How is UE's performance under the EARP relevant to the**  
4 **Commission's adoption of the Alt Reg Plan?**

5 A. As Professor Weisman explained in his rebuttal testimony, because  
6 performance based regulation is more established in the telecommunications industry  
7 than the electric industry, some regulators may be tentative about adopting it for electric  
8 utilities. This Commission has the advantage in that it has had a six-year experiment in  
9 place with performance based regulation with this utility. UE's exemplary performance  
10 over the last six years shows that it has the management in place that can successfully run  
11 a utility under this type of regulatory system. In this case, the Commission does not have  
12 to be concerned that the utility will not be able to take advantage of the incentives that  
13 performance based regulation offers to achieve superior performance at low cost. Indeed,  
14 some of the innovations that UE developed under the EARP will be particularly  
15 important in tomorrow's electricity industry, e.g., their developments in financial  
16 forecasting and risk management.

17 **Q. Why is performance based regulation more important than ever**  
18 **before for UE?**

19 A. As explained in some detail in the rebuttal testimonies of Peter Fox-  
20 Penner, Mr. Baxter, and Professor Weisman, the types of behavior that performance  
21 based regulation seeks to improve are particularly relevant to tomorrow's electric  
22 industry. These behaviors include cost reduction, efficiency and innovation. Although  
23 such behaviors are desirable in any business, including the utility business, they are

1 particularly important for a business that is facing new demands for infrastructure  
2 investment, new ways of doing business because of market changes, and new competitive  
3 pressures.

4 **Q. What changes proposed by UE in the Alt Reg Plan improve its**  
5 **desirability from a public policy perspective?**

6 A. Changes in the Alt Reg Plan will significantly enhance customer and  
7 public benefits and regulatory efficiency and thus appreciably improve its desirability  
8 from a public policy perspective. The Plan advances customers' interests in a number of  
9 ways. The Plan begins by providing lower base rates for electricity. The lowering of  
10 base rates effectively passes on to UE's customers the permanent efficiencies that were  
11 achieved under the EARP. The Plan also establishes a permanent benefit specifically for  
12 low income customers and for economic development. By initiating a low income  
13 consumer assistance program, funding it initially with \$5 million, and crafting a  
14 mechanism that provides an annual contribution to the fund of at least \$1 million (unless  
15 UE's earnings drag behind the minimum expected), the Alt Reg Plan institutionalizes a  
16 recurring benefit to this class of customers in addition to lower base rates. The Alt Reg  
17 Plan establishes a similar benefit with the same dollar amounts for economic  
18 development. Finally, the sharing benefits for customers are enhanced over those in the  
19 EARP: sharing begins at a lower threshold of UE earnings, as explained by Mr. Baxter in  
20 his rebuttal testimony, and sharing participation is greater than under the EARP. As with  
21 the EARP, participation rises as earnings rise so that 100% of incremental earnings are  
22 shared with customers if pre-sharing earnings reach more than 16%.

1           The public, as well as UE's customers, will benefit from changes designed  
2 to increase the certainty of the accounting process and make the regulatory oversight  
3 process simpler and more efficient. Because the sharing amounts are set dollar amounts  
4 whenever the return on equity falls within particular zones, the sharing benefits can be  
5 determined quicker and passed on to customers quicker, and the regulatory oversight  
6 surrounding these sharing credits can take place more efficiently and with many fewer  
7 disputes over the appropriate sharing credit than occurred under the EARP.

