Exhibit No.:	135
Issues:	Summary of Company Position and Testimony; Depreciation/Net Salvage Policy Issues; Impact of Staff's Depreciation Proposal on Missouri, Utility Customers, and Missouri Utilities
Witness:	Warner L. Baxter
Sponsoring Party:	Union Electric Co.
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. GR-99-315

SUPPLEMENTAL DIRECT TESTIMONY

OF

WARNER L. BAXTER

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

St. Louis, Missouri
August, 2004

TABLE OF CONTENTS

SUPPLEMENTAL DIRECT TESTIMONY

OF

WARNER L. BAXTER

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I. INTRODUCTION

Q. Please state your name and business address.

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

Q. By whom are you employed?

A. I am employed as Executive Vice President and Chief Financial Officer ("CFO") for Ameren Corporation ("Ameren"). I also serve in that capacity for a number of Ameren subsidiary companies including: Union Electric Company, doing business as AmerenUE; Central Illinois Public Service Company, doing business as AmerenCIPS; and Central Illinois Light Company, doing business as AmerenCILCO.

Q. What are your responsibilities in your position with Ameren and AmerenUE?

A. My responsibilities include the oversight of the financial and accounting functions, as well as the treasury, tax, risk management, internal audit and budget and corporate modeling functions. I am also the primary company spokesperson in communications with the financial community, including financial analysts, institutional shareholders, and credit ratings agency analysts.

Q. What is your educational and employment background?

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

In October of 2003, I was elected to my current position and named Executive Vice President and Chief Financial Officer of Ameren Corporation, Union Electric Company, and various other Ameren Corporation subsidiaries. I joined Union Electric Company in 1995, first as the Assistant Controller. I have received several promotions since that time. In 1996, I became the Controller of Union Electric Company, and was then promoted to Vice President and Controller of Ameren and Union Electric Company in May 1998. I was elected Senior Vice President - Finance of Ameren in 2001. In January 2003, I was also elected Senior Vice President of CILCORP Inc. and Central Illinois Light Company upon Ameren's acquisition of those companies.

Prior to my employment at Ameren, I was a Senior Manager for Price Waterhouse LLP (now PricewaterhouseCoopers LLP) in Price Waterhouse's St. Louis and New York City offices. My principal responsibilities at Price Waterhouse included supervising audit and consulting services provided to clients in the public utility industry (including Union Electric Company) and manufacturing industries, among others. I also developed Price Waterhouse's financial statement disclosure and content guide for public utilities. In addition, I authored various sections of Price Waterhouse's annual Survey of Financial Reporting and Industry Developments for the public utility industry. I was a

member of Price Waterhouse's National Public Utilities Industry Services Group and their Accounting and SEC Services Department.

I formerly served as Chairman of the executive committee of the chief accounting officers of Edison Electric Institute member companies. I currently serve as President of the Chancellor's Council and a member of the Dean's Advisory Board of the University of Missouri-St. Louis, as a member of the Board of Directors of UMB Bank, and as a member of the Board of Trustees of the Wyman Center.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your supplemental direct testimony?

A. The purpose of my testimony is twofold. First, I will provide a summary of the supplemental direct testimony presented on behalf of AmerenUE. Second, I will provide the Commission with my perspective as AmerenUE's Chief Financial Officer on the fundamental ratemaking and policy implications for the State of Missouri, for its utilities, and for the rate paying public, of the important depreciation and net salvage issues which are before the Commission in this case.

Q. Please briefly describe the supplemental direct testimony sponsored by AmerenUE in this case.

A. In addition to my supplemental direct testimony, we present several experts to assist the Commission in addressing the broad policy issues raised by Staff's proposed shift away from the well-accepted and time-tested ratemaking treatment for depreciation and net salvage, toward a depreciation and net salvage approach that we believe undermines sound ratemaking policies and poses undue and unnecessary risks for

utilities, the state's economy, and customers. These experts are Steven M. Fetter, William M. Stout, and Martin J. Lyons.

Mr. Fetter is a former Chair of the Michigan Public Service Commission, a former Managing Director of the utility group at Fitch, Inc., a leading credit rating agency, and is currently the President of his own energy advisory firm. Mr. Fetter's supplemental direct testimony addresses the regulatory policy problems, inter-generational equity problems, and adverse financial consequences which would flow from a broad-based implementation of Staff's proposal, based on his perspective as a former commission chair and rating agency director.

Mr. Stout, who testifies on these depreciation and net salvage issues on behalf of both Laclede Gas Company ("Laclede") and AmerenUE, is President of the Valuation and Rate Division of Gannett Fleming, Inc.,[1] and one of the leading authorities on depreciation accounting and policy in the country. Mr. Stout has conducted depreciation studies for almost thirty years and has served as an instructor at courses offered by Depreciation Programs, Inc., the Society of Depreciation Professionals, the American Gas Association and Edison Electric Institute. Numerous members of the Commission's Staff have attended courses on depreciation practice and theory taught by Mr. Stout and his colleagues. Mr. Stout addresses broadly the many technical, ratemaking, and regulatory policy problems raised by Staff's proposal, including the inconsistency of Staff's approach with the basic goals of depreciation theory.

Finally, Mr. Lyons, who is the Vice President and Controller of Ameren and AmerenUE, addresses the inconsistency of the Staff's proposal with regulatory

[1] Gannett Fleming, Inc. provides the software used by Staff and AmerenUE, in calculating appropriate depreciation rates.

accounting requirements, including this Commission's accounting rules, and with sound ratemaking treatment and policy. Mr. Lyons also explains how the safeguards inherent in the standard regulatory treatment and regulatory accounting rules that have governed these depreciation and net salvage issues for decades fully protect customers from any adverse effects associated with uncertainties and changes in estimated depreciation parameters used in calculating depreciation expense, including net salvage.

Q. Before you get into any of the more technical aspects of the treatment of net salvage, would you please state in simple terms the role and function of depreciation.

A. Depreciation is used to allocate the cost (i.e., "service value") of a utility's long-lived assets over the estimated "service lives" of these assets. Under standard ratemaking principles, the service value of an asset includes its original costs minus its net salvage. Net salvage is equal to any salvage that may be realized from those retired facilities at the end of their useful lives less the cost incurred in removing the asset from service. Net salvage may be positive or negative. It is positive if the utility is able to sell the asset that is removed from service for a sum greater than the costs incurred in removing the asset from service, and it is negative if the costs of removal exceed any sums the utility is able to realize from its sale or other disposition. For utility property, net salvage is typically negative (i.e., a cost).

