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Witness: Warner L. Baxter
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2010-0036

DIRECT TESTIMONY ON INTERIM RATES

OF

WARNER L. BAXTER

ON

BEHALF OF

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

**St. Louis, Missouri
October, 2009**

1 **DIRECT TESTIMONY ON INTERIM RATES**

2 **OF**

3 **WARNER L. BAXTER**

4 **CASE NO. ER-2010-0036**

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

6 A. My name is Warner L. Baxter. My business address is 1901 Chouteau
7 Avenue, Saint Louis, Missouri 63103.

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

9 A. I am employed by Union Electric Company d/b/a AmerenUE
10 (“AmerenUE” or the “Company”) as President and Chief Executive Officer.

11 **Q. Are you the same Warner L. Baxter who filed direct testimony in this**
12 **case on July 24, 2009?**

13 A. Yes, I am.

14 **Q. What is the purpose of your direct testimony on interim rates?**

15 A. The purpose of my direct testimony is to present information which
16 indicates that regulatory lag inherent in Missouri’s regulatory framework is
17 systematically preventing AmerenUE from recovering its cost of service and earning its
18 authorized return. In addition, I will provide my perspective on the key drivers and the
19 related policy implications of regulatory lag in Missouri, including the fact that excessive
20 regulatory lag creates significant financial challenges and provides a strong disincentive
21 for utilities to make discretionary investments in its energy infrastructure in a manner that
22 is contrary to the public interest. Finally, I will discuss what AmerenUE is doing to help

1 mitigate regulatory lag, including seeking approval of the Company's proposed interim
2 rates in this proceeding.

3 **Q. What do you mean by your use of the term "regulatory lag"?**

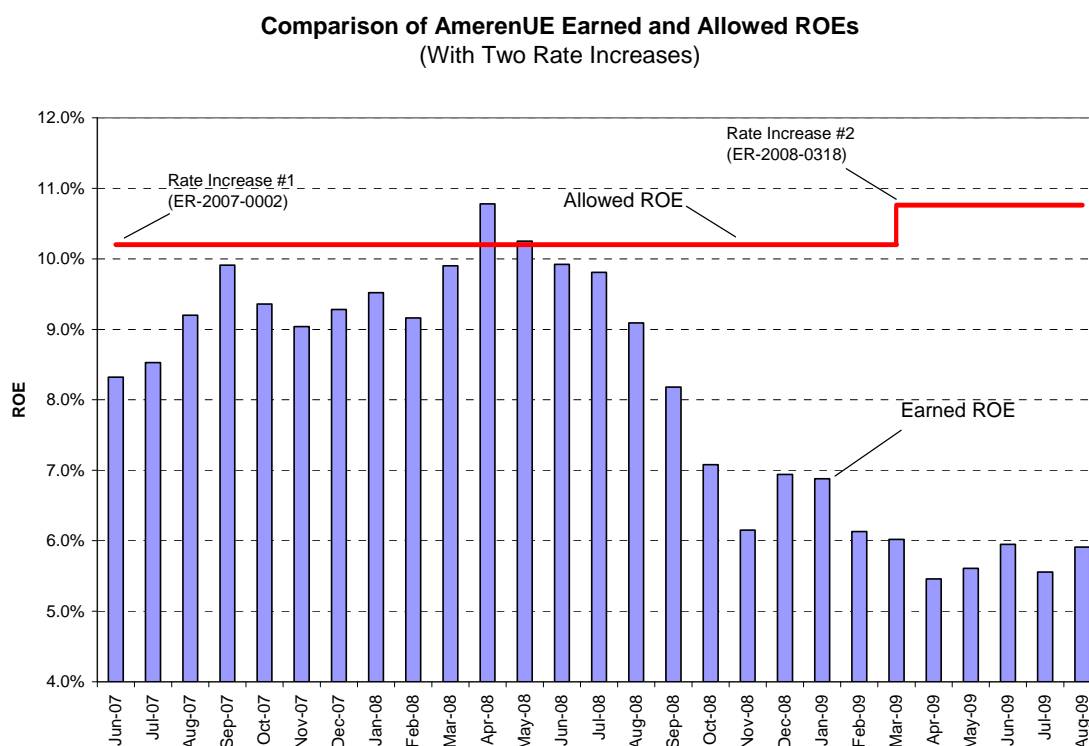
4 A. In general, regulatory lag is the time period between when a utility incurs
5 costs for infrastructure investments¹ or operations and when those costs are reflected in
6 the Company's rates. However, the term "regulatory lag" is really a bit misleading. It
7 suggests that the recovery of costs incurred by the utility to provide service to customers
8 is merely delayed for some period of time and that those costs are then later fully
9 collected. As I will discuss in more detail later in this testimony, certain costs which are
10 incurred before they can be reflected in rates are lost forever to the utility. Consequently,
11 regulatory lag does not simply result in a delay in recovering legitimate costs; it can also
12 prevent the utility from ever recovering them.