8           **Q.     How is the Alt Reg Plan aligned with the Commission's Mission**  
9 **Statement?**

10          A.     The Commission has embraced several missions, in addition to its primary  
11 responsibility to ensure safe and reliable utility service at just, reasonable and affordable  
12 rates, that the Alt Reg Plan will further. These include:

- 13           • Support economic development through either traditional rate of return  
14 regulation or competition, as required by law.
- 15           • Establish standards so that competition will maintain or improve the quality of  
16 services provided to Missourians.
- 17           • Provide an efficient regulatory process that is responsive to all parties

18

19          The Alt Reg plan meets the first goal because it will contribute directly to economic  
20 development in UE's service area. The Alt Reg Plan indirectly encourages economic  
21 development too by giving UE incentives to make productive investment in the electric  
22 infrastructure that is necessary for tomorrow's economic development. Because the Alt  
23 Reg Plan puts in place some of the same types of incentives that are inherent in

1 competition, the Alt Reg Plan builds on the competitive model to improve the quality of  
2 service for UE's customers. This is consistent with the second mission goal. Regarding  
3 the third goal, as explained above, the Alt Reg Plan incorporates within its oversight  
4 provisions a simpler, more efficient regulatory process than that associated with cost of  
5 service ratemaking.

6 **Q. What regulatory risks associated with traditional cost of service**  
7 **regulation are eliminated by the Alt Reg Plan?**

8 A. There are at least four regulatory risks associated with traditional cost of  
9 service regulation that are eliminated by the Alt Reg Plan. First, as Professor Weisman  
10 explains, the lack of an incentive to "remedy" innovations under cost of service  
11 regulation is remedied, while any competing incentive to "hold back" innovations that  
12 will lower costs until after a rate case is eliminated. Under the Alt Reg Plan the utility is  
13 encouraged to bring these innovations online as soon as possible because reducing costs  
14 immediately is rewarded. Second, the incentive that exists under cost of service  
15 regulation to "gold plate" infrastructure so as to increase rate base and thus increase  
16 earnings is eliminated. Under the Alt Reg Plan, there is no incentive to over-invest; the  
17 investments that produce utility service most efficiently also produce earnings most  
18 efficiently. In fact, UE has proposed the investment that it will make in generation,  
19 transmission and distribution during the Alt Reg Plan timeframe. Third, the incentive  
20 that exists under cost of service regulation not to spend money on innovation for fear that  
21 it will not be included in the revenue requirement in the next rate case is eliminated.  
22 Under the Alt Reg Plan, innovations that increase efficiency and lower cost are rewarded  
23 immediately. Finally, the possibility that a utility will have excess earnings exists under

1 cost of service regulation. Under the Alt Reg Plan, UE could earn no more than 13.3%,  
2 as Mr. Baxter explains in his rebuttal testimony.

3 **Q. Assuming, as you opined earlier in your testimony, that Staff is**  
4 **primarily concerned about UE's level of earnings, is this concern addressed in the**  
5 **Alt Reg Plan?**

6 **A.** Yes, as I explained earlier in my testimony, this seems to be Staff's  
7 primary, if not singular, concern. The Alt Reg Plan addresses this with its effective cap  
8 on earnings.

9 **VII. UE'S COST OF SERVICE WILL PRODUCE**  
10 **JUST AND REASONABLE RATES**  
11 **CONSISTENT WITH GOOD PUBLIC POLICY**

12  
13 **A. UE'S COST OF SERVICE WILL PRODUCE JUST AND REASONABLE RATES**

14 **Q. Has UE prepared its own cost of service study?**

15 **A.** Yes. As Mr. Warner Baxter explains in his rebuttal testimony, UE has  
16 prepared its own cost of service study to determine the appropriate level of UE's  
17 Missouri electric retail rates in response to Staff's cost of service study, which is  
18 fundamentally flawed as I discussed in Sections IV and V of my testimony. UE's cost of  
19 service study is presented in the rebuttal testimony of Mr. Gary Weiss.

20 **Q. Is UE proposing that the Commission adopt rates based on its cost of**  
21 **service study?**

22 **A.** UE is not proposing that the Commission adopt cost of service based rates  
23 for it. On the contrary, UE is proposing that the Commission continue a performance  
24 based regulation plan for it, and specifically UE proposes that the Commission adopt its  
25 Alt Reg Plan. However, if the Commission declines to do that, then it should set rates

1 under a traditional regulatory model based on a correct, fair and reasonable determination  
2 of UE's cost of service, taking into consideration cost and important non-cost needs, such  
3 as rate stability, management efficiency, and ability to invest in the infrastructure  
4 required to continue to provide safe and reliable service. UE's cost of service captures  
5 these factors.

