Exhibit No.:
Issue(s): FAC
Witness: KENNETH GORDON, PH.D
Sponsoring Party: UNION ELECTRIC CO.
Type of Exhibit: SURREBUTTAL TESTIMONY
Case No.: ER-2008-0318
Date Testimony Prepared: NOVEMBER 5, 2008

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2008-0318

SURREBUTTAL TESTIMONY

OF

KENNETH GORDON

ON BEHALF OF

UNION ELECTRIC COMPANY

D/B/A AMERENUE

NOVEMBER 5, 2008

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I. PURPOSE AND CONCLUSIONS

Q. PLEASE STATE YOUR NAME.

A. My name is Kenneth Gordon.

Q. ARE YOU THE SAME KENNETH GORDON WHO SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. Union Electric Company d/b/a AmerenUE ("AmerenUE" or the "Company") has asked me to consider the positions taken by parties to this case relating to AmerenUE's fuel adjustment clause ("FAC") request, and, in particular, to review rebuttal testimonies relating to the proposed FAC. In doing so, I have endeavored to "step back" from the details of the normal rate case battles and look at the larger policy picture from my perspective as an economist and former regulator.

This surrebuttal testimony will focus primarily on the question of whether this proceeding is the right place and time for the Missouri Public Service Commission ("Commission") to approve the use of an FAC by AmerenUE. My direct testimony focused on the cost pressures that utilities have faced during the last few years and touched on the basic reasons why most electric utilities have a separate ratemaking

mechanism for fuel and purchased power costs or for net fuel costs,[1] as proposed for AmerenUE in this case. This surrebuttal testimony focuses on why I believe that AmerenUE's customers would be better off if an FAC is approved in this proceeding.

Q. WHAT IS YOUR GENERAL OPINION ON WHETHER THIS IS THE RIGHT TIME AND PLACE FOR AMERENUE TO BEGIN TO USE AN FAC?

A. I believe that it is an appropriate time to implement an FAC for AmerenUE. As an economist, I view getting the pricing right—i.e., ensuring that the rates utility customers pay reflect the cost of providing utility service—is crucial and, as a former regulator, I know that FACs are an important vehicle for ensuring that that occurs. While the FAC proposed by the Company still incorporates significant lags between the actual incurrence of net fuel costs during a given accumulation period, and the recovery in rates of those costs,[2] I nevertheless view the price signals provided by the proposed FAC as being much better than the *status quo* of having no FAC.

An FAC can also help to ensure appropriate levels of reliability and increase the efficiency of the utility network by supporting the utility's credit quality and thus its access to the capital needed to invest in its system. Utilities must make continual investments and, in order to be able to do so, must maintain the ability to raise capital in good markets and bad. If the absence of an FAC makes it more difficult for the utility to maintain strong, investment grade bond ratings (and I understand that this is the case for AmerenUE), then the absence of an FAC could affect the utility's ability to raise the

[1] For convenience, I'll usually refer to "net fuel costs," which are the fuel and purchased power costs net of sales for resale (i.e., off-system sales). Net fuel costs are comprised of a longer list of costs, including direct net fuel costs, purchased power costs, fuel transportation costs, hedging costs, and so on, net of off-system sales revenues, as outlined in the proposed Rider FAC, Fuel and Purchased Power Adjustment Clause, which is filed in this proceeding as Schedule MJL-E1-1.

[2] It is my understanding that these lags are unavoidable given the Missouri FAC regulations, which require use of historical net fuel costs.

capital needed to support investment in utility infrastructure. This, in turn, would affect the utility's ability to provide efficient, safe, adequate and reliable service to customers.

My conclusion that now is the right time to implement an FAC for AmerenUE is based on my analysis that utility *customers* will be better served if AmerenUE has an FAC. My examination of the terms of the FAC and the safeguards that would apply have convinced me that an FAC can be implemented in a way that is consistent with economic efficiency and the interests of customers.

Q. WHAT SPECIFIC CONCLUSIONS HAVE YOU DRAWN?

A. I emphasize four points in this surrebuttal testimony, as follows:

1. The statutory criteria for approval of an FAC have been met, *e.g.*, the FAC is designed to help provide the utility with an opportunity to earn a fair rate of return on equity and it includes an annual true-up procedure. Moreover, AmerenUE's net fuel costs are large, volatile, and beyond the control of the utility.

2. The Company will be held to the same efficient performance standards in all aspects of its business whether or not it has an FAC mechanism. Thus, the Company's incentives to procure fuel efficiently and to otherwise manage its net fuel costs appropriately will not be harmed by the introduction of an FAC. In fact, a number of powerful incentives to continued fuel acquisition efficiency will remain in place.

3. AmerenUE's net fuel costs are a large and uncertain part of its operating expenses. The Company's net fuel costs are considerably more uncertain, and therefore harder to account for in a general rate case based on a historic test

year, than its non-fuel operating costs. Thus, it would be reasonable to recover these costs through an FAC.

4. The lack of an FAC could restrict AmerenUE's ability to invest in transmission and distribution ("T&D"), environmental-related, and generation infrastructure needed to serve electric utility customers in the future. Given recent developments in the credit markets, the importance of this issue is even greater than in the past.

