BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

Case No. ER-83-163 (Remand)

In the matter of Union Electric Company of St. Louis, Missouri, for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the Company.

APPEARANCES: Paul A. Agathen, General Attorney, and Debra H. Janoski, Attorney, Union Electric Company, Post Office Box 149, St. Louis, Missouri 63166, for Union Electric Company.

Robert M. Lee, Associate General Counsel, Laclede Gas Company, 720 Olive Street, St. Louis, Missouri 63101, for Laclede Gas Company.

Robert M. Johnson, Attorney at Law, and George M. Pond, Attorney at Law, 720 Olive Street, Suite 2400, St. Louis, Missouri 63101, for Industrial Intervenors ACF Industries, Inc.; Anheuser-Busch, Inc.; Ford Motor Company; General Motors Corporation; Monsanto Company; Nooter Corporation; PPG Industries, Inc.; Pea Ridge Iron Ore Company; and St. Joe Minerals Corporation.

Michael Madsen, Attorney at Law, Post Office Box 235, Jefferson City, Missouri 65102, for Dundee Cement Company.

Tom Ryan, Attorney at Law, 4144 Lindell Boulevard, St. Louis, Missouri 63108, for Missouri Public Interest Research Group.

Daniel L. Maher, Assistant Public Counsel, Office of Public Counsel, Post Office Box 7800, Jefferson City, Missouri 65102, for the Office of Public Counsel and the public.

William C. Harrelson, General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

REPORT AND ORDER ON REMAND

On December 3, 1982, Union Electric Company of St. Louis, Missouri, submitted to this Commission revised tariffs reflecting increased rates for electric

service provided to customers in the Missouri service area of the company. The proposed tariffs had a proposed effective date of January 2, 1983, and were designed to produce an increase of approximately $122 million or 16 percent in charges for electric service.

By order issued December 23, 1982, the Commission suspended the tariffs until November 2, 1983, and scheduled the matter for hearing.

The following parties intervened in this proceeding: The City of St. Louis; Laclede Gas Company; Rockwood School District; Dundee Cement Company; ACF Industries, Inc.; Anheuser-Busch, Inc.; Ford Motor Company; General Motors Corporation; Mallinckrodt, Inc.; McDonnell Douglas Corporation; Monsanto Company; Nooter Corporation; Pea Ridge Iron Ore Company; PPG Industries, Inc.; St. Joe Minerals Corporation; and Missouri Public Interest Research Group.

By order issued May 25, 1983, the Commission modified the schedule of proceedings, setting the prehearing conference for June 13, 1983, through June 24, 1983, the hearing for July 5 through July 22, 1983, and additional hearings for August 24 and 25, 1983, to address Union Electric Company's Callaway II cancellation costs.

The Commission issued a Report And Order concerning Callaway II cancellation costs on October 21, 1983. In that order the Commission found that Section 393.135, R.S.Mo. 1978, prevented recovery of all Callaway II cancellation costs. Union Electric Company filed an Application For Rehearing which was denied.

An appeal was then taken of the Commission's order. The Circuit Court of Cole County affirmed the Commission and an appeal was taken to the Missouri Supreme Court. On February 26, 1985, the Missouri Supreme Court issued its decision reversing the Commission and remanding the matter for further hearings.

On remand, a prehearing conference was scheduled to explore settlement and to consider the need for further proceedings. Union Electric Company; Laclede Gas Company; Industrial Intervenors: ACF Industries, Inc., Anheuser-Busch, Inc., Ford

Motor Company, General Motors Corporation, Monsanto Company, Nooter Corporation, PPG Industries, Inc., Pea Ridge Iron Ore Company, and St. Joe Minerals Corporation; Dundee Cement Company; Missouri Public Interest Research Group; Office of Public Counsel; and the Commission Staff appeared at the prehearing conference.