6 **Q. Why do you conclude that UE's cost of service will produce just and**  
7 **reasonable rates?**

8 A. As I explained in Section III of my testimony, determining whether rates  
9 are just and reasonable includes finding that the rates (1) are just and reasonable in  
10 themselves, based on competent and substantial evidence, through a process that  
11 meaningfully considers all relevant facts; (2) comply with federal law; and (3) comply  
12 with the federal Constitution. I conclude that UE's cost of service will produce just and  
13 reasonable rates because it meets these legal standards.

14 UE's cost of service will produce rates that are just and reasonable in  
15 themselves because the rates strike an appropriate balance of the interests of all the  
16 affected parties and are not otherwise unlawful in any way. I discuss this in more detail  
17 below. In order to strike an appropriate balance of interests, a cost of service study on  
18 which rates are based must accurately reflect a utility's costs, including appropriately  
19 normalized test year costs and revenues, appropriate depreciation rates, and a reasonable  
20 return on equity. UE's cost of service determination reflects these adjustments to test  
21 year numbers, and they are summarized in the rebuttal testimony of Mr. Baxter.<sup>66</sup> Mr.  
22 Weiss explains in his rebuttal testimony why he makes some adjustments to the test year

---

<sup>66</sup> Rebuttal Testimony of Warner Baxter, Section VII.

1 numbers. Thus, UE's cost of service is supported by competent and substantial evidence  
2 and includes all the facts necessary for the Commission to meaningfully consider it.

3 UE's cost of service is also otherwise lawful. It complies with all aspects  
4 of Missouri law, including with 4 CSR 240-10.020. It does not suffer from any of the  
5 legal infirmities that plague Staff's cost of service proposal; it complies with federal  
6 statutory law and federal constitutional law.

7 **Q. Why do you conclude that UE's cost of service will produce rates**  
8 **consistent with good public policy?**

9 A. First, I want to reiterate that UE's Alt Reg Plan is the best ratesetting plan  
10 to achieve superior performance at a low cost. However, if the Commission decides not  
11 to adopt that plan, UE's cost of service will produce rates consistent with good public  
12 policy because they will advance the interests of UE, its customers, its shareholders and  
13 the public. These rates will provide UE with sufficient cash flow and an adequate credit  
14 rating to enable it to meet the infrastructure challenges it faces and to continue to provide  
15 reliable service at a fair rate. The rate charged for electricity will encourage rational  
16 consumption by UE's customers. The revenue UE will receive will be adequate to  
17 provide its shareholders with a fair return on their investment sufficient and justify their  
18 continued investment in UE. The public can be assured that UE will provide reliable,  
19 reasonably-priced electric service for the foreseeable future, and be in a position to meet  
20 future demands of the electricity marketplace. There will also be sufficient revenue to  
21 continue UE's record of environmental and public safety protection.

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

23 A. Yes.



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

The Staff of the Missouri Public Service Commission,  
Complainant,  
vs.  
Union Electric Company, d/b/a AmerenUE,  
Respondent.

Case No. EC-2002-1

**AFFIDAVIT OF SUEDEEN G. KELLY**

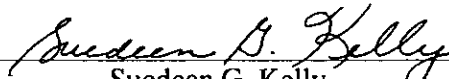
STATE OF NEW MEXICO )  
 ) ss  
COUNTY OF BERNALILLO )

Suedeem G. Kelly, being first duly sworn on her oath, states:


1. My name is Suedeem G. Kelly. I work in Albuquerque, New Mexico and I am employed by the University of New Mexico School of Law as a law professor and by Modrall, Sperling, Roehl, Harris & Sisk, P.A. as an attorney.

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 60 pages, Appendix A and Schedules 1 through 2, 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.

  
Suedeem G. Kelly

Subscribed and sworn to before me this 7<sup>th</sup> day of May, 2002.