13 **Q. Why do you believe that regulatory lag is negatively impacting**
14 **AmerenUE?**

15 A. There are several reasons. First, since June 1, 2007, AmerenUE's earned
16 rate of return has lagged behind its Commission-authorized rate of return in all but a few
17 months. As AmerenUE witness Gary S. Weiss explains in his direct testimony on interim
18 rates, over this period, the difference between the authorized and earned return has been
19 quite significant. Over the past 27 months and despite the implementation of two rate
20 increases that were approved by the Commission, the Company has earned an average
21 return of only 8.06% or an average of 2.26% below the Commission's authorized return
22 on equity. Over the last 12 months, this difference has grown, and the Company's

¹ Including its authorized return on investments.

1 average earned return over this period has been just 6.32%—416 basis points below our
 2 average authorized return on equity.² AmerenUE’s rolling 12-month average earnings
 3 shortfalls over this period are depicted in the following graph, which is an extension of
 4 the graph that was filed with my direct testimony on July 24, 2009:



5
 6 In addition, since January 1, 2007, AmerenUE has experienced negative free cash
 7 flow³ of approximately \$1.6 billion through June 30, 2009. Simply put, AmerenUE’s
 8 cash flows from its operations, which includes the revenues it realizes from the rates it
 9 charges its customers, are significantly less than the monies AmerenUE needs to run its
 10 day-to-day operations and invest in its energy infrastructure in a manner consistent with
 11 regulatory and legislative requirements and its stakeholders’ expectations. As a result,

² Although this difference may not seem significant, each 100 basis point differential between earned and authorized return equals a revenue shortfall of approximately \$50 million per year.

³ “Free cash flow” is defined as cash flow from operations less capital expenditures and dividends.

1 AmerenUE must either borrow against its existing credit facilities or access the
2 debt and equity capital markets to fund its operations. Among other things, this situation
3 drives AmerenUE's financing costs up meaningfully, especially in an environment where
4 the capital markets have been challenging. Both of these factors are indicative that
5 regulatory lag is negatively impacting AmerenUE.

6 **Q. Isn't AmerenUE's failure to earn its authorized rate of return in part**
7 **attributable to the costs associated with the failure of the Taum Sauk reservoir,**
8 **which the Company has agreed to absorb?**

9 A. Yes, but only by approximately 50 basis points. As Mr. Weiss explains in
10 his direct testimony on interim rates, the revenue impact requirement of Taum Sauk not
11 being in operation is approximately \$27 million annually, and the after tax impact on
12 operating income is \$16.5 million. If this were taken into account, AmerenUE's average
13 earned return would be adjusted only about 50 basis points (or .5%). Including the Taum
14 Sauk adjustment over the 27-month period examined by Mr. Weiss only raises the
15 Company's average earned return on equity to 8.52%, which is still an average of 181
16 basis points below the return on equity authorized by the Commission over that period.
17 Over the past 12 months including the Taum Sauk adjustment still leaves AmerenUE's
18 earned return on equity at 6.76%, or 372 basis points below our average authorized return
19 on equity.