By allocating the service values of the assets over their estimated service lives, customers will pay in each year a fair, pro-rata share of the assets' full costs throughout the period during which the assets are used to provide service. For example, for a single asset with $1 million in initial investment costs, a service life of 20 years, and

an additional $200,000 in removal costs, net of salvage value (i.e., $200,000 in "net salvage costs"), the standard regulatory approach to depreciation calculates annual depreciation expenses of $60,000 per year, which is calculated by dividing the asset's $1.2 million service value by its 20 year service life.

Q. Please summarize the issues in this case.

A. In recent years, and particularly since this case began in 1999, Staff has advocated a stark departure from the standard ratemaking approach to the treatment of net salvage that has, for decades, been followed by virtually every regulatory jurisdiction in the country, and for good reasons, as discussed in the Company's testimony.[2] It is Staff's approach that is at issue in this case. Staff's proposal amounts to abandoning sound and time-tested ratemaking principles for net salvage. This issue is once again before the Commission in this case because of a remand of this case from the Missouri Court of Appeals.

Broadly speaking, the Staff's approach, which Staff has advocated in more than 20 cases since 1999,[3] calls for the complete removal of net salvage from the calculation of depreciation. Instead, Staff's approach recognizes in current rates net salvage costs which are based upon the average level of net salvage costs utilities have incurred for retired plant in the past. Put another way, and referring back to the depreciation example I cited earlier, Staff's approach would exclude from the calculation

[2] The specific facts of this case involve the gas distribution plant accounts of Laclede, which are mass property accounts that AmerenUE also has in both its gas and electric utility businesses. AmerenUE believes the ratemaking principles and policies that support the standard approach also apply to electric generation plant, but AmerenUE's testimony in this case (my testimony and the testimony of Messrs. Stout, Fetter, and Lyons) focuses on mass property accounts and is not directed toward depreciation and net salvage as it would apply to generation plant.

[3] All but two of these cases were resolved by stipulation rather than as a result of an evidentiary hearing in which the net salvage issue could have been fully explored by the Commission.

of depreciation the $200,000 of net salvage costs, but instead add back only the average net salvage cost incurred for previously retired plant. In contrast, the standard approach calls for fairly allocating the costs of assets, including net salvage costs (i.e., including the $200,000 from the earlier example), over the life of the assets, so that those customers who are served by the assets pay their fair and proportionate share of the costs.

With respect to Staff's approach to depreciation and net salvage, I believe there are five major issues which need to be considered carefully by the Commission in determining the appropriate ratemaking policy in this area. They are as follows:

(1) Consistency of Staff's approach with standard regulatory treatment and policy, as well as regulatory accounting standards;

(2) Customer inter-generational equity and long-term rate impacts on customers;

(3) Customer (and utility) safeguards embedded in standard depreciation and net salvage policy;

(4) Financial impacts of Staff's approach on utilities and the associated rate impacts those financial impacts will create; and

(5) Long-term energy and public policy implications raised by Staff's approach.

Q. Please summarize AmerenUE's views and conclusions on Staff's proposed approach based on the five issues you identified above.

A. (1) Staff's proposed approach is inconsistent with standard regulatory treatment and policy, regulatory accounting standards, and the treatment of net salvage afforded by virtually every other regulatory commission in the country;

(2) Staff's proposal creates inter-generational equity problems. Staff's approach collects in current rates the net salvage costs incurred for retired plant used only by past customers, but will require future generations of customers to bear net salvage costs that should be paid by today's customers for plant that currently serves them. Furthermore, Staff's approach creates long-term adverse rate impacts such as unnecessary rate volatility, the risk of future rate shock, and unavoidably higher long-term

rates. The effect of asset growth and inflation ensures that Staff's approach will systematically and significantly understate the net salvage costs that will have to be collected from future customers;

(3) Staff's proposed approach, and the problems it creates, are unnecessary because continuation of the standard approach supported by AmerenUE and Laclede includes deliberate safeguards that fairly compensate customers for "over-accruals" of net salvage prior to plant retirements and that protect customers from any adverse effects associated with changes in the estimated depreciation parameters used in calculating depreciation rates, including net salvage;

(4) Staff's proposed approach creates significant, adverse financial impacts on AmerenUE and other Missouri utilities. These adverse impacts will reduce the overall financial stability of Missouri utilities, weaken their credit quality, raise borrowing costs, and ultimately result in higher costs to serve customers; and

(5) Staff's proposed approach will have negative, long-term energy and public policy implications in the state of Missouri. The significant reduction in cash flows under the Staff's proposed approach will place Missouri utilities in a weakened financial condition. These reductions in cash flows could significantly impact AmerenUE's and other Missouri utilities' ability to make critical energy infrastructure investments on a timely basis, could cause adverse impacts on a variety of labor-related matters, and could undermine utilities' ability to contribute to their communities by sponsoring low income programs, economic development programs, and other programs.

I discuss AmerenUE's conclusions on each of these five issues in the remainder of my testimony. Additionally, for the Commission's convenience, I have included as **Appendix A** to my testimony a condensed **Summary of AmerenUE's Position** on the depreciation and net salvage issues presented by this case.

III. AMERENUE'S CONCLUSIONS ON THE MAJOR ISSUES RAISED BY STAFF'S APPROACH

A. CONSISTENCY WITH STANDARD REGULATORY TREATMENT AND POLICY, AS WELL AS REGULATORY ACCOUNTING STANDARDS.

Q. What are AmerenUE's conclusions regarding the first identified issue, consistency with standard regulatory treatment and policy?

A. As Messrs. Fetter, Stout and Lyons explain in more detail, standard ratemaking treatment of depreciation appropriately allocates the service value of assets, which is defined as the difference between the original cost and net salvage value of utility plant, over the plant's estimated service life to the customers who use the plant during that service life. This treatment of depreciation is consistent with regulatory accounting requirements under the Uniform System of Accounts ("USoA")[4], authoritative texts and expert recommendations, and is the standard ratemaking practice used by virtually every other regulatory agency in the country. In contrast, Staff's approach is inconsistent with these regulatory standards and principles, and standard regulatory practice. As shown in Mr. Stout's Schedules WMS-6-1 and WMS-6-2, Staff's approach also leads to depreciation rates that are *significantly* outside the mainstream of the reasonable range allowed by other state regulators. No rational or competent evidence of any kind has been offered by Staff to support such a result.