  
Notary Public

My commission expires:

DEBBY ANZALONE  
Notary Public - Notary Seal  
STATE OF MISSOURI  
St. Louis County  
My Commission Expires: April 18, 2006

# EXECUTIVE SUMMARY

**Suedeem G. Kelly**

*Professor of Law at the University of New Mexico School of Law, and formerly Chair of the New Mexico Public Service Commission and a Fellow with the U.S. Senate Energy and Natural Resources Committee, who writes, speaks and teaches about public utility and energy policy and law*

\* \* \* \* \*

My testimony begins with an overview of why this is a momentous case in the development of Missouri and federal regulatory law, in the implementation of Missouri regulatory policy, and for the future of UE, its customers and Missouri's economic standing in the country. I then address what it means to set just and reasonable rates as a matter of law and regulatory policy. In light of these principles, I explain how the Staff's rate proposal fails to comply with Missouri law, federal statutory law and the federal Constitution. Next, I discuss the policy implications of Staff's proposal and UE's proposed Alternative Regulation Plan (Alt Reg Plan). My principal conclusions are:

- 1) This is a case of national importance because of the enormity of Staff's proposed rate adjustment and the fact that the methodologies used by Staff to support its proposed rate adjustment raise many issues of Missouri law, federal statutory law and federal constitutional law that rarely present themselves in utility rate cases. Also, this case asks the Commission to make a sharp break with its six year old regulatory policy of using performance incentives even though they have successfully contributed to lower UE rates, increased efficiency, enhanced customer service and satisfaction, and management innovations. Finally this case presents the

Commission with a policy choice between two starkly different visions of the future for UE, its customers and Missouri itself. As envisioned by UE, this is a Missouri with a growing, thriving, competitive wholesale electricity market served by an expanded, better integrated, less congested transmission network. As envisioned by Staff, this is a Missouri with an electricity marketplace like that of seven years ago, before the implementation of the electric-industry-changing policies of the Energy Policy Act—a state with traditional utility monopolies experiencing little growth and no change, and a state that is not a vital player in the nation’s electricity marketplace. As UE’s witness, Dr. Peter Fox-Penner explains in his testimony, the problem with this picture is that it just does not exist anymore.

- 2) I disagree fundamentally with the bulk of the legal basis for ratesetting as apparently understood by the Staff, which is set out most directly in the testimony of Staff witness Ronald Bible. Missouri law is more comprehensive than Mr. Bible’s exposition of it, and Missouri rate proposals must also be consistent with federal statutory law and the federal Constitution. Staff, through Mr. Bible’s direct testimony on the law and the proposals recommended by other Staff witnesses without reference to the law, evidences a misunderstanding of constitutional law as it applies to ratesetting.
- 3) The Commission’s obligation to elevate ratesetting to a policy-making endeavor entails choosing the ratesetting plan for each utility that will achieve superior performance at a low cost. Staff has presented no policy analysis of its ratesetting plan.

- 4) Staff misleadingly characterizes UE's earnings under the EARP as "excess"; indeed, they were no more than the earnings authorized by the Commission.
- 5) Staff's rate proposal runs afoul of Missouri law in the following ways:
  - Staff has not met its burden of proof to show by competent and substantial evidence, including all facts relevant to meaningful consideration of its proposal, that its proposed rates are just and reasonable.
  - Staff often relies on testimony by witnesses who have admitted they have no basis for their opinions or who have performed no analysis, or an inadequate analysis, to support their opinions. This renders such testimony incompetent evidence.
  - Staff has failed to include in its case all the facts necessary to allow meaningful consideration of Staff's proposal. For example, Staff has submitted no evidence on the impact changing from the EARP to its cost-of-service-based structure will have on UE, its customers, its shareholders and the public. With respect to many of Staff's specific proposals, including those regarding tax depreciation expense, pensions and OPEBs expense, net salvage expense, depreciation reserve expense, the appropriate rate of return on equity, revenues associated with customer growth, payroll taxes, incentive compensation costs, uncollectible expenses, employee medical costs, injuries and damages, cash working capital, jurisdictional allocations and system energy losses, Staff's witnesses have not considered the impact their proposals would likely have on UE's operations,

including its ability to attract capital and invest in infrastructure, its stock price or its vulnerability to takeover. Without this information the Commission cannot meaningfully consider whether Staff's proposal is just and reasonable.