Much has changed in both the financial and energy markets since the Commission decided not to implement an FAC for the Company in the previous rate case proceeding. Implementing an FAC for AmerenUE is an important—and justified—step that the Commission can take to signal its commitment to supporting the long-term interests of the Company's ratepayers, who need, and expect, the Company to continue to provide efficient, safe, adequate and reliable service. Doing this requires investment in the Company's system, which in turn requires large sums of capital. Large sums of capital require ready access to the debt and equity markets, which in turn depends on sound credit ratings and a sound financial condition. AmerenUE's ability to accomplish all of this will be improved substantially with an FAC, with the benefits ultimately flowing to customers.

Q. ARE YOU CONCERNED THAT AN FAC COULD DAMAGE AMERENUE'S EFFICIENCY INCENTIVES?

A. No. While Mr. Ryan Kind, among others, on behalf of the Missouri Office of Public Counsel, suggests that having an FAC would cause a "change in incentives" that

would cause the utility to operate less efficiently,[3] the plain fact of the matter is that the Company will be held to the same prudence standard whether or not it has an FAC—and thus will have the same incentive to meet that standard. When I was a regulator I was more interested in various types of "incentive ratemaking" than FACs, so I agree that this is an important question to consider, but I would firmly state that, given the range of factors promoting efficiency in fuel acquisition and in making off-system sales, this proposed FAC would not degrade AmerenUE's efficiency incentives. My view is in accordance with the unmistakable mainstream view of other regulatory bodies, which almost universally use FACs for their electric utilities.

I would add one additional point here. While I view the significant lags between the Company's actual incurrence of net fuel costs and the recovery of those costs in rates to be undesirable from the standpoint of allocative efficiency (the idea that prices should reflect costs), the lags that the plan retains do provide the utility with an additional incentive to procure fuel and purchased power efficiently and to make off-system sales where possible. I am aware that states sometimes build in these sorts of ratemaking lags when introducing an FAC for the first time. Thus, I view this as largely a transition mechanism that can ease the way to a more economically rational ratemaking approach in Missouri.

[3] Ryan Kind, Rebuttal (Oct. 14, 2008), pp. 5-6.

II. FACs ARE NEAR-UNIVERSAL REGULATORY TOOLS AND WILL NOT DISRUPT REGULATORY OVERSIGHT OR DAMAGE INCENTIVES

Q. IF THE COMMISSION APPROVES AN FAC FOR THE COMPANY, WILL THE COMPANY CONTINUE TO HAVE AN OBLIGATION TO PROCURE ITS FUEL AND TO MANAGE ITS NET FUEL COSTS PRUDENTLY?

A. Yes. Given the regulated nature of the Company's business and its unchanged obligation to prudently incur its fuel and prudently manage its overall net fuel costs, too much has been made of the possible effects of an FAC on the efficiency of fuel procurement and net fuel cost management. Utilities are expected to provide efficient, safe, adequate, and reliable service for their customers. Regulatory oversight of the Company's net fuel costs will continue whether or not an FAC is used. Introducing an FAC for net fuel costs will not weaken the effectiveness of utility regulation in Missouri.

Q. PLEASE DISCUSS WHAT YOU UNDERSTAND TO BE THE PRINCIPAL UNDERLYING TOOLS FOR PUBLIC UTILITY RATEMAKING IN MISSOURI.

A. Regulators' primary regulatory "tool" for overseeing the utility is the traditional rate-of-return/cost-of-service rate case, which provides the regulator with a forum for investigating and determining just and reasonable rates. Using a "historic test year" revenue requirement, the Commission examines the reasonableness of the utility's sales growth projections, operating expenses, cost of capital, and other cost components,

and then sets rates that provide the utility a reasonable opportunity to recover its prudently incurred costs.

This regulatory oversight and scrutiny can continue when an FAC is used. Rather than recovering net fuel costs through base rate proceedings, a separate ratemaking mechanism, *i.e.*, an FAC, can be used. This does affect the timing of fuel-related rate increases, but not the obligation to perform efficiently. Finally, and importantly, the ability or inability to recover those costs in a timely way directly affects the utility's opportunity to earn its allowed rate of return. Indeed, when an FAC is used, the amount of time between base rate cases can increase, which would improve the utility's incentive to control base rate costs. A utility has considerably more influence over base rate costs than it has over net fuel costs. Utility ratepayers would share in the benefits of these efficiency gains through the normal ratemaking process.

The other side of this, of course, is that if rates remain unchanged during a period when costs that are substantially beyond management's control rise in ways not contemplated in the last rate case, the utility may not be afforded a reasonable opportunity to achieve its allowed rate of return. During this period systematic under-earning can occur that can prevent a utility from having the opportunity to recover its costs, including the cost of capital.

A reasonable balance needs to be found that provides the benefits of regulatory lag in base rate case proceedings while recovering net fuel costs through an FAC. In Missouri, I understand that base rate proceedings typically take about 11 months. With a fuel clause, the regulatory lag for net fuel costs will be shorter (but still not negligible in the proposed plan). The basic fact of the matter is that the *price* of fuel,

and the level of off-system sales, are beyond the control of the utility, ratemaking oversight will not diminish, and these costs are a large and volatile part of AmerenUE's costs.