As Mr. Lyons also shows, Staff's proposed treatment completely removes net salvage from the calculation of depreciation rates. Staff points out that net salvage values of current assets need to be estimated and that these estimates are uncertain, and then attempts to use that fact to argue that the

[4] Adopted in Missouri pursuant to 4 CSR 240-20.030 (electric) and 4 CSR 240-20.040 (gas).

standard approach simply cannot be used or that "actual" costs are better than estimates.[5] But in a logically inconsistent fashion, Staff has no difficulty relying upon similar estimates of service lives for depreciating the original cost of assets. If the Commission were to reject decades of informed opinion and practice by finding that the safeguards inherent in standard depreciation accounting and regulatory treatment are insufficient in light of any uncertainty the Commission might have about the depreciation parameters, the Commission would need to abandon the entire principle of accrual accounting for depreciation in ratemaking. Just as net salvage costs would be expensed and reflected in current rates under Staff's proposal, initial investment costs of assets would also need to be expensed and reflected in current rates as opposed to being capitalized and depreciated over the assets' estimated service lives. This treatment, of course, would constitute a sharp break with well-established and time-tested ratemaking principles and regulatory accounting requirements, but that is essentially what Staff has proposed with respect to the treatment of net salvage.

B. Inter-generational Equity and Long-Term Rate Impacts.

Q. You indicated earlier in your testimony that the second major issue the Commission should consider carefully with respect to Staff's proposed approach deals with inter-generational equity and long-term rate impacts. What points will you be addressing in this section of your testimony?

[5] Staff's "actual costs" are not "actual" at all, but rather, are averages of past years' costs which bear no relationship to the actual costs that will be incurred years into the future when the plant serving current customers is ultimately retired.

A. I will summarize how:

(i) Staff's treatment of net salvage costs creates significant inequities in the costs paid by different generations of utility customers, and specifically how it results in unfair subsidization of current customers' rates by both past and future customers, compared to the standard treatment of net salvage;

(ii) Due to asset growth and inflation, Staff's approach systematically and significantly understates net salvage costs recovered in rates associated with plant currently used to serve customers;

(iii) Staff's approach unnecessarily increases rate volatility by exposing future customers to the spikes and valleys of plant retirement and replacement cycles, volatility that is removed from rates under the standard treatment of net salvage costs; and

(iv) In the long run, Staff's approach inevitably leads to higher costs for all customers, even if accruals for net salvage were to continue to exceed net salvage costs for the foreseeable future.

(i) The Staff's Net Salvage Approach Creates Significant Inter-generational Subsidies of Current Rates

Q. Please summarize AmerenUE's conclusions regarding the impact of Staff's approach on customer inter-generational equity.

A. Broadly speaking, inter-generational equity is a fundamental ratemaking concept that calls for current customers of a utility to be charged in rates for their fair share of costs of assets currently used to supply them service. The standard approach to depreciation and net salvage is a classic example of a ratemaking policy adopted to foster inter-generational equity. Under the standard depreciation and net salvage approach, current customers are charged a pro-rata share of the net salvage costs expected to be incurred for currently used assets. In contrast, Staff's approach departs from this fundamental ratemaking concept. Staff's approach results in current and future

customers paying net salvage costs for assets that are no longer providing any benefit (and in some cases never provided any benefit) to those customers.

Q. Why is this a problem?

A. Staff's approach defers significant net salvage costs associated with current assets to future customers. In so doing, Staff's approach recovers net salvage expenses from future customers for assets that will no longer be used and useful at that point in time. As Mr. Stout explains, while the standard approach charges current customers the net salvage cost associated with currently-used plant, the Staff's approach collects in current rates the net salvage costs incurred on retired plant used only by past customers. In other words, Staff's approach leaves the net salvage costs associated with currently-used plant to be recovered only from future customers after that plant has been retired from service. These future customers in effect are forced to subsidize current customers who are benefiting from those assets.

Q. Is that the only subsidy created by Staff's approach?

A. No. Staff's approach also subsidizes rates charged to current customers with monies accrued from past customers. As part of its normal depreciation analysis, the Staff examines utilities' depreciation reserve, which represents the cumulative amount of depreciation expense (including net salvage) that has already been collected by the utility for plant that has not yet been retired.

The problem is that past depreciation rates, which were approved by this Commission and used by Missouri utilities to accumulate the depreciation reserve, were based on the standard treatment of net salvage that the Commission has used for decades. Because Staff calculates the target depreciation reserve as if Staff's approach had been

used all along (i.e., no net salvage would have been accrued from past customers), it appears (falsely) that too much depreciation was collected in the past. When Staff amortizes these "over-accruals" in current rates, Staff essentially takes money properly paid by past generations of customers to fund net salvage associated with plant used to serve them, and refunds that money to the current generation of customers.

In AmerenUE's last electric rate case (Case No. EC-2002-1), Staff recommended in its pre-filed testimony that an "over-accrual" of several hundred million dollars in depreciation reserve be amortized starting immediately. This would have amounted to a substantial subsidy of current rates through the refund of net salvage that was collected from past generations of customers but would have further increased rates for future customers because the proposed amortization would have increased rate base over time. In other rate cases, Staff proposed to postpone any amortization until another depreciation study was conducted,[6] but left no doubt that the apparent "over-accruals" would eventually be addressed. This would be achieved through means such as negative amortizations or reduced depreciation rates so that the "over-accrued" amount would be "paid back" to customers in the form of lower rates.[7]

In summary, Staff's approach of removing net salvage from depreciation constitutes poor ratemaking policy because it improperly defers net salvage costs to future customers, forcing them to subsidize current customers, but then Staff makes that already poor policy even worse with its amortization of net salvage accruals collected from past customers to further subsidize current customers.

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[6] *See, e.g.,* Direct Testimony of Rosella L Schad in Case Nos. ER-2004-0034 and HR-2004-0024 (Aquila), December 2003, p. 16.

[7] *See, e.g.,* Direct Testimony of Paul W. Adam, Case No. ER-2002-424 (Empire), August 16, 2002, p. 10.

Q. Have these inter-generational equity concerns been addressed in other jurisdictions?

A. Yes. For example, the Indiana Utility Regulatory Commission ("Indiana Commission"), in a Public Service Company of Indiana ("PSI") rate case,[8] recently examined extensive evidence, both for and against Staff's approach as contrasted with the standard approach, and endorsed the standard, time-tested approach (referred to in the PSI case as the "traditional" approach). As Mr. Fetter discusses in more detail, with regard to inter-generational equity issues, the Indiana Commission rejected the use of historical averages for net salvage because it "means that the next generation of customers will be paying for salvage costs related to facilities from which they may never have received service."[9]

In discussing generating stations, the Indiana Commission also found that passing these costs on to future customers does not constitute "sound regulatory policy" and is not "based on sound ratemaking principles," stressing that "we do not believe it would be appropriate for the Company to backload the dismantlement costs for future ratepayers to pay when the facilities associated with these costs are providing service to current customers. Rather, we find it is appropriate that these costs be shared by all customers that received service from PSI's [the utility's] generation facilities".[10] If applied to Missouri utilities, these findings would clearly be applicable to the depreciation treatment of distribution assets that are involved in the present Laclede case.

