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Witness:	Kenneth J. Rademan
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Sponsoring Party:	Union Electric Company
Case No:	EO-96-14

MISSOURI PUBLIC SERVICE COMMISSION

Case No. EO-96-14

VERIFIED STATEMENT

OF

KENNETH J. RADEMAN

ST. LOUIS, MISSOURI
May, 1999

Exhibit No. 39
Date 6-9-99 Case No. EO96-14
Reporter KS

BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of the Monitoring of the Experimental Alternative Regulation Plan of Union Electric Company.	)))	Case No. EO-96-14

STATEMENT OF KENNETH J. RADEMAN

1. I am submitting this Statement because I was intimately involved in the development and negotiation of the experimental alternative rate plan ("EARP") to which the Missouri Public Service Commission, Union Electric Company ("UE"), the Staff of the Commission, the Office of Public Counsel, and others, are parties. The Stipulation and Agreement (the "Agreement") memorializing the EARP is set out in the Report and Order in Case No. ER-95-411 (July 21, 1995). (The Agreement in this case is nearly identical to the one establishing the second EARP, which is set out in the Report and Order in Case No. EM-96-149 (March 4, 1997).) The Agreement embodied a new, progressive approach to the regulation of rates that marked not only a distinctive break with traditional rate regulation that holds much promise for enhancing the Commission's ability to fulfill its current mission under the law, but also constituted a forward-looking mechanism that could smooth the transition to a competitive electric utility market. Because what is at stake in these proceedings are the important policy initiatives embodied in the Agreement and the integrity of the Commission process, but pressing matters in conflict with the hearing schedule prevent me from personally appearing at that time, I respectfully submit this Statement for the consideration of the Commission. Consistent with this motivation, and the law, I am not being compensated by any party to this proceeding to submit this Statement.

2. In understanding the terms of the Agreement, and what the Commission hoped to achieve by committing itself to it, it is helpful to remember the circumstances created by traditional rate regulation which the Commission faced prior to 1994. Briefly put, the Staff would initiate a complaint case to deal with overearnings by a utility based on a particular historical test year, and the Commission would then order a rate reduction, notwithstanding the protestation of the involved utility that it would immediately need a rate increase as the result of more current data. The utility would then promptly pursue a rate case seeking a rate increase, which the Commission would have to grant based on the cost of service as it was then calculated on the more current historical test year. When the Staff began overearnings reviews of UE and other utilities in 1994, it did not want to repeat such senseless ratemaking.

3. The Southwestern Bell ("SW Bell") case, to which some have already referred in their testimony, was the first case to adopt an alternative regulation plan in this state with a sharing grid by which a company agreed to share its earnings with its customers when those earnings resulted in a return on equity above certain levels. It is that sharing grid mechanism, and not other terms of the SW Bell arrangement, that was the model in the minds of the parties negotiating the UE EARP. No understandings that were not written in the Agreement were part of the UE EARP.

4. The sharing grid mechanism by itself illustrates that the UE EARPs did not involve any concept of inappropriate or excessive earnings that is so familiar in the context of traditional rate regulation. Instead of reducing rates to reduce excessive earnings 18 months or more after the fact as would be the case under the traditional approach, the EARP establishes an automatic, mechanical procedure – not requiring

elaborate regulatory proceedings, but based on an up-front policy judgment of appropriate sharing levels – by which earnings above those levels are shared with customers. In this way the problem of excessive earnings is dealt with much more quickly, and without the regulatory transaction costs, that would be the case under the traditional approach, all to the great benefit of consumers and, I believe, the Commission's ability to fulfill its mission of ensuring safe and reliable utility services, reasonable rates for consumers, and a reasonable return on investment for utilities and their investors.

5. The sharing grid concept also has a forward-looking aspect, anticipating a transition to a competitive electric power market. As mentioned above, the sharing grid was first used as an alternative to traditional ratemaking for a telephone company, a context, unlike that of electric utilities, in which rate setting is not strictly based on the cost of service, but on the value of service. Traditional ratemaking in large measure relies on a determination of the costs of service in evaluating whether a company is overearning, and so should be ordered to reduce rates. The sharing grid avoids the complex calculations needed to identify the often shifting costs of services. Rather, earnings, evaluated in terms of the return on equity, above a certain level are simply shared with customers. If the electric power market is deregulated to inaugurate competition, the pricing of an electric utility's power will be more on a value of service basis, with that value and price being set by the market. As a result, the sharing grid can be seen as a kind of transitional step toward the fully competitive, unregulated market.