Q. WOULD PRUDENCE REVIEWS OCCUR REGULARLY IF AN FAC IS ADOPTED IN THIS PROCEEDING?

A. Yes. Missouri's FAC regulations and AmerenUE's proposed FAC state that:

> "*Prudence reviews of the costs subject to this Fuel and Purchased Power Adjustment Clause shall occur no less frequently than every eighteen months, and any such costs which are determined by the Missouri Public Service Commission to have been imprudently incurred shall be returned to customers with interest at the Company's short-term borrowing rate*."[4]

While FACs are sometimes viewed as "automatic" cost pass-through mechanisms, AmerenUE's FAC proposal assures that prudence reviews will occur at least once every 18 months. Thus, there will be no diminishment of ratemaking oversight.

AmerenUE knows that it will continue to be subject to regulatory scrutiny of its net fuel cost management, including the operation of its power plants. This is true both because of the regular prudence reviews, and because of the fact that AmerenUE's FAC mechanism itself will be under review at least every four years. Moreover, safeguards have been put into place to guard against any weakened incentives. Therefore, AmerenUE's incentives to operate efficiently would be strong whether or not it has an FAC.

[4] Schedule MJL-E1-1, *supra* note 1.

Q. ARE UTILITIES EXPECTED TO PROCURE AND MANAGE RESOURCES EFFICIENTLY?

A. Yes. A utility has an obligation to procure its fuel and to manage its resources in a prudent manner—and that obligation would not change with an FAC. The National Regulatory Research Institute ("NRRI") notes that a utility is not "excused from hard-nosed, tough bargaining" and goes on to explain that "state public utility commissions often hold utilities to a standard of care of a prudent business man in negotiating fuel contracts before allowing the cost to flow through a fuel adjustment or purchased gas adjustment clause."[5]

Fuel procurement has "physical" and "financial" aspects. Utilities must make sure that they have the necessary fuel on hand to provide utility service. Utilities use contracts and financial products to hedge the price of fuel. It is important to remember that hedging has costs and that generally rates will be higher but less volatile when net fuel costs are hedged. This hedging must necessarily be judged on a forward-looking basis: were the hedges reasonable based on what the utility knew at the time that it implemented the hedges?

Utilities also procure and sell electricity on a wholesale basis. I understand that AmerenUE has in the past had significant amounts of off-system sales, the volume of which varies depending on demand, which is in turn influenced by weather, economic conditions, and so on. AmerenUE's FAC focuses on fuel and purchased power net of off-system sales (*i.e.*, net fuel costs).

[5] Robert Burns, Mark Eifert and Peter Nagler, "Current PGA and FAC Practices: Implications for Ratemaking in Competitive Markets," National Regulatory Research Institute, November 1991, p. 4. Hereinafter referred to as "NRRI Report."

It is also my understanding that AmerenUE has a governance structure and policies in place to oversee its fuel procurement and off-system sales activities and the presence of an FAC in the Company's tariff would not change this. Some of this structure is discussed in Schedule MJL-E4-9 to AmerenUE witness Martin J. Lyons, Jr.'s direct testimony, where it is stated that "[t]o ensure fuel purchases are prudent, the fuel acquisition for AmerenUE's generation is governed by the Ameren Energy Fuels and Services company ("AFS") Risk Management Policy."[6] The Schedule states that the policy in place sets specific rules and guidelines, as approved by Ameren's Risk Management Steering Committee, regarding commodity transactions, including levels of coal and natural gas that must be acquired and hedged for future periods. The policy also mandates extensive monitoring and reporting requirements, which would help to ensure transparency in the Company's energy purchases. AmerenUE Schedule MJL-E4-9 notes that the policy has not been designed to "result in the lowest possible price for fuel, but strike[s] a balance between price stability and security of supply."[7]

Q. ARE UTILITIES EXPECTED TO OPERATE THEIR OWNED GENERATING PLANTS EFFICIENTLY?

A. Yes. AmerenUE's obligation to operate its plants efficiently would not change and "heat rate/efficiency" testing and reporting requirements in the Missouri FAC regulations would support its continued incentive to operate its plants in a way that minimizes costs. Staff and the Company have agreed on an approach for this in accordance with Missouri's FAC regulations.

[6] AmerenUE Schedule MJL-E4-9.

[7] *Id.*

Where the utility operates its own generating stations, the utility would have some degree of control over the efficiency of its use of fuel in the generation process. While there are many constraints on a utility's ability to improve heat rates, availability rates, and other key operating measures, it is clear that evaluation of key generation performance metrics would continue to be a necessary part of the ratemaking process. The Company's approach seems reasonable to me and provides an added assurance that economic efficiency will not be harmed.

Q. DOES THE PROPOSED PARTIAL PASS-THROUGH (95 PERCENT) PROVIDE AN ADDITIONAL ASSURANCE THAT THE COMPANY'S EFFICIENCY INCENTIVE WILL NOT BE WEAKENED?