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[8] PSI Energy, Inc., 2004 Ind PUC LEXIS 150 (May 18, 2004).
[9] PSI Energy, Inc. 2004 Ind PUC LEXIS 150, p. 200 (May 18, 2004). The Indiana Commission's entire analysis of depreciation and net salvage issues starts at page 158 and ends at page 203 (all page references are to pagination provided by LEXIS of the Indiana Commission's opinion). In addressing these issues, the Indiana Commission uses the term "dismantlement cost" in place of the more commonly used "removal costs."
[10] PSI Energy, Inc., 2004 Ind PUC LEXIS 150, pp. 196-97 (May 18, 2004).

(ii) Due to Asset Growth and Inflation, Staff's Approach Systematically and Significantly Understates Net Salvage Costs Associated with Plant Currently Used to Serve Customers

Q. You noted that Staff's approach collects in current rates only the net salvage costs incurred on retired plant used by past customers. Why does this result in substantial deferrals of net salvage obligations to future customers?

A. This occurs because, as Mr. Stout explains, Staff's use of net salvage costs incurred in the past, even the recent past, systematically and significantly understates the net salvage costs that will have to be incurred in order to retire the plant that is currently in service for at least two reasons: (1) asset growth; and (2) inflation.

Q. Why does utilities' asset growth lead to a systematic understatement of net salvage costs associated with plant currently used to serve customers?

A. The sheer magnitude of the universe of plant that is used to provide service to the current generation of customers is far greater than the universe of plant from which recent retirements come. For example, electric poles being retired by AmerenUE today on average were placed in service decades ago, when the Company had far fewer customers, the system was several orders of magnitude smaller, and there were consequently far fewer poles in service. Obviously the cost incurred in the recent past to retire that small universe of electric poles is a poor proxy for the cost that will be incurred to retire the much larger universe of electric poles that is currently being used to provide service to today's customers.

Q. Why does inflation lead to a systematic understatement of net salvage costs?

A. By using historical net salvage costs, the Staff's approach also ignores the impact of future inflation, which will make the costs to retire today's electric poles even

higher. This is important because, for example, three percent annual inflation will more than triple costs over the course of only 40 years. By ignoring both asset growth and inflation, the Staff's approach grossly understates the net salvage costs associated with the utilities' current plant, and leaves it to future generations of customers to make up for current customers' failure to pay their fair share of these costs.

Q. Have other utility commissions agreed that the problems you cite above exist if Staff's approach is followed?

A. Yes. The Indiana Commission, in its recent analysis of this issue, found asset growth and inflation to be critical factors that required the retention of the standard approach. With regard to the use of historical averages as a means to set net salvage allowances in current rates, the Indiana Commission stated:

> use of historical averages...does not take into account the current configuration of PSI's [the utility's] system with regard to its production, transmission, distribution and general facilities. Facilities in service 40-50 years ago did not take into account the significantly enhanced customer base that PSI now serves, nor the current configuration of PSI's facilities that serve these customers. It seems appropriate to utilize best cost estimates for net salvage values taking into account the specific facilities now serving PSI's customers in developing depreciation rates that today's customers should pay.[11]

With regard to the impact of future inflation, the Indiana Commission had this to say:

> Inflation has been a fact of life in the American economy for many years. Not factoring inflation into dismantlement costs to be incurred in the future would understate those costs, with the result being that future customers would have to pay costs arising from facilities that are not serving them. This result flies in the face of matching rates with costs incurred for service, a sound ratemaking principle followed by this Commission. Moreover, current customers receive a benefit by factoring

[11] PSI Energy, Inc., 2004 Ind PUC LEXIS 150, pp. 200-01 (May 18, 2004).

in inflation, as it may appropriately allow for a reduction in rate base because of the increased accumulated reserve for depreciation.[12]

Q. Has AmerenUE's universe of plant grown significantly over the past decades?

A. Absolutely. For example, as depicted in Schedule WMS-3-2 to Mr. Stout's testimony, in 1960, AmerenUE's total distribution plant in service was only 8% of what it was in 2003. Even in 1980, AmerenUE's distribution plant in service was only 24% of the level in 2003. Based on historic data, Staff estimated in AmerenUE's last rate case that the average service life of distribution plant is over 46 years. Given that even in 1980 the installed asset base was only about a quarter of its 2003 value, it should not be surprising that net salvage value of recent retirements (which, on average were installed decades ago) is significantly below appropriate accruals for net salvage costs of assets used to serve customers today.

(iii) *Staff's Depreciation Approach Increases Rate Volatility*

Q. Why do you believe that Staff's approach increases rate volatility?

A. The level of incurred net salvage expenses associated with plant retirements can fluctuate widely over time. This can lead to material rate increases whenever a significant amount of plant needs to be retired at once. Under Staff's proposal, the customers who are being served at that time would face both the net salvage costs associated with the "spike" in retirements as well as the costs of the corresponding "spike" in more expensive new plant needed to replace the retired plant.

[12] PSI Energy, Inc., 2004 Ind PUC LEXIS 150, p. 198 (May 18, 2004).

Spikes in the overall level of plant retirements can result from accelerated growth in customers during periods in the past. Decades later, a spike in retirements of plant installed during those periods can be expected. Spikes in the retirement of specific categories of plant can also occur due to economic or technological obsolescence, environmental regulations, or other reasons. For example, gas utilities throughout the country, including AmerenUE, have been replacing cast iron mains and steel service lines at a rapid pace due to safety concerns.

The standard depreciation approach to net salvage obligations removes from revenue requirements such fluctuations in net salvage costs by accruing net salvage costs over the entire service lives of the assets. In contrast, under the Staff's approach, if a spike (or a trough) of retirement activity occurred in the recent past, this higher (or lower) level of costs would be reflected in rates, leading to unnecessary rate volatility. This is yet another reason that the Commission should reject the Staff's approach.

(iv) Staff's Depreciation Approach will Lead to Higher Cost of Service Even in a Steady State in Which Appropriate Current Accruals for Net Salvage Continue to Exceed Recent Net Salvage Expenses

Q. If current accruals for net salvage under the standard approach continue to exceed the net salvage expenses recently incurred on plant retirements year after year, doesn't the Staff's approach consistently result in lower rates in spite of the deficiencies you have identified?