On July 12, 1985, a schedule of proceedings was established, with hearings set for October 28 and 29, 1985. On August 16, 1985, the parties participating in the proceedings on remand filed a Stipulation And Statement Of Positions setting out the issues still in dispute. The hearing was held as scheduled on October 28, 1985. The reading of the transcript was not waived. Union Electric Company, Industrial Intervenors, Public Counsel, Missouri Public Interest Research Group and Commission Staff filed briefs.

Findings of Fact

Having considered all of the competent and substantial evidence upon the whole record, the Missouri Public Service Commission makes the following findings of fact.

This matter is before the Commission on remand from the Missouri Supreme Court. The remand involves the treatment of costs associated with the cancellation by Union Electric Company (UE) of its Callaway II nuclear generating station. The Commission had determined originally it was precluded from allowing the recovery of any amount from ratepayers on account of abandoned construction under the provisions of Section 393.135, R.S.Mo. 1978, also referred to as Proposition One. The Missouri Supreme Court held that Proposition One did not preclude recovery for cancellation costs. State ex rel. Union Electric Company v. P.S.C., 687 S.W.2d 162 (Mo. banc 1985). The case was remanded to the Commission for further proceedings.

On remand the parties stipulated to the dollar amounts involved and what additional evidence could be adduced as follows:

(1) The total cost incurred by UE for Callaway II was $131,731,000. This amount includes $51,478,000 (including AFUDC) transferred from Callaway I to Callaway II in Cases No. EO-85-17/ER-85-160. Of the total $131,731,000, approximately $35,497,000 is AFUDC (of which approximately $12,470,000 is the common equity portion).

(2) 80.7 percent of the total of any allowed Callaway II costs shall be allocated to UE's Missouri operations. The allocation factor used is the same used in Cases No. EO-85-17/ER-85-160. Assuming a total cost of $131,731,000, the amount allocated to Missouri would be $106,307,000.

(3) Any additional evidence adduced at the hearing on remand would be limited to evidence relevant to the financial condition of UE; the cost sharing accomplished under the alternative cost recovery recommendations; rate design; and the question of whether the disallowance of AFUDC and the deduction from rate base of the deferred taxes related to AFUDC in effect constitutes a duplication of the same disallowance.

There are three distinct issues presented in this proceeding. First, should UE be allowed to recover all or a portion of the cancellation costs associated with Callaway II. If the Commission determines recovery should be allowed, then a determination must be made of how that recovery should be apportioned between shareholder and ratepayer. The last issue is how the portion of costs assigned to the ratepayers should be recovered from the various customer classes. The Commission will address the recovery issue first since a determination that no recovery is to be allowed will make a discussion of the other issues unnecessary.

TOTAL DISALLOWANCE

UE's Position

UE in this case is not asking that the amounts expended on Callaway II be placed in rate base, but rather that the amounts be treated as expense and recovered over a five-year period. UE is thus seeking a return of its investment, not a return on its investment. UE contends it should recover all expenses of Callaway II which it reasonably and prudently incurred in contemplation of its statutory duty to serve.

UE asserts its position is supported by an overwhelming majority of other jurisdictions who have addressed this issue. Those jurisdictions have held that a utility may recover through amortization costs associated with abandoned plants if it is found that the costs have been prudently incurred. The utility's decision to initiate, continue and cancel the project must have been reasonable and prudent.

UE argues that the "used and useful" standard, which is applied to property allowed in rate base, does not prevent recovery of cancellation costs. The "used and useful" standard has been utilized to determine whether a return should be earned on property used in the public service. UE points out the standard is applied to determine whether utility property will be allowed in rate base, thus permitting the utility to earn a return on its investment in that property as well as a return of its investment.

By seeking to recover the cancellation costs as expenses, UE states, the focus moves from "used and useful" to whether the expenditure was prudent. If prudently made, the utility must be allowed to recover the expense. UE contends that no party has asserted the decision to build and the decision to cancel Callaway II were imprudent; therefore, recovery must be allowed.