- Staff has arbitrarily excluded from its recommended revenue requirement costs that UE has incurred or accrued through normal and prudent business practices, resulting in more than a \$73 million recommended deflation of UE's annual revenue requirement. Such costs cannot be considered for exclusion by the Commission without Staff's providing a cogent rationale for why the practices leading to the incurrence or accrual of these costs constitute an abuse of discretion or were otherwise imprudent at the time made.
- Staff's proposal would violate Commission rule 4 CSR 240-10.020 governing the treatment of accumulated depreciation when calculating the return component of a utility's revenue requirement. It also contains recommendations inconsistent with previous orders issued by the Commission, and it recommends accounting treatment of OPEBs inconsistent with the accounting treatment required by Missouri law, Section 386.315 Revised Statutes of Missouri.

For these reasons, Staff's proposal does not produce just and reasonable rates.

- 6) Several of Staff's proposed rate adjustments would violate federal law, specifically, previous rates and agreements approved by the Federal Energy Regulatory Commission (FERC), rules enacted by the IRS and pension regulations promulgated under the Employee Retirement Income Security

Act (ERISA). These include, among others, impermissibly crediting UE with revenues from FERC-regulated interstate sales, impermissibly imputing to UE revenues that FERC has not allowed UE to receive pursuant to the allocation of interchange sales under the Joint Dispatch Agreement, and disallowing costs associated with UE's 2001 power purchase contract with AEM, which has been approved by FERC.

- 7) Staff's proposed rate adjustments would violate the federal Constitution, by their opportunistic shifting of ratesetting methodologies as described by the U.S. Supreme Court in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); by retroactive ratemaking; by putting an undue burden on interstate commerce in violation of the Commerce Clause; by taking UE's property without just compensation; by depriving UE of the procedural due process guaranteed by the 14<sup>th</sup> Amendment; by impairing the obligations of contract in violation of the Contracts Clause; and by infringing on federal regulatory action in violation of the Supremacy Clause.
- 8) Staff's proposal does not focus on ratesetting but rather on profit regulation. If Staff's proposal were to be implemented, UE's superior performance will erode, UE's customers' rates will increase, UE's ability to attract capital will decrease, and the public's interest in a thriving electricity market served by an efficient transmission network will be compromised.
- 9) UE's Alt Reg Plan is the best ratesetting plan from a public policy perspective. UE's six year track record of superior performance under the EARP shows that it has the management in place to successfully run a utility under performance based regulation. Performance based regulation is the

best approach to UE's regulation given its past experience and the challenges it faces over the next three years in a demanding marketplace. The changes proposed by UE in the Alt Reg Plan will enhance customer benefits and regulatory efficiency and thus make it desirable from a public policy perspective. The Alt Reg Plan eliminates a number of perverse incentives associated with traditional cost of service regulation. It also caps possible earnings for the utility. These features add to its superiority for UE over cost of service regulation.

- 10) UE has prepared its own cost of service study to determine the appropriate level of UE's Missouri electric retail rates in response to Staff's cost of service study, which, as I have explained above, is fundamentally flawed. Should the Commission decide not to adopt the Alt Reg Plan, UE's cost of service will produce just and reasonable rates consistent with good public policy.

**SUEDEEN G. KELLY**

University of New Mexico  
School of Law  
1117 Stanford Drive N.E.  
Albuquerque, New Mexico 87131-1431  
(505) 277-2146

**PUBLICATIONS:**

*Domestic Energy Policy in the Era of Electric Industry Deregulation: The Future of Coal, Oil and Gas, Nuclear, and Renewable Energy*, 47 ROCKY MT. MIN. L. INST., 1-1 (2001).

ENERGY LAW AND POLICY FOR THE 21<sup>ST</sup> CENTURY (Rocky Mt. Mineral Law Fd'n, 2000) (co-authored with J. Hickey, M. Mansfield, J. Tomain, and D. Zillman).