A. No. Staff's approach results in lower rates only in the short run. Even under the best case scenario for Staff, where proper accruals for net salvage would always exceed recently incurred net salvage expenses, Staff's approach will accumulate less depreciation reserve and thus lead to a higher rate base. As Mr. Stout explains, in

less than ten years the reduction in current rates due to net salvage under Staff's approach will be more than offset by the increased revenue requirements associated with the higher rate base created by Staff's approach.

C. Safeguards Inherent in the Standard Approach

Q. Please summarize AmerenUE's conclusions regarding the third major issue you noted above, the safeguards built into the regulatory process that protect customers from changes of estimated depreciation parameters.

A. Standard depreciation accounting and ratemaking has been broadly implemented with the knowledge that depreciation is a cost that cannot be measured with absolute precision in any period since both the service lives of assets and their net salvage values must be estimated. As Mr. Lyons explains in his testimony, time-tested analytic approaches have been employed to ensure reasonable accuracy of the estimated service lives and net salvage values used in the depreciation accounting and ratemaking processes.

Moreover, the accounting and regulatory treatment of depreciation assures that customers are fully protected against inaccuracies or changes in estimated service lives and net salvage values. As Mr. Lyons explains in more detail, these safeguards are as follows:

(1) The accounting for accrued and actually spent net salvage amounts in the depreciation reserve provides a monitoring and "true-up" mechanism (e.g., amortization of over- or under-accruals) that ensures recovery from customers does not exceed (or fall short of) actual expenditures.

(2) The rate base treatment of the depreciation reserve fully compensates customers for "accrued but not yet spent" net salvage amounts and offers customers and utilities full protection against over- or under-estimated depreciation parameters. This rate base treatment does this by effectively

providing customers a return on the accrued net salvage costs equal to the utility's authorized return on rate base.

(3) The requirement in the Commission's rules that utilities must undertake periodic depreciation studies to update estimated depreciation parameters ensures that these parameters remain consistent with actual operations and costs of the currently-used assets.

As both Mr. Lyons and Mr. Stout explain, the use of unbiased, best estimates for service lives and net salvage of the current assets ensures that there is no material cross-subsidy to or from past or future generations of customers and neither customers nor utilities will be harmed or be able to enjoy any windfall gains. The standard approach does not create winners and losers, but rather, fairly allocates the full cost of an asset to those who use it, and provides protections when the estimates diverge from actual experience over time. In contrast, Staff's approach discards these safeguards thereby creating a virtual certainty of net salvage-related winners and losers.

D. FINANCIAL IMPACTS OF STAFF'S PROPOSAL.

Q. What are your conclusions regarding the fourth major issue you identified above, the financial impacts that would be imposed on AmerenUE and other Missouri utilities by Staff's approach to depreciation and net salvage?

A. Staff's approach imposes significant financial risks on AmerenUE and other Missouri utilities that would also negatively impact customers in the long run. As Mr. Stout shows in his Schedules WMS-6-1 and WMS-6-2, Staff's approach leads to sharply reduced depreciation expenses that are substantially below the levels that regulators have allowed for utilities in other parts of the country. While these reduced depreciation allowances do not directly affect utilities' earnings (because depreciation expenses are reduced by the same amount as allowed revenues), Staff's treatment of

depreciation and net salvage significantly reduces utilities' internally generated cash flows. As Mr. Fetter also explains, this decreases utilities' financial flexibility and puts significant downward pressure on their credit ratings ? facts that are clearly recognized by rating agencies and that have already contributed to the significant downgrade of two Missouri utilities, including Laclede. Intuitively, the impact of this reduction in cash flow is clear. If the utility has less internally generated cash, it will need to borrow more money to finance its infrastructure requirements. This ultimately increases costs to consumers because (1) raising funds in capital markets is more expensive than using internally generated cash flow due to, among other things, transaction costs; and (2) the costs of borrowing will be higher due to utilities' reduced financial health and lower credit ratings.

Staff's approach reduces utilities' near-term rates and overall cash flows by deferring the net salvage obligation associated with currently-used assets to future customers who will no longer have use of these assets. This also adversely affects utilities' financial strength by creating the risk of future rate shock as the deferred net salvage costs are recovered while, at the same time, the retired assets need to be replaced with new, more expensive plant. As Mr. Fetter explains, the deferral of net salvage costs also increases the risk that utilities will not fully recover them due to regulatory lag or regulatory actions. The combination of such under-recovery risk and substantially reduced cash flow under Staff's approach will undermine utilities' financial health and make the financing of necessary infrastructure investments significantly more risky, more costly, and potentially less timely. This would inevitably lead to higher longer-term costs to Missouri utility customers, in addition to the future rate increases that would already

be necessitated by the Staff's deferral of current assets' net salvage costs to future customers.

AmerenUE's circumstances bear out the existence of these impacts. As shown in Schedule WMS-5-2 to Mr. Stout's testimony as proposed in AmerenUE's last electric rate case, Staff's approach would have drastically reduced AmerenUE's depreciation-related cash flow at exactly a time when these cash flows were needed more than ever to provide part of the capital necessary to finance new infrastructure. Mr. Stout's Schedule WMS-5-2 shows that Staff's depreciation proposal in the AmerenUE rate case would have reduced the depreciation expenses for distribution plant from approximately $100 million per year to only approximately $55 million per year at a time when AmerenUE's investment requirements for distribution infrastructure exceeded $120 million per year.

In the settlement of AmerenUE's last electric rate case, AmerenUE reduced depreciation rates slightly (due to changes in estimated service lives for distribution assets), but was able to maintain the Commission's standard approach to depreciation and net salvage (Staff's approach, though advocated by Staff, was not adopted). This result has permitted AmerenUE to maintain adequate cash flow and financial strength despite committing to a four year rate plan that offered over $2 billion in infrastructure improvements as well as significant rate reductions. Without the cash flows afforded by the standard depreciation approach, the Company's ability to commit to and finance over $2 billion in infrastructure over the period agreed upon in the settlement would have been more difficult, if not impossible. At a minimum, these investments would have been more expensive, and potentially less timely.

Q. Are there other significant financial impacts arising from Staff's approach in addition to those you have previously addressed?

A. Yes. There are several, but a particularly notable one that is discussed in detail in Mr. Stout's testimony deals with what AmerenUE believes would be a systematic under-recovery of net salvage costs under Staff's approach due to the use of out-dated historical averages. As Mr. Stout's Schedule WMS-1 shows, the 10-year historical average of net salvage expenses (as proposed by Staff in AmerenUE's last electric rate case, Case No. EC-2002-1) is consistently and significantly below the actual net salvage expenses of almost every current year (the chart also shows that AmerenUE's total net salvage expenses were quite volatile, sharply increasing over several years only to fall off significantly in the next few years). Importantly, this under-recovery would occur even if AmerenUE were to file a rate case every single year and historical averages included even the most recent year.