20 **Q. Aren't the differences in AmerenUE's authorized and earned return**
21 **explainable by normalization adjustments the Commission makes to the Company's**
22 **cost of service in setting the authorized return on equity?**

1 A. No. Although due to normalization there are almost always some
2 differences between a utility's authorized and earned returns, this does not explain
3 AmerenUE's consistent inability to earn its authorized return. AmerenUE's actual earned
4 returns should be just as likely to be above or below an authorized return based on
5 normalized data. Instead, AmerenUE's earned return since June 2007 has fallen
6 consistently below the authorized return by a significant amount. This consistent and
7 almost entirely one-directional difference between authorized and actual earned returns is
8 attributable to the persistent regulatory lag in Missouri that prevents recovery of
9 increasing levels of cost and investment.

10 **Q. In your view, what are the key drivers of regulatory lag in Missouri?**

11 A. I believe several factors are driving regulatory lag in Missouri. They
12 include the following:

- 13 • The length of the regulatory process in Missouri. Today it takes
14 approximately 11 months from the time a rate case is filed until the time
15 rates are implemented. Of course, this time frame does not reflect the
16 significant amount of time that must be spent well in advance of a rate
17 case in order to prepare the filing.
- 18 • The use of historical costs to set rates.
- 19 • Missouri statutes do not permit utilities to reflect construction work in
20 progress in rate base (and consequently rates).
- 21 • Lack of a mechanism to periodically adjust rates for changes in rate base
22 for plant in service between rate cases to reflect the return, property taxes,
23 and depreciation associated with increases in net plant in service.

1 **Q. Can you quantify to what extent any of these regulatory frameworks**
2 **or policies are negatively impacting AmerenUE's financial results?**

3 A. Yes. In his direct testimony on interim rates, Mr. Weiss has estimated the
4 impact of regulatory lag related to plant placed in service since our last rate case.

5 **Q. How much additional investment in its system has AmerenUE made**
6 **in the period since its most recent rate case?**

7 A. The Company has invested \$346.8 million in net plant additions from
8 October 1, 2008 through September 30, 2009. All of this investment was placed in
9 service after the true-up cut-off date established in the Company's most recent rate case
10 (Case No. ER-2008-0318). As a consequence, none of the costs of the Company's
11 investment in plant made since that date have been recovered. In fact, unless the
12 Commission approves AmerenUE's proposed interim rate increase request, none of the
13 Company's investment in plant will be recovered until rates are ultimately set in this rate
14 case, probably in June, 2010.

15 **Q. What is the dollar amount of the costs that AmerenUE will fail to**
16 **recover over this period?**

17 A. AmerenUE will fail to recover approximately \$75 million over this period
18 associated with these in-service investments. This \$75 million figure, which was
19 calculated by Mr. Weiss, reflects AmerenUE's under-earnings associated with net rate
20 base additions⁴ from October 1, 2008 through September 30, 2009, and is comprised of
21 the return, depreciation, and taxes on net increased investment in plant during that period.
22 Under the current regulatory framework in Missouri, these costs will be permanently lost

⁴ Net plant additions are the increase in plant-in-service less the increase in accumulated depreciation reserve on all of AmerenUE's plant.

1 to the Company in total if no interim rate increase is authorized, and to a significant
2 degree, even if the interim rate increase is authorized. As I mentioned earlier, this is just
3 one example of the impact of regulatory lag in Missouri, and it has a material impact. As
4 I will discuss later in my testimony, losses of this magnitude create a substantial
5 disincentive for AmerenUE to make discretionary investments in energy infrastructure
6 and are not sustainable in the long-term.