*The New Electric Powerhouses: Will They Transform Your Life?*, 29 ENVIRONMENTAL LAW 285 (1999).

*The New, New Mexico Public Regulation Commission* (1998)( reprinted in ENCHANTMENT MAGAZINE, Oct. 1998)

*Municipalization of Electricity: The Allure of Lower Rates for Bright Lights in Big Cities*, 37 NAT. RESOURCES J. 43 (1997).

REPORT AND DRAFT LEGISLATION TO RESTRUCTURE THE ELECTRIC INDUSTRY IN NEW MEXICO (N.M. Public Utilities Commission 1997) (co-authored with Maureen Sanders).

BILL TO CREATE THE N.M. PUBLIC REGULATION COMMISSION (N.M. Legislative Council Service, 1977).

*New Approaches to Structure and Organization of Regulatory Commissions* (N.M. Legislature, Public Regulation Commission Joint Committee, 1997).

*It's Electric Rates, Stupid: The Municipalization Option*, ELECTRICITY INSTITUTE 8-1 (RMMLI 1997)



*The Antitrust State Action Doctrine and its Potential Role in Assuring Consumer Protection in a More Competitive Utility Environment*, 17 NAT'L REG. RES. INST. Q. BULL. 395 (1996) (co-authored with Robert E. Burns).

*Legal Issues In Retail Wheeling: State Versus Federal Jurisdiction Over Wheeling*, chapter in THE IMPACT OF A RETAIL WHEELING STATUTE IN NEW MEXICO: AN EVALUATION (N.M. Public Utilities Commission, 1995).

*LDC Access Conditions*, 1995 U.S. DEP'T. OF ENERGY-NAT'L A. OF REG. UTIL. COMM'RS GAS CONF. 211.

*A Hypothetical Problem on Energy Development in Mexico*, 3 U.S.-MEXICO L. JOURNAL 109 (1995) (with William D. De Grandis, Michael W. Gordon, Abdon Hernández, Miguel Jauregui Rojas and William M. Wilson, Jr.)

Chapter titled *The Politics of Regulation in New Mexico*, in NEW MEXICO GOVERNMENT (C. Garcia and P. Hain, 3rd ed., UNM Press, 1994) (co-authored with H. Jenkins-Smith).

*Integrated Resource Planning: Concepts and Issues*, 8 N.M. NAT. RESOURCES REPORTER 47 (1994).

*Overview of Competition in Electricity*, XVI PUBLIC UTILITIES LAW ANTHOLOGY PART II xvii (1994).

*State Developments in Natural Gas Transportation and Marketing*, NATURAL RESOURCES, ENERGY AND ENVIRONMENTAL LAW, THE YEAR IN REVIEW: 1992 89 (ABA Sec. of Nat. Resources, Energy & Env'tl. L. 1993).

*Natural Gas: Current Federal Regulatory and Legislative Issues*, 7 N.M. NAT. RESOURCES REPORTER 25 (1993).

*Intrastate Natural Gas Regulation: Finding Order in the Chaos*, 9 YALE J. REG. 355 (1992).

*State Developments in Natural Gas Transportation and Marketing*, NATURAL RESOURCES, ENERGY AND ENVIRONMENTAL LAW, THE YEAR IN REVIEW: 1991 86 (ABA Sec. of Nat. Resources, Energy & Env'tl. L. 1992).

*State Developments in Natural Gas Transportation and Marketing*,  
NATURAL RESOURCES, ENERGY AND ENVIRONMENTAL LAW, THE YEAR IN  
REVIEW: 1990 83 (ABA Sec. of Nat. Resources, Energy & Env'tl. L.  
1991).

*Toward Competition in the Distribution of Natural Gas in the States:  
Unbundling Comes in Many Forms*, CURRENT ISSUES CHALLENGING THE  
REGULATORY PROCESS (N.M. State University 1990).