6. The sharing grid approach has other benefits. Because it does not involve a regulatory authority in essence taking away earnings from a company after the fact, but sets out a sharing plan based on predetermined levels of earnings, it encourages the productivity of a utility's employees. For one simple example, the sharing grid avoids the situation of an employee working hard to increase the earnings of the company, only to see those earnings taken away later because a regulatory authority judged those earnings to be "excessive." Under the grid, the company and its employees know it will share in its increased productivity. Moreover, this increase in productivity can take many forms. For example, a mid-level manager might work extra hours to do a better job, which in turn contributes to the safety and reliability of the electric power provided by the utility. This incentive is one reason why the sharing grid approach is often called sliding scale incentive regulation. And again, such an incentive to encourage productivity is exactly one of the strengths of the market mechanism that traditional rate regulation has not been able to replicate.

7. To achieve these benefits of a sharing grid, there are certain elements of any alternative rate plan that are absolutely crucial. I agree with the following testimony presented by Mark L. Oligschlaeger of the Staff in a 1997 proceeding before the Commission, Case No. ER-97-394:

> Sliding-scale incentive regulation should be thought of as a surrogate for traditional regulation, in that it can lead to rate changes or the issuance of rate credits to customers without the time and personnel needs of a full-blown traditional rate case, and ideally without the same degree of adversarial relationship between the parties. This requires two things: up-front agreement on how earnings should be calculated for purposes of determinings whether customer sharing is called for, and a high degree of cooperation on discovery so that the Staff and other parties can make their recommendations to the Commission within the truncated time period called for in the past sliding-scale plans used in Missouri....

8. In the UE EARP, this up-front agreement on the calculation of earnings is made unmistakable by the text of the Agreement. Section 3.f.i provides: "The return on common equity for determination of 'sharing' will be calculated by using the methodology set out in Attachment C, Reconciliation Procedure, appended hereto." So as part of the operation of this Plan, after months of detailed negotiations, the parties agreed on a specific "methodology" to calculate earnings, and further set out the actual terms of that methodology – that is, the operation of the agreed-upon methodology – in the Reconciliation Procedure.

9. The Reconciliation Procedure, which is Attachment C to the Agreement, describes the agreed-upon methodology in terms of the calculation and production of an earnings report. The Procedure begins with the Missouri "operating revenues, expenses and average rate base" of UE as of the end of an annual sharing period, which is June 30. These figures, of course, come from UE's books and records. Thus the parties agreed to start the earnings calculation in the most obvious and practical way, with figures that were produced by the accounting methodologies used by UE in its books and records. Of course those accounting methodologies embodied in UE's books and records were not dreamed up by UE for the purposes of the EARP, but are long-established accounting practices that have been shaped not only by the requirements of the accounting profession (set out in the body of generally accepted accounting principles, or "GAAP"), but also by the requirements of this Commission, by FERC through the Uniform System of Accounts (which in large measure follows GAAP), and by the SEC.

10. The parties did not stop with those figures from UE's books and records. Sections 2.c through 2.f of the Reconciliation Procedure set out no fewer than 19 specific adjustments to be made to those base figures from UE's books and records in preparing the earnings report. Equally important are the traditional ratemaking adjustments that were deliberately excluded by the parties, such as the normalization of the effects of weather or of expenses for injuries and damages, and the annualization of the payroll expense. In the end, this agreed-on accounting for UE's earnings was designed to be a simple, mechanical process – almost like filling out a simple, one-page tax return – that did not involve the cost-by-cost fly-specking of traditional ratemaking. This simplicity intended by the parties is obviously reflected in several aspects of the Agreement, such as the target date of September 1, 1998 set not only for the final credit of the first EARP, but also for the permanent rate reduction, a date only two months after the close of the third sharing period.

11. No provision of the Agreement authorizes any party to unilaterally change this methodology of calculating earnings, either by modifying the adjustments that are set out in the Procedure or by adding new adjustments to it. The parties intended the methodology they agreed to and memorialized in the Agreement to be the actual, settled methodology by which the earnings calculations were to be made under the EARP.