UE characterizes Public Counsel's and Missouri Public Interest Research Group's positions on this issue as merely a reassertion of the positions they took during the appeal of the first Commission order. UE contends that a disallowance of cancellation costs based upon the "used and useful" standard violates both the

United States and Missouri constitutions. The disallowance, UE contends, would be confiscatory and thus violate its due process rights under the U.S. Constitution, Amendment XIV, Section 1, and the Missouri Constitution, Article 1, Section 10.

UE points out that although the Missouri Supreme Court in its decision on the Proposition One issue did not specifically declare Proposition One unconstitutional, it recognized there might be constitutional problems if it required a forfeiture of canceled plant costs. UE contends the U.S. Supreme Court has stated that expenditure of a utility cannot constitutionally be ignored for ratemaking purposes unless there is a showing of abuse of discretion by utility management. State of Missouri ex rel. Southwestern Bell Telephone Co. v. P.S.C., 262 U.S. 276, 289, 43 S. Ct. 544 (1923).

Public Counsel's Position

Public Counsel's position is that UE should not be allowed to recover in rates any costs associated with the Callaway II nuclear plant since those costs cannot be tied to any service to be furnished by UE to its ratepayers. Public Counsel asserts that the costs sought to be recovered by UE are for a plant that will provide no service or benefits to the ratepayers. Public Counsel asserts that Sections 393.270.3 and 393.140(5) prohibit the Commission from charging ratepayers for utility expenses which are not associated with "service to be furnished".

Section 393.140 states the Commission shall determine and prescribe just and reasonable rates for the service to be furnished whenever it finds the existing rates are unjust and unreasonable or unduly discriminatory. Sections 393.270.2 and 393.270.3 state the Commission shall determine the maximum price to be charged for service to be furnished. These statutes, Public Counsel contends, prohibit the Commission from assessing ratepayers for expenses not associated with service furnished by the utility. Public Counsel states that since Callaway II will never be

used to furnish service, expenses associated with the canceled plant cannot be recovered from ratepayers.

Public Counsel cites two cases from other jurisdictions to support its position. The Ohio and Indiana Supreme Courts held that costs associated with canceled plants cannot be recovered from ratepayers since there is no connection between the costs and service to customers. Office of Consumers' Council v. Public Utilities Commission of Ohio, 423 N.E.2d 820 (Ohio 1981); Citizens Action Coalition of Indiana, Inc. v. Northern Indiana Public Service Company, Ind. S. Ct. No. 1185 S 470.

Public Counsel argues further that allowance of the cancellation costs would be retroactive ratemaking. Public Counsel contends that the Commission is precluded from altering rates prospectively in order to allow recovery for past expenses which were not recoverable under previously established rates. Public Counsel bases its retroactive ratemaking argument on the decision of the Missouri Supreme Court in State ex rel. Utility Consumers Council of Missouri v. P.S.C., 585 S.W.2d 41 (Mo. banc 1979).

Missouri Public Interest Research Group (MoPIRG)

MoPIRG asserts primarily that the Missouri Supreme Court in its decision on Proposition One did not limit the Commission's discretion for total disallowance of Callaway II costs. MoPIRG states the Supreme Court only decided that Proposition One did not preclude the Commission from allowing recovery for canceled plant costs, and that the Commission should not conclude that the Supreme Court decided UE was entitled to recover some of its Callaway II expenses.

MoPIRG encourages the Commission to adopt the minority view on recovery of cancellation costs. That view, MoPIRG asserts, is based upon a solid regulatory foundation. MoPIRG cites cases from Ohio, Indiana, Montana and Wyoming where no recovery was allowed.

These courts found that the shareholders should bear the risk of a project being canceled. A shift of risk from the shareholder to the ratepayer was found to be unreasonable. These decisions rejected the attempt by the affected utilities to recharacterize as operating expenses costs which would normally be included in rate base if a plant was completed. These decisions held generally that it is improper to shift the risk of a project to the ratepayers when that project is canceled.

MoPIRG further contends that the only time the cost of canceled plant should be shifted to the ratepayers is where a total disallowance would jeopardize the utility's financial position. MoPIRG contends that UE is in no danger of financial collapse, and in fact the evidence of Staff's witness Shackelford was that UE's earnings are up and that UE has recently increased its dividends.