7 **Q. Is the plant associated with these costs in service?**

8 A. Yes. All of the plant is already being used to provide service to
9 customers.

10 **Q. How does the \$75 million figure you mention above relate to the**
11 **approximately \$37.3 million interim rate request that the Company has filed in this**
12 **case?**

13 A. The \$37.3 million dollar request reflects the cost of net plant placed in
14 service from October 1, 2008 through May 31, 2009. The \$75 million figure I cite above
15 carries that May 31, 2009 calculation date forward to September 30, 2009, using actual
16 data for plant that is in service. The Company's interim rate filing does not address the
17 difference between the two figures, which will simply be lost even if the interim rates the
18 Company seeks are implemented. The Company will also not recover the full \$37.3
19 million annual increase if interim rates are implemented because the interim rates would
20 only apply for approximately six months, assuming that they took effect on January 1,
21 2010.

22 **Q. So is it correct that the Company's interim rate increase request**
23 **doesn't seek the full \$75 million the Company has lost?**

1 A. That is correct. The increase in net plant using data available at the time
2 this rate case was filed supported an interim rate increase request of approximately \$37.3
3 million on an annual basis. Since that time, substantial additional investment has been
4 made, which means that the corollary figure for plant placed in service through
5 September of this year (i.e., adding additional increases in net plant service in June, July,
6 August, and September) is \$75 million on an annual basis. The interim rate request will
7 not address the difference (\$37.7 million) nor will it even allow recovery of the full \$37.3
8 million, as I noted above, because interim rates will only be in effect for approximately
9 six months.⁵

10 **Q. Isn't regulatory lag a good thing?**

11 A. Yes, it is true that some level of regulatory lag can be a good thing for
12 customers and utilities, but it is also true that excessive regulatory lag creates significant
13 financial challenges for utilities and creates a strong disincentive to make discretionary
14 investments due to the rising cost environment and significant investment cycle in which
15 we are operating.

16 **Q. Doesn't regulatory lag focus the attention of utilities on cost control**
17 **and efficiency measures?**

18 A. Yes, it does focus the attention of utilities on cost control. From my
19 perspective, AmerenUE has done a very good job in cost control, as evidenced by the fact
20 that our electric rates are approximately 40% below the national average and over 20%
21 below the rates of other investor owned utilities in the state. Having said that, regulatory
22 lag of the magnitude we are experiencing in Missouri is excessive and not in the best

⁵ The interim rate request will also not address the substantial net rate base additions that are expected to be placed in service after September 30, 2009, but before the final rates are approved in this case.

1 long-term interest of all of our stakeholders for the reasons I have discussed, including
2 because it consistently and systematically prevents utilities from recovering their
3 legitimate costs and earning their authorized returns, while also creating a disincentive to
4 make discretionary investments.

5 **Q. Isn't regulatory lag a normal feature of utility regulation that occurs**
6 **in every state?**

7 A. Yes, some degree of regulatory lag does occur in many states. However,
8 the degree to which regulatory lag occurs in Missouri is much more significant than other
9 states, as the survey data presented with the direct testimony on interim rates of
10 AmerenUE witness Johannes Pfeifenberger demonstrates. For example, Missouri has a
11 maximum period for rate cases of 11 months, which is among the longest in the country,
12 and materially above the 8.5-month national average. Missouri uses an historical test
13 year to set rates, whereas several states use projected data in an effort to match rates more
14 closely to the costs they are designed to reflect. Missouri statutes do not permit utilities
15 to reflect construction work in progress ("CWIP") in rate base, whereas most other states
16 do not have a similar prohibition. And finally, Missouri has typically not permitted
17 interim rates in the absence of a dire emergency, whereas the Federal Energy Regulatory
18 Commission ("FERC") and several other states do. For these reasons, Missouri's
19 regulatory lag prevents utilities from recovering their costs on a timely basis more than
20 most other states.