*LEGAL ISSUES IN THE MARKETING OF NEW MEXICO NATURAL GAS*, (N.M.  
Energy, Minerals and Nat. Resources Dept. 1989) (co-authored with  
C. DuMars, R. Levin and M. O'Leary).

*Administrative Law*, 19 NEW MEXICO LAW REVIEW 575 (1988) (co-authored  
with Debra A. Hill).

*Public Service Co. of New Mexico's Proposed Restructuring Plan: An  
Analysis*, THE ALBUQUERQUE JOURNAL, Jan. 10, 1988, at B3, col. 1  
(Part 1) and Jan. 11, 1988, at A5, col. 2 (Part 2).

*Regulatory Reform in the U.S. Natural Gas Industry: A Summing Up*, 27  
NAT. RESOURCES J. 841 (1987).

*The Role of State Regulatory Commissions in the Development of New  
Gas Purchasing Strategies*, 2 NATURAL GAS 4 (March 1986).

*Administrative Law*, 14 NEW MEXICO LAW REVIEW 1 (1984) (co-authored  
with Marilyn C. O'Leary).

*Rural Co-op Conservation Loan Programs*, 3 ENERGY CONSERVATION  
BULLETIN 2 (March-April 1984).

Chapter titled *U.S. Regulation of Fluorocarbons in* INTERNATIONAL  
REGULATION OF FLUOROCARBONS and COMPARATIVE LEGAL STUDY OF  
REGULATIONS BANNING AND RESTRICTING FLUOROCARBONS (Federal  
Republic of Germany, Environmental Agency, December 1978).

*Small Counties Are in Vogue Internationally*, Earthscan Syndication  
Service, London; International Newspaper Feature, Sept. 1978  
(reprinted in ASIAN WALL STREET JOURNAL, October 1978).

*Regulation of Chlorofluorocarbons: Completion of Phase I*, 20  
ENVIRONMENT MAGAZINE 5 (May 1978).

*International Regulation of Chlorofluoromethanes*, 3 ENV. LAW AND POLICY  
129 (1977) (co-authored with Thomas B. Stoel, Jr. and Ruby I.  
Compton).

**SUEDEEN G. KELLY**

University of New Mexico  
School of Law  
1117 Stanford Drive N.E.  
Albuquerque, New Mexico 87131-1431  
(505) 277-2146

**PAPER PRESENTATIONS/SPEAKING ENGAGEMENTS:**

- 2002      "The Role of Renewables in Current U.S. Energy Policy," Stanford Law School Environmental Law Speakers Series, Palo Alto, CA, April 2002.
- "U.S. Energy Law and Policy: Any Interest in Alternatives?" Association of American Law Schools Annual Meeting, New Orleans, LA, January 2002.
- 2001      "Which Way Does the Wind Blow? The Likely Future of Wind Energy in the Increasingly Competitive U.S. Electricity Market," Annual Meeting, International Leadership Council of The Nature Conservancy, Santa Fe, NM, December 2001.
- "Domestic Energy Policy in the Era of Electric Industry Deregulation: The Future of Coal, Oil and Gas, and Nuclear Energy," 47<sup>th</sup> Rocky Mountain Mineral Law Foundation Annual Institute, Santa Fe, NM, July 2001.
- "A Primer on Electricity Restructuring," ABA and Rocky Mt. Mineral Law Fd'n Natural Resources Teachers Conference, Estes Park, CO, June 2001.
- "California Energy Deregulation: Problems of Liberalization and Privatization," 14<sup>th</sup> European Energy Law Seminar, Leiden, The Netherlands, May 2001.
- 2000      "Electricity Deregulation and Restructuring," New Mexico State Bar Annual Conference, October 2000.
- "States' Perspective on the RTO Order," American Bar Association National Teleconference, A Primer: Regional Transmission Organization Guidelines After the FERC Decision, Feb. 2000.
- 1999      Panel Member, "Electric Industry Restructuring: Generating New Business Opportunities," ABA Section of Environment, Energy and Natural Resources

Fall Meeting, San Diego, CA, October, 1999.