MoPIRG asserts finally that the decision to cancel Callaway II was made to benefit the shareholders. Statements of UE's company officers at the time of cancellation were to that effect. MoPIRG argues that the decision to cancel should be viewed based upon the information known to UE at that time. That information, MoPIRG contends, shows cancellation would cost ratepayers $547 million more in added fuel costs.

Commission Staff

Staff's initial brief focused on the Missouri Supreme Court's decision on Proposition One and the precedent for cost sharing between shareholder and ratepayer. Staff presented the Supreme Court decision as establishing four points:

(1) Section 393.135 does not prohibit recovery of canceled plant costs;

(2) there is an established practice of allowing cancellation costs;

(3) recovery of all or any part of the cancellation costs is not mandated but within the proper exercise of the Commission's ratemaking authority; and

(4) the constitutional issues presented remain undecided.

Staff discussed points (2) through (4) in its brief. Its position as to point (2) is that there is sound precedent for cost sharing. Staff asserts that under point (3) the Commission could totally disallow all costs associated with Callaway II. Staff, though, states the Supreme Court's decision might indicate a total disallowance is unreasonable. Staff recommends the recovery of cancellation costs through disallowance of AFUDC and amortization. Staff recommends the disallowance "of the utility's entire cost of capital attributable to both the precancellation period (AFUDC) and the period of amortization." Staff recommends a 20-year amortization period and rate base offset for deferred taxes. Although Staff's recommended amortization period and treatment of AFUDC and deferred taxes would result in a greater disallowance than total disallowance, Staff presents its position as cost sharing rather than total disallowance. As to point (4), Staff states it believes cost sharing is constitutional.

Industrial Intervenors

Industrial Intervenors did not take a position on the total disallowance issue.

Discussion

In 1975 the Commission authorized UE to begin construction of two nuclear generating stations which became known as Callaway I and Callaway II. UE had decided to build two generating plants to meet its estimated load growth. The two plants were planned and designed to be built together, using the same design. The two plants were to share certain costs and thus, UE asserted, reduce the overall costs for the two plants.

Callaway I became operational under Commission criteria in December 1984. In Cases Nos. EO-85-17/ER-85-160 UE sought to include $2,403,446,000 (Missouri jurisdictional) in rate base for Callaway I. In its Report And Order the Commission

reduced UE's rate base request by $384 million. 27 Mo. P.S.C. (N.S.) 183, 199 (1985). Based upon its decision in EO-85-17/ER-85-160, the Commission authorized UE to increase gross revenues, exclusive of gross receipts and franchise taxes, by approximately $454,809,000 on an annual basis. The Commission authorized UE to phase in this rate increase over an eight-year period, thus reducing the yearly impact but resulting in a total increase after eight years of $652,382,000. This was a one-time increase of approximately 45 percent and a 66 percent increase in rates over the eight-year phase-in. Id., p. 318.

Callaway II was canceled by UE in October 1981. UE requested as part of this rate case filing to recover the cancellation costs of Callaway II. These costs have now been stipulated to as $106,307,000, Missouri jurisdictional. The Commission is now faced with consideration of whether UE should be allowed to recover any of this amount associated with Callaway II from UE ratepayers.

Regulation and ratemaking is a balancing process. Although there are some general guidelines and restrictions placed on a regulatory body's discretion concerning rates, that discretion is very broad within those parameters. The determination of utility rates focuses primarily on four factors. These factors are the rate base upon which a return may be earned, the rate of return the utility has an opportunity to earn, the depreciation costs of plant and equipment, and allowable operating expenses. 34 Hastings L.J. 1133 (1983). The revenue allowed a utility is the total of approved operating expenses plus a reasonable rate of return on the rate base. The rate of return is calculated by applying a rate of return to the cost of property less depreciation. The property upon which a rate of return can be earned must be utilized by the utility to provide service to the utility's customers. That is, it must be "used and useful". The used and useful concept presents a well-defined concept for determining what properties will be allowed into rate base. Once it has been decided that facilities are not necessary for the provision of service to

customers, those facilities cannot be included in rate base. Hastings L.J., supra, 1149.