A. Yes. I do not view partial pass-through to be a necessary part of an FAC because it can harm allocative efficiency (the idea that utility rates should reflect costs) while also potentially making it more difficult for the utility to invest in needed infrastructure (if the lack of a 100% FAC harms investors' perceptions of the Company's financial integrity). As I discuss below, most FACs do not share changes in the fuel or net fuel costs that are tracked in an FAC.

Nevertheless, the Company has voluntarily proposed a "partial" FAC mechanism wherein 95% of net fuel costs would be passed through to customers through the FAC with the other 5% held for future recovery.[8] I understand that such a mechanism has been found appropriate by the Missouri Commission in each of the other two instances where FACs were approved. Several witnesses, including Mr. Kind,

[8] The draft FAC mechanism proposed by Union Electric Company states that "[n]Ninety-five percent of the difference between Actual Net fuel costs and [Net Fuel Based Costs] for all kWh of energy supplied to Missouri retail customers during the respective Accumulation Periods shall be reflected as an FPAc credit or debit, stated as a separate line item on the customer's bill […]." See: Schedule MJL-E1-1, *supra*, note 1.

contend that the 95% sharing is not sufficient.[9] The implication here is that the proposed sharing is not meaningful or, at least, not sufficiently meaningful. I find, however, that the voluntary 5% partial pass-through goes well beyond the minimum, and provides a meaningful, additional assurance that incentives will remain unharmed.

Company witness Martin J. Lyons, Jr. describes the substantial financial stake the proposed sharing represents[10] and only a distinct minority of states have any sharing at all. I would note that most of the states that share changes in their FACs did not historically have a fuel clause until fairly recently. My expectation is that these states will, over time, reduce their emphasis on FAC sharing mechanisms.

Q. WOULD THE COAL POOL PROVIDE AN ADDITIONAL EFFICIENCY INCENTIVE IN TERMS OF COAL PROCUREMENT?

A. Yes. The Company will have direct economic incentives—pursuing its own self-interest—to acquire coal efficiently through the operation of a coal pool that serves its unregulated as well as regulated generation.

Q. ARE THERE ALSO EMPLOYEE INCENTIVES IN PLACE THAT REINFORCE NET FUEL EFFICIENCY?

A. Yes, I am told that there is a variety of such incentives. As an example from pages 17 and 18 of Company witness Robert Neff's rebuttal testimony, "the Coal Supply Department has both individual and department incentive compensation which provides employees with additional incentive to control fuel costs…. 12.5% of a Coal Supply employee's incentive bonus is determined by the delivered coal cost KPI [Key Performance Indicator]."

[9] Kind rebuttal, p. 6.

[10] Lyons rebuttal testimony, pp. 23 to 27.

Q. PLEASE DESCRIBE HOW AN FAC WOULD AFFECT ALLOCATIVE EFFICIENCY.

A. The Commission's ability to set cost-reflective rates is enhanced when an FAC is used. Utility rates should be designed to signal the cost of electricity in the market on as close to a real-time basis as practical. This means that wholesale prices must be passed through (*i.e.*, be visible) to the end-use customer. Then, and only then, can the demand side of the market play its role in moderating price fluctuations, ensuring reliable supply, and encouraging investment. A timely FAC can enhance a Commission's ability to assure that utility rates are cost reflective.

Indeed, some variation in rates is desirable as a timely FAC mechanism provides economically-correct price signals: when consumers are aware of, and can respond to, the cost effects of their energy consumption decisions they have an incentive to reduce their demand when the price outweighs the benefit. This results in wiser energy use and a net gain in consumer welfare.

Q. COULD AN FAC ENHANCE A UTILITY'S ABILITY TO ACHIEVE DYNAMIC (I.E., INVESTMENT) EFFICIENCY?

A. Yes. The impact would be through an improved posture in the capital markets, and would be meaningful. By introducing an inter-temporal component—which recognizes that utilities must make continual investments that ensure appropriate levels of reliability and increase the efficiency of the utility network—dynamic efficiency underscores the need for utilities to maintain the ability to raise capital in good markets and bad. If the absence of an FAC makes it more difficult for the utility to maintain strong, investment grade bond ratings, then the absence of an FAC could limit the

utility's ability to raise the capital needed to support the investment in utility infrastructure that is needed to provide efficient, safe, adequate and reliable service to customers. That would, in turn, affect the utility's ability to operate as efficiently as possible in the future.

Q. ARE YOU SATISFIED, ON BALANCE, THAT THE COMPANY'S INCENTIVES WILL NOT BE DAMAGED BECAUSE OF THE PROPOSED FAC?

A. Yes. Substantial safeguards have been proposed (or retained) to prevent that from happening.

Significant incentives are summarized at pages 20 to 23 of the rebuttal testimony of Mr. Lyons and, include): (1) the 95%/5% sharing mechanism; (2) Ameren's coal pool, through which AmerenUE and its unregulated affiliates pay the same price for coal; (3) individual employee incentives; (4) prudence reviews; (5) cash flow lags because of the use of historical costs in an FAC; (6) heat rate/efficiency requirements and monitoring; and (7) periodic FAC reviews in each rate case.