21 **Q. Isn't it true that the existing regulatory policies and framework have**
22 **been in place in Missouri for many years? Why is regulatory lag having such a**
23 **negative impact on AmerenUE currently versus what occurred in the past?**

1 A. While it is true that the current framework and policies have been utilized
2 in Missouri for decades, it is also true that much has changed over the last several years.
3 Those changes are highlighting the inadequacy of this framework now and in the future.

4 **Q. Can you discuss what some of these changes are?**

5 A. Certainly. I will highlight a few examples. First, in terms of investment,
6 the level of investment that is necessary and expected to address the ongoing needs of
7 power plants and distribution systems, to meet current environmental and reliability
8 requirements, and meet our customers' and other key stakeholders' expectations is
9 significantly higher than it was in the past. Of course, these categories do not address our
10 investment requirements for renewables, energy efficiency and likely new mandates for
11 expenditures to address carbon emissions. Simply put, we are in the middle of a
12 tremendous investment cycle in our industry that I believe will persist for many years to
13 come. As I discussed earlier in my testimony, as investment requirements rise, so does
14 regulatory lag (and losses) under the regulatory framework in Missouri.

15 Second, we are not in a declining cost environment. Costs to provide service to
16 our customers continue to rise, and rate cases where rates are based on historical costs
17 simply cannot keep pace.

18 Last, but certainly not least, we are operating in one of the worst economic
19 periods our country has ever experienced. The recession has been deep and most experts
20 believe the economic recovery will be slow in this country. While the recession has
21 many consequences, one notable impact is the material increase in financing costs we
22 have seen over the last 12 months.

1 The bottom line is that these new factors are significantly increasing the impact of
2 regulatory lag. When combined with the decades-old regulatory frameworks that we
3 currently use in Missouri for our investments and other costs, regulatory lag becomes a
4 significant and persistent problem.

5 **Q. Hasn't the approval of fuel adjustment clauses in Missouri helped to**
6 **mitigate regulatory lag?**

7 A. Yes, for those costs and revenues addressed by the fuel adjustment clause
8 – essentially fuel to fire our power plants and off-system sales made from those plants –
9 the fuel adjustment clause substantially mitigates regulatory lag. However, the fuel
10 adjustment clause in Missouri allows much slower recovery of fuel costs than similar
11 adjustment clauses in other states. For example, fuel cost increases in Missouri are
12 recovered over a period extending at least 16 months after the costs are incurred, which is
13 a much longer recovery period than fuel adjustment clauses in other states. Also, the
14 Missouri fuel adjustment clause requires the Company to participate in a 5% sharing of
15 fuel cost changes, whereas most fuel adjustment clauses have no sharing at all. Most
16 importantly, however, is the fact that the fuel adjustment clause does nothing to mitigate
17 the impact of increasing levels of other expenses and capital investment AmerenUE
18 incurs between rate cases. As I mentioned earlier, it is the severe regulatory lag
19 associated with these increasing levels of non-fuel expenses and notably the level of
20 capital investment AmerenUE has been making in its system to meet the very high
21 expectations of its customers, and to comply with governmental mandates, that has
22 created the serious policy issue we are endeavoring to address, in part, through our
23 request for interim rates in this case.

1 **Q. Doesn't regulatory lag cut both ways? In other words, don't utilities**
2 **benefit in periods where costs decrease?**

3 A. Yes, it is true that utilities can benefit when there is a declining cost
4 environment and when the level of investment required in their energy infrastructure is
5 declining. Having said that, I do not see a period in the foreseeable future whereby
6 overall costs are falling below levels already established in current rates, and as
7 important, I do not see a period in the foreseeable future wherein investment levels would
8 be such that we experience a decline in net rate base. To the contrary, all signs point to
9 higher levels of costs and investment requirements in the future based on existing and
10 expected federal and state energy policies and economic conditions. The bottom line is
11 that regulatory frameworks should permit the establishment of rates that fairly reflect a
12 utility's prudently incurred costs in a timely fashion, no matter which way changes in
13 those costs cut.