There is no question in this case that Callaway II was canceled and therefore was not used to provide service to UE's customers. UE has not sought to include the cancellation costs of Callaway II into its rate base. The Commission therefore finds that Callaway II is not "used and useful" for service and the costs associated with Callaway II are not includable in rate base.

UE has sought to recover the cancellation costs as expenses. UE has proposed an amortization of the costs over five years with no recovery of AFUDC from the date the plant was canceled. The Commission must consider whether the cancellation costs are properly includable as expenses.

Recoverable expenses are usually those which are prudently made during an approved test year. These expenses are operating expenses. Operating expenses include salaries and wages, maintenance costs and taxes and other test year expenses. Appeal of Public Service Co. of New Hampshire, 480 A.2d 20 (N.H. 1984). Operating expenses are those expenditures of a public utility which are incurred to provide service. One factor in the determination of just and reasonable rates is historical test year expenditures. The public utility's rates in Missouri are set prospectively based upon the test year experience. Operating expenditures of the public utility are reviewed to determine if they were just and reasonable and properly chargeable to the ratepayer and thus recoverable. The Commission has the discretion to disallow operating expenditures which it finds are unjust or unreasonable or which are not necessary to provide service.

Utilities also attempt to recover expenses which are not recurring operating expenses and which may not fall within the approved test year. One type of nonrecurring expense is costs associated with extraordinary losses. It is permissible under public utility regulation, and this Commission has authorized, the recovery of costs associated with extraordinary losses to property and plant.

Suelflow, Public Utility Accounting: Theory and Application, Michigan State University (1973). This has occurred when plant, already used and useful, ceases to provide service to ratepayers through some extraordinary event. This recovery is usually allowed because it is associated with plant which has been used to provide service.

Since cancellation costs are not associated with plant which was used and useful, they present a different aspect of a public utility's operations. In Missouri after Proposition One, the investment, expenses and other costs associated with building a power plant were to be recovered only after the plant went into service. When that plant is canceled, those costs can no longer be recovered as a rate base adjustment since the plant will never be "used and useful" in providing service to the ratepayers.

Since the costs of canceled plant are not allowed into rate base, utilities have attempted to recover the costs associated with canceled plant by characterizing those costs as expenses. The utilities, and UE in this case, have sought to have these cancellation costs treated in the same manner as normal operating expenses. The Commission does not believe cancellation costs should be treated the same as normal operating expenses. Cancellation costs are extraordinary and recovery should be decided separately from normal operating expenses.

Some state courts have held that cancellation costs are not even recoverable as expenses. A Wyoming court held that investment and expenses on property which would normally qualify as used and useful for inclusion in rate base could not be recovered as operating expenses. Pacific Power & Light Company v. P.S.C. Wyoming, 677 P.2d 799, 805 (Wyo. 1984). The court cited 73B C.J.S. Public Utilities Section 36, p. 364, to show what was includable as operating expenses. The court concluded that the public utility would not have contended the cancellation costs were operating expenses if the plants had gone into service, and should not be allowed to do so once the plants were canceled.

The Ohio Supreme Court dealt with the issue of canceled plant costs. That court held that operating expenses were normal, recurring expenses incurred by the public utility in providing service. Office of Consumers' Council v. Public Utilities Commission of Ohio, 423 N.E.2d 820 (Ohio 1981). The court listed the types of expenses that were includable as operating expenses and then characterized the cancellation costs as an extraordinary loss. The extraordinary loss, the court said, could not be transformed into ordinary expense.

An Indiana appeals court went through a similar analysis. The public utility had sought to recover the cancellation costs as future expenses. The court held that the expenses were to replenish capital, which is an obligation of the stockholders. The court said if the expenses were recoverable, they were recoverable when made and old losses could not be recovered through future rates. Citizens Action Coalition of Indiana, Inc. v. Northern Indiana Public Service Co., Inc., 472 N.E.2d 938, 947 (In App. 2 Dist. 1984). The Indiana Supreme Court affirmed the appeals court's decision. Ind. S. Ct. No. 1185 S 470.