III. THE USE OF AN FAC IS JUSTIFIED BECAUSE AMERENUE'S NET FUEL COSTS ARE BEYOND THE ABILITY OF THE UTILITY TO CONTROL, AND ARE LARGE AND VOLATILE

Q. STAFF WITNESS PROCTOR ESSENTIALLY ARGUES THAT NOTHING HAS CHANGED SINCE THE LAST RATE CASE (WHEN THE COMMISSION, BASED UPON THAT RECORD, FOUND THAT AMERENUE'S NET FUEL COSTS WERE NOT VOLATILE), AND ARGUES THAT AMERENUE HAS NOT SHOWN ENOUGH VOLATILITY TO LEAD TO A DIFFERENT DECISION IN THIS CASE. IS THIS THE CORRECT STANDARD?

A. No. Let's keep in mind the question that needs to be answered to decide whether an FAC is appropriate: does it make sense to have a separate ratemaking mechanism for net fuel costs instead of dealing with these costs in base rate cases? The conventional answer to this question is that an FAC can be justified if fuel and purchased power costs are large, volatile and uncertain, and beyond the control of the utility. It is my understanding that S.B. 179, which authorizes the Commission to adopt FACs, also makes it clear that the impact of an FAC on the ability of the utility to earn a fair return on equity is also an important consideration in Missouri.

By treating large, volatile, and unpredictable costs outside of base rate cases, the regulatory lag between full-blown base rate cases can potentially increase—or at least the issues in those cases can be narrowed somewhat. Regulatory lag gives a utility the incentive to control the costs that are under a utility's control between rate cases, but cost pressures related to net fuel costs—where the utility is a ''price taker'' procuring fuel from a market or selling power into the wholesale market and therefore cannot control the price—can be recovered in an FAC without harming the utility's incentives.

Many states have used a "volatility" standard when considering whether to adopt an FAC, but the relevant volatility needs to be considered carefully. The standard is not an "absolute" standard but rather is "relative" in nature. The standard should be that if *the designated category of costs (e.g., net fuel costs) are sufficiently more volatile and uncertain than base rate costs then a separate, more timely ratemaking procedure is justified*.

Q. IS THE *PRICE* OF FUEL AND POWER BEYOND THE CONTROL OF THE UTILITY?

A. Yes. The utility has to procure resources (such as fuel) and make sales for resale prudently, but the prices will be set in markets over which the utility has no control. I would point out that the Company's obligation to justify the reasonableness of its costs to its regulator will mean that it will continue to procure resources prudently and that the Company is but one of many that procure fuel from markets and therefore cannot control the *price* of fuel.

Just as "exogenous costs" in price-cap mechanisms pass through costs that are beyond the control of the utility without damaging incentives, so too can the *price* of fuel and power be said to be beyond the control of the utility. An NRRI report from 1991 notes that "[u]nless a utility is vertically integrated so that it owns the fuel source (whether it is the coal mine, gas well, or others), it is unlikely that the utility can exert much control over the cost of the fuel."[11]

There are additional considerations. First, as noted earlier, the Company will still have direct economic, as well as regulatory, incentives to acquire coal efficiently (*e.g.*, through the operation of a coal pool that serves its unregulated as well as regulated generation). Second, the FAC will retain a significant fuel cost lag, with the net fuel costs in rates lagging the Company's actual net fuel costs by a number of months; this works against prompt recovery of costs and does provide a continued incentive to reduce costs. Third, and not unimportantly, an FAC would allow quicker pass-through of any *decreases* in fuel costs, in the form of savings to end-use customers. These aspects and the other incentives I have noted earlier relating to the proposed FAC should not be overlooked.

[11] NRRI Report, *supra* note 5, p. 4.

Q. ARE AMERENUE'S NET FUEL COSTS A LARGE AND VOLATILE COMPONENT OF TOTAL COSTS?

A. Yes. Other witnesses have established that AmerenUE's fuel costs are a large part of its total costs. With respect to volatility, I would only add that a very straightforward comparison of the volatility of AmerenUE's net fuel costs and non-fuel costs shows, as presented in Table 1, that AmerenUE's net fuel costs have been substantially more volatile than its non-fuel operating costs.

Table 1. Coefficients of Variation

Coefficients Of Variation (2003-2007)

	AmerenUE
Non-fuel Costs	0.0817
Net Fuel and Purchased Power (Less Resale)	0.2988

Note: The coefficient of variation is calculated by dividing the standard deviation by the mean for a given sample.
Source: SNL Interactive

Q. ARE AMERENUE'S NET FUEL AND PURCHASED POWER COSTS "VOLATILE ENOUGH" TO QUALIFY FOR AN FAC?

A. Yes. Staff argues that AmerenUE's net fuel costs are not "volatile enough" to qualify for an FAC, arguing that those costs are not as volatile as those of Aquila and Empire. This debate is evidenced by Staff witness Michael Proctor and Company witness Ajay Arora's discussion of complicated volatility-related issues.