E. Long-Term Energy and Public Policy Implications of Staff's Approach

Q. What are your conclusions regarding the fifth major issue you identified above, which relates to the long-term energy and public policy implications of Staff's approach?

A. My conclusion is that all of the impacts I discuss above have important long-term energy and public policy implications for the State of Missouri that can adversely affect the economic vitality and development of the state.

Lessons from the not-too-distant past point out how inextricably linked energy policy is to such public policy matters as economic development. The August

2003 blackout clearly demonstrated how critical a reliable energy infrastructure is to the functioning of businesses and communities. Ratemaking policies which undermine utilities' ability to maintain and invest in that energy infrastructure on a timely basis have the clear potential to foster costly disruptions for customers and the economy of a state.

Moreover, a robust utility infrastructure is obviously an important consideration when existing businesses consider whether to expand their operations in Missouri, or whether to locate here at all. Regulatory policy that tends to undermine timely and cost-effective investments in infrastructure tends to impede the economic development and growth that is important to every state, including Missouri. States with a regulatory environment that encourages timely and cost-effective infrastructure investments will have an advantage over those states that do not. Given that adoption of Staff's approach would take Missouri far out of the mainstream, it is reasonable to be concerned about how that step will affect Missouri's relative competitive position vis-à-vis the overwhelming majority of states that continue to use the standard approach.

I also mentioned the risk of rate shock and increased rate volatility inherent in Staff's approach. Rate shock clearly dampens economic activity and diminishes the viability of economic development in the utilities' service territory. In addition, all utility customers, from residential customers to commercial customers to industrial customers, make plans to varying degrees based upon the level of utility costs they can reasonably expect. Policies that tend to cause rates to fluctuate more widely make planning more difficult. If the utility costs actually incurred by customers fail to reflect their expectations, they may suffer negative economic consequences. Customers also dislike surprises, particularly those that cost them money unexpectedly or drastically

increase their costs in a short time frame. This leads to lower customer satisfaction, a result that neither the Commission nor utilities should view as favorable.

And finally, financially weaker Missouri utilities could suffer adverse impacts on a host of labor-related issues. In addition, this type of policy could compromise utilities' ability to contribute to their communities through energy assistance programs, economic development programs, and other programs, all to the ultimate detriment of Missouri communities.

In short, if the utilities of this state are viewed as having difficulties meeting infrastructure needs in a cost-effective and timely manner, experience rate volatility that upsets customers' expectations, and are financially weaker, the business climate and economic development of this state will most certainly suffer.

IV. CONCLUDING REMARKS

Q. Do you have any other observations that you believe the Commission should consider in addressing these important policy issues?

A. Yes. In this case AmerenUE again is asking the Commission to reject Staff's approach to net salvage. In doing so, we are not asking for anything more than the retention of the standard treatment of net salvage that has reflected, and that continues to reflect, a sensible ratemaking policy that has served the state well for decades, and that has resulted in low utility rates and sound utility infrastructure. Those low rates and that sound infrastructure give Missouri a competitive advantage when it comes to meeting the energy delivery needs of citizens and businesses that may choose to locate and operate here.

It is my sincere belief that Missouri utilities and their customers would not be served well by Staff's attempt to move the state's regulatory policy entirely out of the mainstream with regard to net salvage cost recovery. It is not in Missouri's interest to move away from a rational reflection of depreciation expenses in rates toward an allowance for net salvage costs using historical averages for assets that are no longer in service. This approach results in the improper deferral of costs to future generations of ratepayers and amortization of accruals already paid for by past customers, all at the expense of future customers who will have to pay higher rates to later retire assets that may never have served them at all.

Simply put, I strongly believe that the Commission would be ill-advised to follow the Staff's approach to net salvage that:

- Creates inappropriate subsidies among generations of customers for the sake of short-term rate reductions in a state with already low rates;
- Threatens utilities' ability to generate cash flows needed to invest in a robust utility infrastructure in the state;
- Results in adverse energy and public policy consequences in the state which ultimately threaten economic development and create other problems;
- Will inevitably lead to higher customer rates in the long term;
- Will result in rate volatility; and
- Abandons a sound ratemaking approach that has long served this state's needs very well by adopting a policy that is far outside of the mainstream.

When it is all said and done, it is my sincere belief that the only rational approach to addressing this issue is to follow the standard, time-tested approach to net salvage which has served Missouri well for decades.

Q. Does this conclude your testimony?

A. Yes, it does.

Summary of AmerenUE's Position On Net Salvage
Case No. GR-99-315

In this case and other recent rate proceedings, the Staff has proposed a fundamental departure from the standard treatment of utilities' net salvage costs. Net salvage costs are the costs that a utility incurs to remove its facilities from service at the end of their useful lives, less any salvage value that may be realized from those retired facilities. Under the standard ratemaking approach, the service values of utility facilities that are currently in service, which includes estimated net salvage costs, are ratably allocated over the service lives of those facilities and those costs are recovered through the utility's depreciation rates. In other words, just like the original cost of the facilities, the net salvage costs are allocated over the lives of the underlying assets, so that customers who benefit from the use of those facilities pay their fair share of the full cost of the facilities.

The Staff's proposal ignores the net salvage cost associated with plant that is currently in service, and instead includes in rates only the cost of net salvage that the utility has experienced for plant retired in recent years that is no longer in service. AmerenUE's testimony lays out the many sound reasons why the Staff's treatment of net salvage should not be adopted.

First, the Staff's approach is inconsistent with the regulatory treatment of net salvage afforded by virtually every other regulatory commission in the country, with regulatory accounting standards as reflected in the Uniform System of Accounts, and with the treatment of net salvage costs recommended by the most authoritative texts written on the subject. Staff's approach would unnecessarily take Missouri's treatment of net salvage far outside the mainstream and ignore the time-tested conventions that have governed the recovery of net salvage costs in Missouri and elsewhere for decades. The unreasonable result would be that Missouri utilities would recover the cost of their facilities at a rate far below that which is permitted utilities operating in other jurisdictions (See Mr. Stout's Schedule WMS-6-2 attached hereto).

Second, Staff's approach would create substantial inter-generational equity problems for utility customers and lead to adverse rate impacts in the future. The approach creates inter-generational inequity because it will require future generations of customers to bear the net salvage costs that should have been paid by today's customers for plant that currently benefits them. In addition, since Staff's approach to net salvage falsely suggests that utilities have over-accrued net salvage costs to-date, Staff has proposed to amortize the "over-accrual" of the depreciation reserve by reducing rates even further. This practice exacerbates the inter-generational inequity problem by also subsidizing current ratepayers with lower rates reflecting an amortization of net salvage already paid by past generations of customers. This is in addition to the subsidy provided to current customers by future generations of customers who will have to pay even greater net salvage costs.