The Commission approves of the reasoning of the courts which have denied recovery of cancellation costs as expenses, but does not believe a strict standard is applicable. The Commission believes cancellation costs should be treated similarly to extraordinary losses. The Commission, though, believes that a utility has a greater burden to justify cancellation costs than extraordinary losses, because cancellation costs are not associated with used and useful property. Each fact situation will present different considerations, and the Commission believes it should weigh those considerations on a case-by-case basis.

The Minnesota Supreme Court discussed the principle of law in that state concerning extraordinary losses due to obsolescence. Minneapolis Street R. Co. v. City of Minneapolis, 86 N.W.2d 657 (Minn. 1957), 22 P.U.R.3d 223, 233. The court stated there was a twofold test:

> First, the future consumer may not be charged for obsolescence through any method of accounting unless the investor has suffered

> an actual loss by not having fully recovered prudently invested funds. Secondly, even if such loss has occurred, it is unreasonable to charge the consumer if the investor has been compensated for assuming the risk of obsolescence.

The Commission believes similar considerations should be addressed in viewing cancellation costs.

The Commission does not believe that Sections 393.270.3 or 393.140(5) prevent the recovery of these cancellation costs. The Commission considers the sections cited by Public Counsel indicate only that the Commission shall set rates for the "service to be furnished". These sections do not address the recovery or nonrecovery of expenses by the utility.

The Commission has been granted broad discretion by the legislature in setting just and reasonable rates. U.C.C.M., supra. The Commission considers its analysis and proposed treatment of cancellation costs in this case to be well within the general regulatory scheme as discussed by the New Hampshire court in Appeal of Public Service Co. of New Hampshire, supra, and cited favorably by the Missouri Supreme Court. Union Electric Company v. P.S.C., supra, p. 165. The New Hampshire court disallowed recovery of cancellation costs. The disallowance was based upon a New Hampshire statute and so the case was distinguished from Proposition One by the Missouri Supreme Court. The general discussion of the regulatory process, though, is still applicable to Missouri.

The New Hampshire court stated that state commissions regulate rates by controlling several variables. Those variables are operating expenses, rate base and rate or percentage of return allowed on the rate base. The Commission believes that expenses such as cancellation costs do not fall within these variables. Since these expenses fall outside the normal variables for regulating costs, the Commission believes it has more discretion whether to allow a company to recover the expenses in rates. The Commission reached the same conclusion regarding the cancellation costs of UE's Rush Island 3 and 4. 22 Mo. P.S.C. (N.S.) 6, 25. There, the Commission characterized the expenses as "extraordinary expenses". The Commission allowed

recovery of Rush Island 3 and 4, but indicated it might treat this issue differently in the future.

The threshold determination of whether any expense, whether extraordinary or not, is recoverable is whether the expense and investment were prudently incurred. For operating expenses this determination is usually sufficient to allow recovery. There are operating expenses which are not allowed even though they may be said to be prudently incurred. The disallowance of these operating expenditures is based upon the finding that they were not made for the benefit of the ratepayer. Thus, even for normal operating expenses prudency is not the only criterion for recovery. Since cancellation costs are not normal operating expenses, they should be even more closely scrutinized to determine if they should be recovered.

The Commission must look at several factors in determining whether to allow recovery of cancellation costs. The factors which are of primary concern are how allowance or disallowance will affect the utility and what effect the possible increased rates will have on the ratepayer. The first factor to address is, who bears the initial risk of cancellation costs. Many jurisdictions have felt this is a shared risk. (The Commission, though, wonders if the risk-sharing allowed by some courts was more a reflection of the balancing of a utility's financial position against increased rates rather than an analysis of the proper treatment of the costs.)