"Future of Nuclear Power in a Restructured U.S. Electric Industry," International Nuclear Bar Association Conference, Washington, DC, October 1999.

"Electric Industry Restructuring Developments in Congress," Latham & Watkins, Washington, DC, November 1999.

1998 Panel Member, N.M. Public Regulation Commission Candidates Debate, N.M. Assoc. of Commerce and Industry Forum, Albuquerque, N.M., October 1998.

"The Future N.M. Public Regulation Commission," New Mexico Rural Electric Cooperatives Annual Meeting, Ruidoso, N.M.

"Public Utility Law Reforms and Their Impact on Mining," New Mexico School of Mining and Technology, Socorro, N.M., April 1998 and 1997.

1997 "Borrowing From Antitrust Law to Decide Whether to Deregulate," National Regulatory Attorneys Conference, Santa Fe, N.M., April 1997.

Moderator, New Mexico Water Law Symposium, UNM Law School, Santa Fe, N.M., February 1997.

1996 "Public Client Confidentiality," New Mexico State Bar Assoc., Conference on Electricity Restructuring, Albuquerque, NM, December 1996.

"It's Electric Rates, Stupid: The Municipalization Option," Special Institute on the Electric Industry, Rocky Mt. Min'l Law Fdn, Salt Lake City, UT, November 1996.

Moderator, Symposium on The Future of Oil and Gas Law, UNM Law School, October 1996.

Moderator, Electric Industry Symposium, UNM Law School, October, 1996.

"Antitrust: The Protagonist in the Drama of Restructuring," Current Issues Challenging the Regulatory Process, Santa Fe, NM March, 1996.

1995 "Water Entities in New Mexico: Comparisons and Contrasts," Water Law Conference, CLE International, Santa Fe, NM, August 1995.

"The Brave New World of Energy Law," Eighth Institute for Natural Resources Law Teachers, Reno, NV, June 1995.

- "LDC Access Conditions Policy," 4th Annual U.S. Dept. of Energy and NARUC Conference on Natural Gas Use, Orlando, FL, February 1995.
- "LDC Rate Policy: Debate on Cost-of-Service versus Performance-Based Regulation," 4th Annual U.S. Dept. of Energy and NARUC Conference on Natural Gas Use, Orlando, FL, February 1995.
- 1994 "The Effects of Unbundling," Competition Behind the City Gate, U.S. Dept. of Energy and NARUC Workshop, Chicago, IL, October 1994.
- "Implementation of FERC Order 636," 17th Annual Public Utilities Conference, New Mexico State University, Albuquerque, NM, October 1994.
- "Access to LDC Facilities: Should 636 Apply to LDCs?" U.S. Dept. of Energy and NARUC Conference on Natural Gas Use, Nashville, TN, February 1994.
- 1993 "Incentive Regulation in the Electric Industry: The Wave of the Future or Just a Passing Fancy?" Annual Meeting of Accounting Standards Committee of the Edison Electric Institute, Albuquerque, NM, November 1993.
- "Utilities in Bankruptcy," National Conference of Regulatory Attorneys, Whitefish, MT, June 1993.
- "Overview of Integrated Resource Planning Concepts," Today's Energy Environment; Discourses on Law and Policy, Continuing Legal Education of the State Bar of New Mexico, Albuquerque, NM, May 1993.
- "A Brave New World: Restructuring Local Gas Distribution Markets," Keynote Address to the Conference on Restructuring Local Gas Distribution Markets, States' Responses to FERC Order 636, The Center For Regulatory Studies, Chicago, IL, May 1993.
- "Utility Rate Design in a Gas Marketing Regime," Short Course on Practical Natural Gas Marketing, Rocky Mountain Mineral Law Foundation, Albuquerque, NM, May 1993.
- "State Regulation of Natural Gas Marketing," Short Course on Practical Natural Gas Marketing, Rocky Mountain Mineral Law Foundation, Albuquerque, NM, May 1993.
- "The Role of Administrative Law in the Regulatory Process," 16th Annual Public Utilities Conference, New Mexico State University, Pittsburgh, PA, April