This situation occurs because the amount currently spent for net salvage is much lower than the net salvage that will be incurred for the retirement of currently used plant for the following reasons:

(a) The universe of current plant is much larger than the universe of plant from which the recent retirements came. Since the size of most utilities' systems has dramatically increased over the past decades, recent retirement costs for assets that were put into service many years ago are not representative of retirement costs applicable to current plant.

(b) Recent retirement activity does not reflect the cost of inflation, which is certain to occur before plant that is currently in service is retired.

As a result of these two factors, Staff's approach grossly underestimates the net salvage costs that utilities should include in current rates to reflect the cost of plant that is currently in service, and leaves for future generations of customers the burden of paying for these under-recoveries.

The Staff's approach further leads to adverse rate impacts, including the unnecessary risk of rate volatility, which would result whenever facility retirements occur in waves; the risk of future rate shock; and the certainty that over the long term rates will be unavoidably higher than if the standard approach to net salvage had been retained. Although Staff's approach calculates lower net salvage costs in the short run (by failing to recognize the growth in the asset base and the impact of inflation as explained above), Staff's approach leads to a larger rate base and higher rates for customers within a relatively short period of time.

Third, the adoption of Staff's approach is completely unnecessary given that the following safeguards to protect both utilities and their customers are built into the standard approach:

(a) Depreciation and net salvage costs that are included in rates are ultimately trued up with actual costs incurred by the utility through the balancing mechanism of the depreciation reserve. As a result, under the standard approach, the utility will only recover the exact amount it spent for net salvage—not a penny more or less. This is not the case under Staff's current approach, which only allows in rates the historical average of net salvage costs without any reconciliation between allowed and actual costs.

(b) To the extent a utility collects estimated net salvage costs from ratepayers in advance of actually incurring those costs to retire facilities under the standard approach, the ratepayers are fully compensated for the use of their money because the utility's rate base is reduced by the accrued depreciation reserve in calculating rates. In effect, the ratepayers receive interest on any prepaid net salvage at a rate equal to the utility's overall rate of return.

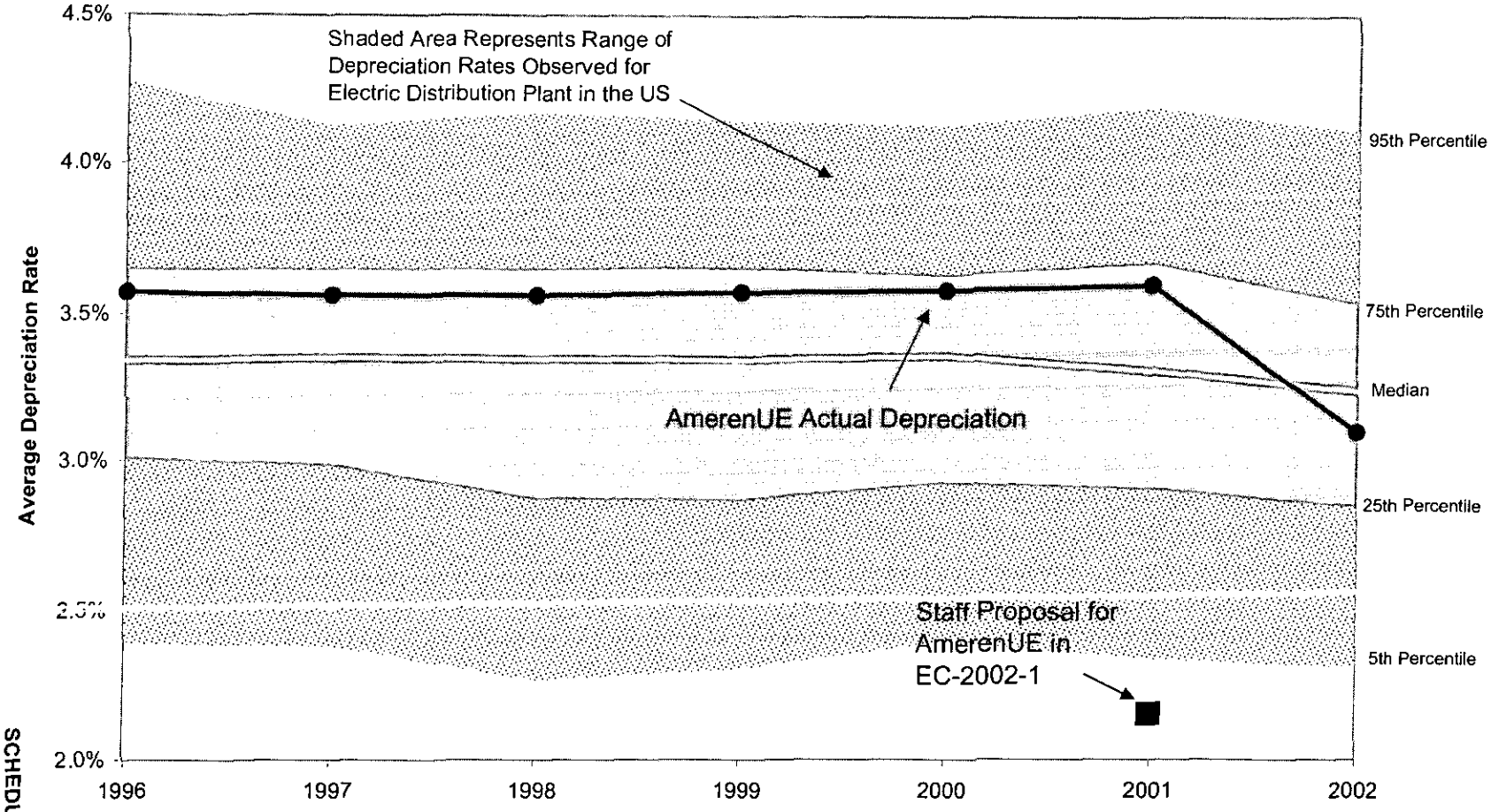
(c) Under the Commission's rules, utilities are required to periodically update their depreciation studies. These updates insure that both service lives and net salvage values used to calculate depreciation rates reflect the best available estimates consistent with the most up-to-date data and developments.