The utility makes the initial decision to build plant. Part of that calculation is the risk of cancellation. The utility seeks investment based upon an analysis of the profit and risk involved in the project. The reasonable investor examines the potential profit and potential risk and acts accordingly. Part of the potential profit to the investor is the reasonable certainty that a completed plant will be placed in rate base and both the investment and a return on investment will be recovered from the ratepayers. Part of the potential risk is that the plant may

not be completed and therefore all or a portion of the investment may not be recovered through rates.

It can be seen from this analysis that the initial risk of cancellation is borne by the investor stockholder. If this were not true and a stockholder could be assured a return of his investment whether the plant was canceled or not, it would make the investment practically risk-free. The experience of UE in obtaining financing for its Callaway plants indicates the investors did not consider the investment risk-free.

The next factor to examine is the effect of nonrecovery on the utility and therefore on the stockholder. Here, the Commission must examine the financial history of the utility and its current financial position. It could be argued in this case that only the financial position of the utility at the time the recovery was sought should be considered. The Commission cannot agree. The rates to be placed into effect will be prospective and one element in the reasonable determination of those rates is a utility's current financial position.

MoPIRG has argued that UE's stockholders have been compensated for the risk of cancellation through the rate of return allowed UE by the Commission since the inception of the project. The Commission agrees that stockholders and other investors have received some compensation for their risk through the rate of return allowed by the Commission. In ER-77-154 the Commission authorized a return on common equity of 13.1 percent. 22 Mo. P.S.C. (N.S.) 6, 24. The Commission authorized the return on common equity based upon the discounted cash flow (DCF) method. The risk of a stock is an element of the DCF calculation.

The Commission has utilized the DCF method for determining the required return on common equity for UE in subsequent cases where the issue was not resolved through a stipulation. In ER-82-52 the Commission authorized a return on equity of 15.62 percent. The Report And Order in ER-82-52 was issued July 2, 1982. The decision to cancel Callaway II occurred after the filing in ER-82-52. In ER-81-180

and this case (non-Callaway II issues) UE stipulated to a total dollar amount, so no calculation of a return on equity was decided. The Commission considers that the stipulated amounts included a reasonable return on equity or the issue would have been litigated.

Based upon the use of the DCF method for determining the return on equity, the Commission finds that stockholders have received some compensation for the risk of their investment in UE which includes the risk of cancellation of the nuclear projects. The rate of return cannot be apportioned between the construction of the nuclear plants and the remainder of UE's operations but, in turn, the investor did not invest just in the Callaway nuclear plants, but invested in the entire company. This reinforces the need to look at the entire company when deciding whether to allow recovery of cancellation costs.

UE witness Birdsong explains the DCF return as the rate at which investors are discounting the future dollars they expect to receive from holding UE's stock. (Exhibit 5, p. 14). Birdsong states the investors' expected cash flow is discounted to reflect the time value of money and the riskiness of the cash flow. The risk is the likelihood of expected dividend yields and the growth rate of the dividend.

Birdsong's Schedule 3 shows that UE's dividends for 1981 were $1.52; for 1982, $1.58; for 1983, $1.64 (annualized); and projected the dividend for 1984 at $1.70 and for 1985, $1.85. This included a projected increase in dividends by 3 cents in July 1984. UE increased its quarterly common dividend in July 1985 by 3 cents, which increased the annual dividend from $1.72 to $1.84. (Shackelford, Exhibit 7 on remand). These increases indicate that UE has continued to pay its dividends as projected and without the $106,307,000 requested for Callaway II.

Shackelford indicated that UE's current long term debt rating has been upgraded by both Standard & Poor's Corporation and Moody's Investors Service. These upgrades, Shackelford indicates, are due to the rate increases authorized in EO-85-17/ER-85-160. These are UE's highest ratings since 1980. UE's common stock is

also trading at a market to book ratio higher than at any period since 1977. UE's earnings per share have also increased and its return on equity as of August 2, 1985, is above that return authorized. The Company has benefited from the shift from a noncash income (AFUDC) statement to a cash income statement because of the nuclear project, which has now been recognized in rates.