Staff and others (Mr. Kind, referring to Staff's Cost of Service Report) focus on a comparison of AmerenUE's fuel mix with other Missouri utilities, and conclude that AmerenUE uses less natural gas and spot purchased power relative to Aquila and Empire. However, Staff did not include sales for resale (off-system sales) in its analysis despite

the fact that sales for resale are a part of AmerenUE's net fuel costs tracked in the proposed FAC.

While it is true that AmerenUE's fuel is predominantly coal and nuclear, and it does not rely heavily on either gas or purchased power to serve its load, that doesn't mean that its fuel costs lack uncertainty and volatility or that its net fuel costs are not more volatile than its non-fuel, base rate operating costs. When the proper standard is used, it is clear that AmerenUE's net fuel costs are volatile enough to justify recovery through an FAC.

The relevant question is not whether AmerenUE's net fuel costs are relatively more or less volatile than other electric utilities' net fuel costs, but, rather, are AmerenUE's net fuel costs sufficiently more volatile than its non-fuel operating costs to warrant an FAC? AmerenUE's net fuel cost volatility meets this standard.

IV. AN FAC WOULD HELP AMERENUE TO IMPROVE ITS FINANCIAL INTEGRITY

Q. WHAT ISSUES DO YOU WANT TO ADDRESS WITH RESPECT TO FINANCIAL INTEGRITY?

A. Those who oppose an FAC for AmerenUE (*e.g.*, Staff, Office of the Public Counsel) are ignoring and failing to consider issues of financial integrity and the relationship of using a mainstream mechanism like an FAC to the financial health of a utility. As an economist, this is of great concern to me. For example, I am concerned that current ratemaking procedures, particularly the usual length of a rate case in Missouri, have the effect of limiting AmerenUE's opportunity to earn its allowed rate of return. This may, in turn, increase AmerenUE's difficulty in raising capital and make it

more difficult for AmerenUE to provide service to customers. A primary concern is that AmerenUE operate efficiently *over time* as well as at any point in time. To do this, AmerenUE must have the ability to raise necessary capital at reasonable rates in good markets and bad. Thus, financial integrity is a means toward an end, which is that the utility have the financial standing needed to provide efficient, safe, adequate and reliable service to customers. That is the end result I am concerned with.

There are two issues here. First, I am concerned that the continued absence of an FAC could make it very difficult for the Company to improve its credit standing from its current weak, barely investment-grade, standing. Second, I am concerned that lack of an FAC, coupled with the very low allowed ROE recommended by Staff witness Stephen Hill and which Mr. Hill continues to advocate in his rebuttal testimony, would also make it very difficult for AmerenUE to raise needed capital.

We live in interesting times. The state of capital markets has changed since the previous rate case decision. Given that AmerenUE is barely investment grade, there is a real question whether AmerenUE will be able to raise needed capital in the future at a reasonable cost to customers. The absence of timely recovery of net fuel costs could disadvantage AmerenUE in this regard.

Q. WHY ARE YOU CONCERNED THAT THE LACK OF AN FAC WILL LIMIT AMERENUE'S ABILITY TO RAISE NEEDED CAPITAL?

A. The credit rating agencies, the most visible of parties who evaluate the financial health of AmerenUE and its peers, have emphasized the importance of having an FAC. As one example, Moody's recently stated:

> The downgrade also reflects the challenging regulatory environment for electric utilities operating in the state of Missouri, as Union

> Electric is one of the relatively few utilities in the country operating without fuel, purchased power, and environmental cost recovery mechanisms. The lack of such automatic cost recovery provisions creates uncertainty regarding the timely recovery of the higher costs and investments being incurred and leads to significant regulatory lag.[12]

Schedule KG-SE2 provides a number of quotes where Moody's, S&P, and Fitch discuss their views on the role of FACs. An FAC that meets the statutory standard of being "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity" would do much to address the concerns that rating agencies have regarding the financial position of AmerenUE.[13]

Q. DO YOU HAVE COMMENTS ABOUT THE ALLOWED ROE THAT WILL BE SET IN THIS PROCEEDING?

A. Yes, I just want to raise a concern about moving from the "middle of the pack" to the low end of recent rate case decisions. I want to stay at the policy level here and will avoid involving myself in the details of how the results of discounted cash flow ("DCF"), capital asset pricing model ("CAPM") and other cost of capital models are evaluated.

In Schedule RAM-RE9 of his rebuttal testimony, Company witness Roger Morin presents a summary of recent decisions on the allowed returns on common equity in state ratemaking proceedings. This figure shows that Missouri is currently in the middle, a position that may help Missouri's utilities compete for capital. I am concerned

[12] *Moody's Investor Service*, "Moody's Downgrades Union Electric; Places Ameren and AmerenGenco on Review." May 21, 2008, p. 1.

[13] RSMo, § 386.266 (2005).

that moving to the low end of allowed ROEs now could make it more difficult for utilities to attract capital.

Q. WHY ARE YOU CONCERNED THAT THE LACK OF AN FAC AND/OR AN UNUSUALLY LOW ALLOWED ROE WOULD DAMAGE A UTILITY'S ABILITY TO INVEST IN INFRASTRUCTURE?