Fourth, the adoption of the Staff's approach would create significant adverse financial impacts on Missouri utilities that would further raise costs for customers. Staff's approach to net salvage costs impairs utility cash flows (see Mr. Stout's Schedule WMS-5-2 attached hereto), and increases what utilities will have to borrow to finance needed infrastructure improvements. Credit rating agencies view Staff's approach to net salvage negatively, and Staff's approach has already contributed to the significant downgrade of two Missouri utilities' credit ratings, including Laclede's. Higher costs of financing Missouri infrastructure investments occasioned by Staff's approach will ultimately be reflected in higher customer rates.

Fifth, and perhaps most significantly, Staff's approach would have negative energy and public policy implications for the State of Missouri. Weakened cash flows and impaired credit ratings resulting from the implementation of Staff's approach would make it more costly and more difficult for utilities to invest in the infrastructure necessary to support the local economy and attract and retain businesses in the state. More volatile and ultimately higher rates would harm all customers and also make Missouri less attractive to economic development. Finally, financially weaker utilities will suffer adverse impacts on a host of labor-related issues, and be less able to contribute to their communities through energy assistance programs, economic development programs, and other programs, all to the detriment of the communities they serve.

For all these reasons, the Commission should reject Staff's out-of-the-mainstream proposal for the treatment of net salvage and should retain the standard treatment of these costs.

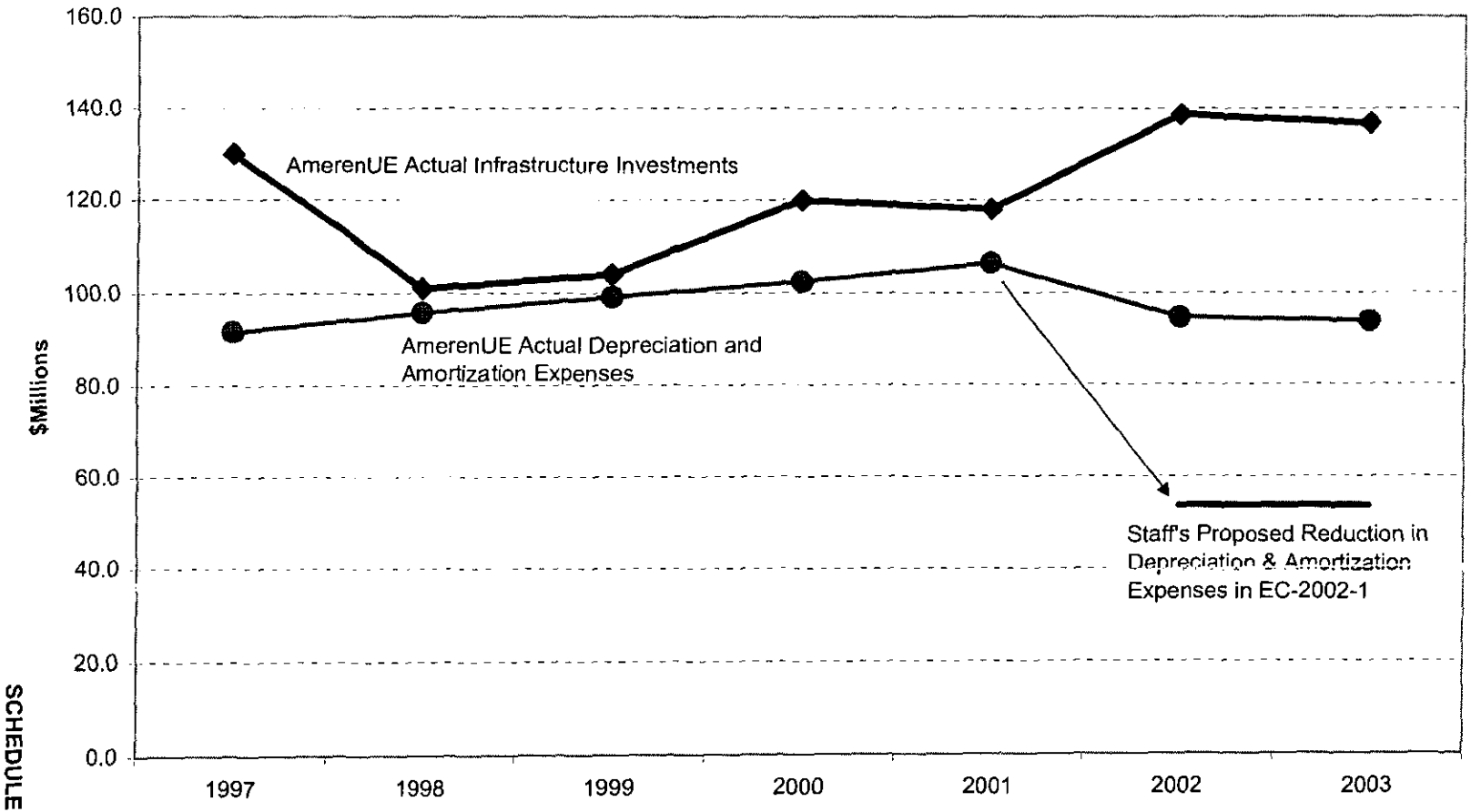
Schedule WMS-6-2
Average Depreciation Rate for Investor-Owned Electric Utilities in the US
(Electric Distribution Plant)



Sources and Notes:
Depreciation and amortization rates and AmerenUE actual based on UDI and Platts databases for electric distribution plant.
Average Depreciation Rate calculated as (Depreciation and Amortization Expenses / Gross Plant Value).
Staff proposal: Staff Schedule 5.

SCHEDULE WMS-6-2
Appendix A
Page 4 of 5

Schedule WMS-5-2
AmerenUE Infrastructure Investment vs. Depreciation & Amortization Expense
Electric Distribution Plant



Sources and Notes:
AmerenUE Actual Depreciation Expense 1997 - 2002: UDI / Platts. 2003: Ferc Form 1.
All Other Data: AmerenUE.
All infrastructure investments and depreciation expenses include Illinois and Iowa electric distribution plant.

SCHEDULE WMS-5-2
Appendix A
Page 5 of 5

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's)
Tariff to Revise Natural Gas Rate Schedules) Case No. GR-99-315

AFFIDAVIT OF WARNER L. BAXTER

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

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

1. My name is Warner L. Baxter. I work in the City of St. Louis, Missouri, and I am employed by Ameren Corporation as Senior Vice President and Chief Financial Officer.

2. Attached hereto and made a part hereof for all purposes is my Supplemental Direct Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 27 pages and Appendix A, all of which have been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Warner L. Baxter

Subscribed and sworn to before me this 20th day of August, 2004.

Carolyn J. Woodstock
Notary Public

My commission expires: May 19, 2008.

CAROLYN J. WOODSTOCK
Notary Public - Notary Seal
STATE OF MISSOURI
Franklin County
My Commission Expires: May 19, 2008