14 **Q. In your opinion, what are the key policy implications of regulatory**
15 **lag?**

16 A. I believe there are several policy implications associated with regulatory
17 lag, including:

- 18 • The Commission's obligation to set just and reasonable rates;
- 19 • The fact that regulatory lag is having a material and detrimental effect on
20 earnings and cash flows at AmerenUE; and
- 21 • The fact that Missouri's existing regulatory framework creates a strong
22 disincentive for any utility to pursue new investments to meet increasing

1 customer expectations or strongly support state and federal policies and
2 initiatives.

3 **Q. Please elaborate on those policy implications.**

4 A. First, while I am not an attorney, I believe it is the Commission's job to set
5 just and reasonable rates that are fair to both customers and the utility. In doing so, it
6 must carefully balance the needs and expectations of all stakeholders, including utility
7 customers and shareholders. The rates the Commission sets should provide the utility
8 with a reasonable opportunity to fully recover its prudently incurred costs of providing
9 service, as well as the opportunity for its shareholders to earn a fair return on their
10 investment. Unfortunately, the current regulatory framework is systematically preventing
11 this from occurring.

12 Second, regulatory lag is materially affecting the cash flows of AmerenUE, and
13 our financing costs (both debt and equity) are negatively impacted by this situation (i.e.,
14 they are higher). As explained by AmerenUE witness Lee R. Nickloy in his direct
15 testimony on interim rates, higher financing costs will ultimately result in higher rates for
16 our customers.

17 Finally, Missouri's existing regulatory framework creates a strong disincentive for
18 any utility to pursue new investments to meet increasing customer expectations or
19 strongly support state and federal policies and initiatives. At a time when infrastructure
20 investment should accelerate to enhance reliability, replace aging equipment, and support
21 evolving state and federal policies, the current regulatory framework in Missouri
22 systematically lowers returns associated with these incremental investments. I strongly
23 believe this Commission should do what it can to mitigate the harmful effects of

1 regulatory lag and encourage such investments. Approval of the Company's interim rate
2 request in this case would be a small but important step in this direction.

3 To be clear, I recognize that it is our obligation to provide safe and adequate
4 service to our customers and we have certain minimum expenditure requirements we
5 must meet for reliability or environmental matters. Those investments have been and will
6 continue to be made. However, should our objective be to meet the bare minimum
7 operational and regulatory requirements for our customers? At this time, when energy
8 policy matters are clearly at the top of federal and state agendas, when the need for
9 investment to improve reliability or generation performance is being sought, and when
10 investment is needed to fuel the state's economy and create jobs, should we have
11 regulatory policies that are inconsistent with these needs and objectives?

12 I think not. As a result, I believe that the regulatory framework employed in
13 Missouri must be enhanced from its current state to address these key policy matters. It
14 will take time, but when progress can be made, I encourage the Commission to exercise
15 its discretion to do so. Our request for interim rates in this proceeding is one step that I
16 believe the Commission can and should take.

17 **Q. What steps has AmerenUE taken to mitigate the impact of regulatory**
18 **lag?**

19 A. From an operations standpoint, we have identified, and in certain
20 instances, implemented meaningful cost reductions. From a regulatory perspective, we
21 are seeking to implement certain mechanisms that will reduce regulatory lag in this rate
22 case, including seeking interim rates. Among the several steps that have been taken to
23 address regulatory lag are the following:

- 1 • Reducing planned expenditures in 2009;
- 2 • Identifying approximately \$1 billion in reductions of certain costs
- 3 originally included in the 5-year plan we developed in 2009;
- 4 • Implementing a voluntary separation program; and
- 5 • Seeking continuation of our existing cost tracking mechanisms, while also
- 6 seeking to establish an environmental cost recovery mechanism and a
- 7 modification to the tariff under which Noranda Aluminum is served.