12. It is my understanding that Staff witnesses have claimed that other provisions of the Agreement allow the Staff to propose adjustments not set out in the Agreement. In the Reconciliation Procedure itself, Section 2.g allows the parties to petition the Commission "for resolution of disputed issues relating to the operation or

implementation of this Plan." Nearly identically, Section 3.f.vii of the Agreement gives the parties the right to bring to the Commission "issues which cannot be resolved by them, and which are related to the operation or implementation of the Plan." Clearly, a dispute over the operation or implementation of the Plan can be brought to the Commission for resolution. But that is far from saying that a party has the right to ask the Commission to add obligations to the Plan or changes its operation and implementation in any other way. If the parties agreed to give each other the power to seek such a change in their Agreement, why would we have expended the time and resources to set out the terms of an agreement in the first place? As we said above, the operation and implementation of the Plan with respect to the calculation of earnings is precisely set out in the Reconciliation Procedure, and no term of the Agreement says a party can change the steps of the agreed-upon accounting methodology set out in detail there. If, as the Staff now claims, it has the power to seek an additional adjustment not set out in the Reconciliation Procedure, a power nowhere set out in the Agreement, what is to prevent the Staff from a different exercise of the same power, say to propose a change in the levels of the sharing grid?

13. Another provision of the Agreement that has been mischaracterized by the Staff is Section 3.f.viii, which allows the parties to present to the Commission "concerns" they may have over any "category of cost" involved in the earnings calculation that "has not been included previously in any ratemaking proceeding." In understanding this provision, it must be remembered that the parties devoted months to a very detailed consideration and negotiation of the Reconciliation Procedure. In the context of our work on that Procedure, all the parties had access to financial materials of all kinds

concerning UE's operations and cost of service dating back for decades. In short, at the time of the first EARP, we all knew, or could have known, all the categories of costs that were involved in accounting for UE's earnings. The detailed nature of many of the adjustments set out in the Reconciliation Procedure illustrates the care that everyone put into the development of this Procedure. Section 3.f.viii obviously addresses the arrival on the scene of a new category of costs that had not previously affected UE's earnings. By referring to this new category as one that had not previously been "included" in any ratemaking the parties did not mean that the Commission had to have explicitly ruled on or addressed the category. Clearly, the Commission directly addresses only a few of the categories of costs set out in UE's accounting for its cost of services that is included in a ratemaking proceeding. "Included" in a ratemaking here meant presented in the context of a ratemaking so the category of costs was knowable and had been open to challenge previously, whether or not it in fact had been the subject of a dispute. Equally clearly, our use of the notion of a new "category" of costs means that new forms of costs that are really part of an established category were not within the scope of Section 3.f.viii.

14. The fact that the agreed-upon accounting methodology for the earnings calculation was precisely set out in the Agreement, and the Staff does not have the power to propose changes or additional adjustments now, does not in any way suggest that the Staff does not have the full power under Section 3.e of the Agreement to scrutinize all reports and data concerning the earnings calculations, and if necessary submit data requests to UE or ask to interview relevant UE personnel. If UE fails to respond to such monitoring efforts, or if UE, in the judgment of the Staff, has failed to

follow the accounting methodologies set out in the Reconciliation Procedure, the Staff is free to bring such disputes over the operation of the Plan to the Commission for resolution.

15. Finally, I must underscore what we mentioned above: the Staff's positions in this case profoundly threatens the integrity of the regulatory process by which the Commission must fulfill its important duties. Much of that process is not adversarial, but relies on agreements approved or adopted by the Commission. Regardless of the legal aspects of these arrangements, as a practical matter, the Commission's faithfulness to agreements such as the one at issue here, and the corresponding reliances the parties can place on them, are essential if compromise and agreement, as opposed to evidentiary hearings and litigation, are to remain viable and trusted avenues for the regulatory process.

16. I appreciate the opportunity to submit this Statement to the Commission, and sincerely hope the Commission remains faithful to the vision embraced in the UE EARPs.

Respectfully submitted

Kenneth J. Rademan

Kenneth J. Rademan

DATED: May 25, 1999