A. AmerenUE has major capital expenditure programs planned for upgrades and additions to its generation, transmission, and distribution infrastructure. In Schedule TRV-E2 of his direct testimony, Company witness Thomas Voss shows that expected capital expenditures over the next five years likely will be considerably greater than the last five years. AmerenUE will need to maintain a strong financial position to raise the capital necessary for these investments in infrastructure.

Q. IS IT IMPORTANT TO ADDRESS THE FAC NOW, EVEN THOUGH THE COMPANY MAY FILE ANOTHER RATE CASE IN THE NEAR FUTURE?

A. Yes. Some commentors posit that the Company is likely to file another rate case in the relatively near term and therefore argue that there is no need to approve an FAC now. But that is not a sufficient reason. Approving an FAC would help to begin the process of improving the Company's financial integrity. Moreover, with an FAC in place the next rate case could provide a greater focus on other issues, *e.g.*, AmerenUE's investments in environmental upgrades, increased system reliability, and similar issues, rather than re-litigating net fuel costs, thereby focusing the Commission's administrative resources more effectively.

Many of the relatively few states that historically haven't had FACs are now finding that FACs are justified in the current environment. Table 2 shows all of the FAC-like adjustment mechanisms implemented from January 2007 to October 2008.

Table 2: Recently Implemented Fuel Adjustment Mechanisms, 2007-2008

State	Utility	Date
Arizona	Tucson Electric Power	Pending
Missouri	Empire	July-08
Missouri	Aquila	May-07
Montana	MDU Resources	April-08
New Mexico	PSNM	May-07
Oregon	PGE	January-07
Vermont	Central Vermont Public Service	September-08
West Virginia	Monongahela Power	May-07
West Virginia	Potomac Edison	May-07

Source: Regulatory Research Associates

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a AmerenUE for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Company's Missouri Service Area.	)))))	Case No. ER-2008-0318

AFFIDAVIT OF KENNETH GORDON

STATE OF MAINE)
) ss
COUNTY OF CUMBERLAND)

Kenneth Gordon, being first duly sworn on his oath, states:

1. My name is Dr. Kenneth Gordon. I work in Windham, Maine, and I am employed by National Economic Research Associates, Inc. (NERA) as a Special Consultant.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 22 pages, Schedule KG-SE2, 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.

Kenneth Gordon

Subscribed and sworn to before me this 3rd day of November, 2008.

Notary Public

My commission expires: 3/4/2012

CARRIE A. COLE
Notary Public, Maine
My Commission Expires March 4, 2012

Rating Agency Perspective

This appendix provides discussion from three rating agencies about their view on FACs with regard to how they affect their credit ratings for AmerenUE and credit rating decision-making more generally.

The presence of FACs has always been noteworthy in ratings agency reports for the electric utility sector. In terms of fuel adjustment clauses and utility credit quality, *S&P* states:

> Standard & Poor's is frequently asked what weight is given to FPPA. It is clear that continued gas price volatility and upward trends in historically stable coal prices underscore the importance of FPPAs….to the extent that an FPPA is transparent and well structured, regulators are likely to be less inclined to disallow a utility's fuel and purchased-power costs.[14]

With respect to AmerenUE, *Moody's Investor Services* cited the lack of an FAC in downgrading the utility:

> The downgrade also reflects the challenging regulatory environment for electric utilities operating in the state of Missouri, as Union Electric is one of the relatively few utilities in the country operating without fuel, purchased power, and environmental cost recovery mechanisms. The lack of such automatic recovery provisions creates uncertainty regarding the timely recovery of the higher costs and investments being incurred and leads to significant regulatory lag.[15]

In an August credit opinion, Moody's reaffirmed the impact the lack of an FAC has on Ameren's credit rating:

> The rating reflects Ameren's diversification, with four utilities operating in two states; a concentration of coal fired generation; and a generally challenging regulatory environment in both of its jurisdictions plus no fuel, purchased power, or fuel adjustment clauses in place in Missouri….

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[14] *Standard & Poor's* "Fuel and Power Adjusters Underpin Post-Crisis Quality of Western Utilities." October 14, 2004.

[15] *Moody's Investor Service*, "Moody's Downgrades Union Electric; Places Ameren and AmerenGenco on Review." May 21, 2008, p. 1.

Moody's also reaffirmed this impact at the AmerenUE level in August:

> A combination of higher operating costs, limited rate relief, and the lack of cost recovery mechanisms in place has resulted in a steady decline in Union Electric's financial metrics and ratings over the last several years.
>
> What Could Change the Rating – Up
>
> An increase in the supportiveness of the regulatory environment for electric utilities in Missouri; the implementation of fuel, purchased power, and/or environmental cost mechanisms…
>
> What Could Change the Rating – Down
>
> An adverse outcome of its pending rate case, including the inability to implement a fuel adjustment clause…[16]

S&P also views the lack of an FAC as a challenge to AmerenUE's financial health. *S&P* cited the, "[c]hallenging regulatory climate in Missouri and current lack of a fuel adjustment clause," as one of AmerenUE's weaknesses in a May 2008 report and again in August 2008.[17]

Fitch Investor's Service (formerly *Duff & Phelps*) discusses the potentially extreme adverse consequences of a state not enacting a PCA/FAC with regard to the Western-US energy crisis in 200:

> California remains an extreme example of what can go wrong when FACs are eliminated, rates are frozen, and regulators are either unable or unwilling to extend support to local utilities.[18]

Three years after the Western-US energy crisis, *S&P* stated the following:

> It has been more than three years since the California energy crisis led to the rapid deterioration of credit quality for many Western electric utilities…The severe market distortions of the California crisis have faded, but FPPAs continue to play a significant role in the financial well-being of western electric utilities. Natural gas volatility, poor hydro conditions in the Northwest, the Southwest's sustained drought, and uncertainty over future generation development are daily reminders that **it is increasingly difficult for utilities to sustain their financial health**

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[16] *Moody's Investor Services*, "Credit Opinion: Union Electric Corporation." August 14, 2008, pp. 2-3.

[17] *Standard & Poor's* "Research: Union Electric Co. d/b/a AmerenUE." May 24, 2008, p 1; *Standard & Poor's* "Research: Union Electric Co. d/b/a AmerenUE." August 12, 2008, p. 1.

[18] *Fitch*, "Natural Gas Price Sensitivity of the U.S. Utility Sector." July 1, 2004, p. 7.

> **solely through the use of hedging policies and regular general rate case filings** [emphasis added][19]

Fitch also discusses the effect of FACs of an investor-owned utility's bond rating:

> In today's environment, the safest bonds in the utility industry may be those of vertically integrated utilities operating under commission-approved mechanisms to recoup prudently incurred power costs. Such companies typically operate in supportive regulatory environments which continue to feel the need for healthy reserve margins of generation.[20]

In terms of handling fuel volatility, Moody's states that:

> Regulated vertically integrated utilities operating without regulatory recovery of potentially high electricity costs from spot-market purchases are equally vulnerable, particularly during periods of peak energy demand and/or supply shortages…. Moody's ultimately believes that companies exposed to supply risk must demonstrate the ability to appropriately hedge this risk in order to preserve its financial integrity and maintain its bond rating.[21]

In terms of natural gas price sensitivity of the U.S. Utility Sector, *Fitch* states that:

> The high price of natural gas and the increased price volatility witnessed during the past three years have presented challenges of varying degrees to issuers in U.S. electric and gas coverage. The ability of these companies to manage commodity price exposure varies considerably among firms within the sector and is an important rating factor…. However, integrated utilities with the obligation to serve and no adequate fuel cost recovery mechanism, as well as electric distributors operating under frozen rate tariffs that are required to defer power purchases, are generally more exposed to volatile commodity prices.[22]

In 1998, *S&P* noted that "[a]utomatic pass-through mechanisms that hold companies harmless from uncontrollable costs, such as fuel or foreign exchange effects, are viewed favorably."[23]

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[19] *Standard & Poor's* "Fuel and Power Adjusters Underpin Post-Crisis Quality of Western Utilities." October 14, 2004.

[20] *Fitch*, "Procuring Power in California: A Potential Stranded Cost." September 7, 2000, p. 4.

[21] *Moody's Investors Service*, "Credit Implications of Power Supply Risk." July 2000, p. 3.

[22] *Fitch*, "Natural gas Price Sensitivity of the U.S. Utility Sector." July 1, 2004, p. 1.

[23] *Standard & Poor's*, "Rating Methodology For Global Power Utilities," *Standard & Poor's Infrastructure Finance*, September 1998, p. 66.

With respect to integrated utility companies, *Fitch* states,

> Although a majority of integrated utilities remain substantially protected from fluctuating commodity price levels due to the existence of fuel/purchased power adjustment clauses (FACs), a handful of companies possesses regulatory mechanisms that offer only partial protection while others lack such a clause altogether…. Unless a protective adjustment mechanism is in place, utilities purchasing power from the spot market to meet load requirements will be particularly exposed to high costs during periods of high demand, when gas is likely to be on the margin in all U.S. regions.[24]

Moody's mirrors *Fitch's* sentiments by stating:

> Regulated vertically integrated utilities operating without regulatory recovery of potentially high electricity costs from spot-market purchases are equally vulnerable, particularly during periods of peak energy demand and/or supply shortages…. Moody's ultimately believes that companies exposed to supply risk must demonstrate the ability to appropriately hedge this risk in order to preserve its financial integrity and maintain its bond rating.[25]

With regard to Provider of Last Resort service in restructured states, *Moody's* states that:

> In general, utilities have little incentive to accept the financial risk PLR service creates without being compensated by regulators with some form of pass-through. Each state will determine its own plan, and Moody's believes that elements of a purchased power adjustment clause will be retained for PLR service.[26]

These are typical passages from ratings agency reports in the era of competitive power markets. The ability of electric utility companies to charge compensatory rates in light of changing market power costs is of key importance in assessing the risk to which investors expose their capital.

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[24] F*itch*, "Natural gas Price Sensitivity of the U.S. Utility Sector." July 1, 2004, p. 4.

[25] *Moody's Investors Service*, "Credit Implications of Power Supply Risk." July 2000, p. 3.

[26] *Moody's Investors Service*, *supra* note 83, p. 3.