8 **Q. Please describe these mitigation efforts in more detail.**

9 A. From an operational standpoint, we have made some very tough choices
10 and materially reduced our planned expenditures in 2009. In addition, we have reviewed
11 the original 5-year plan for 2009 – 2013 and have identified approximately \$1 billion in
12 reductions of certain costs. While our plan beyond 2009 has not been approved by our
13 Board of Directors at this time, I expect us to implement many of these cost reduction
14 measures. Consistent with this approach, we recently offered 256 employees of
15 AmerenUE and affiliates that provide service to AmerenUE a voluntary separation
16 package. That offer will expire on October 22, 2009. In addition, I expect that these
17 groups will also face involuntary separations by the end of the year. Not only do these
18 kinds of cost reductions help reduce regulatory lag for the Company, but they will help
19 reduce the impact of expected rate increases in the future.

20 From a regulatory perspective, we have made several requests in this rate case to
21 reduce the impact of regulatory lag. Those requests include continuation of the fuel
22 adjustment clause and the vegetation management/infrastructure inspection and
23 pension/OPEB tracking mechanisms. We have also requested the ability to implement

1 our proposed environmental cost recovery mechanism and storm cost tracking
2 mechanism, as well as requested revisions to the Large Transmission Service (“LTS”)
3 tariff, to mitigate losses associated with changes in volumes delivered to our largest
4 customer, Noranda Aluminum. Furthermore, we have reached agreement with the other
5 parties to this case on (and the Commission has adopted) a true-up of costs and revenues
6 to January 31, 2010. And, of course, we have also requested interim rates to recover in
7 part the cost of plant that is already serving customers.

8 All of these steps are being taken to reduce the significant impact of regulatory
9 lag in Missouri. Unfortunately, all the actions will still not fully eliminate the problem of
10 excessive regulatory lag. Further progress will need to be made in the future. Having
11 said that, it is imperative that this Commission use its authority to implement these key
12 mechanisms today so that progress can continue to be made. Granting our request for
13 interim rates is consistent with this goal.

14 **Q. How would approval of interim rates in this case impact the**
15 **disincentive to invest created by regulatory lag?**

16 A. Approval of interim rates in this case would be a small, but important step
17 in the direction of mitigating regulatory lag and removing the current disincentive for
18 AmerenUE to continue the high level of investments it has been making in its system. It
19 will allow the more timely recovery of the cost of investment in some of the new plant
20 that is already serving customers today. It will reduce, but not eliminate the reduction in
21 earnings that results from new plant investments. However, we also need to continue to
22 explore other options for reducing regulatory lag and eliminating the disincentive to
23 invest.

1 **Q. If interim rates are approved and based on review later in this**
2 **proceeding it is determined that the interim increases were not justified, will**
3 **customers be harmed?**

4 A. No, because the interim rates would be subject to refund with interest.
5 Consequently, in the unlikely event that the Commission found that this relatively modest
6 increase to cover the cost of plant that is already in service was not justified, customers
7 would be made whole. However, if the interim rate increase is not put into effect, it will
8 be impossible for the Commission to make the Company whole for the costs it has
9 incurred during the pendency of this case. Those costs will be forever lost.

10 **Q. Does this conclude your direct testimony on interim rates?**

11 A. Yes, it does.

In the Matter of Union Electric Company d/b/a) Case No. ER-2010-0036
AmerenUE's Tariffs to Increase its Annual) Tracking No. YE-2010-0054
Revenues for Electric Service.) Tracking No. YE-2010-0055

[illegible]

ounded are true and correct.

Warner L. Baxter

Warner L. Baxter

Amanda Tesdall
Notary Public

Amanda Tesdall - Notary Public
Notary Seal, State of
Missouri - St. Louis County
Commission #07158967
My Commission Expires 7/29/2011