This evidence indicates that UE is currently enjoying the benefits of its completed construction. These benefits are inuring to the shareholders and indicate the reduced risk perceived by the shareholder of the company's operations. It can be said that the shareholders have been rewarded for their investment and compensated for the risk they incurred. Thus, the investment risk in the two nuclear plants has been rewarded.

Compare these results to what has happened to the ratepayer. The ratepayer received approximately a 9 percent increase in ER-82-52. The order was issued July 2, 1982. In the stipulated portion of this case the ratepayer received approximately a 4.14 percent increase in rates. In Case No. ER-84-168 the Commission approved approximately a 2 percent increase. In EO-85-17/ER-85-160 rates were increased approximately 45 percent on a one-time basis. The 45 percent increase was phased in over eight years and will eventually be a 66 percent increase because of carrying costs associated with the phase-in. As of April 9, 1986, UE's rates will have increased approximately 39.3 percent since 1982, including the first two years of the phase-in period. The phase-in does not preclude UE from filing for additional rate increases during the eight-year period. The recovery of the Callaway II cancellation costs would increase rates approximately another 10 percent on a one-time basis.

Based upon the above discussion, the Commission finds that there should be no allowance of the costs associated with Callaway II. UE planned the two nuclear power plants as a single project and proceeded with the construction. The increased costs of the project and the eventual cancellation of Callaway II were risks taken

into account by stockholders in investing in UE. Those risks were partially compensated for by the rate of return authorized by the Commission. The completion of Callaway I and the resulting improvement in the financial position of UE has compensated the stockholders for their investments.

The Commission finds that it would not be just and reasonable to allow an additional increase in the rates charged UE's customers when the customers are already paying for the nuclear project. To allow this recovery, the Commission believes, would be a windfall to stockholders and would send the wrong investment signals to investors since there would be no perceived or actual risk to investors. The balancing of UE's need for the recovery versus the effect on the ratepayer clearly indicates the increased rates associated with recovery would be unjust and unreasonable.

UE argues that total disallowance is not within the Commission's discretion. UE argues that expenditures of a utility cannot constitutionally be ignored for ratemaking purposes unless there is a showing of abuse of discretion by utility management. UE's position is that once it is determined an investment was prudently made, the utility may recover the investment through rates. UE cites State of Missouri ex rel. Southwestern Bell Telephone Company v. P.S.C., 262 U.S. 276, 289, 43 S. Ct. 544 (1923), for this proposition. The Commission does not agree.

The Southwestern Bell case did not deal with cancellation costs and was, in fact, a case in the line of cases which applied the fair value concept to a utility's rate base. The holding in Southwestern Bell referenced by UE involves the disallowance of rents paid by Southwestern Bell for equipment and services. The court found that there was no evidence of bad faith on the part of Southwestern Bell's managers and thus the expenses should be allowed. The general rule cited by the U.S. Supreme Court states that a commission cannot ignore items charged as an operating expense unless there is an abuse of discretion. The court cites State Public Utilities Commission ex rel. Springfield v. Springfield Gas & Electric Co., 125 N.E. 891, 901.

This general rule is not applicable to cancellation costs since cancellation costs are not normal operating expenses.

UE has also cited Justice Brandeis's concurring opinion in the Southwestern Bell case where Justice Brandeis states the "thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the federal constitution guarantees to the utility the opportunity to earn a fair return.", 43 S. Ct. 547, supra. Justice Brandeis's position has never been adopted by a majority of the Supreme Court. It should be noted that in a footnote to this statement, Justice Brandeis recognizes that there is a balancing of the opportunity of a fair return guaranteed a public utility against rates that may be prohibitive, exorbitant or unduly burdensome to the public. 43 S. Ct. 547 n. 2, supra.

UE also argues that the Missouri Supreme Court in the Proposition One decision implicitly indicated that the Commission must allow the expenses if they were prudently made. UE cites several passages from the Proposition One decision to support its position. At 687 S.W.2d, p. 166, the court states: "There is a limit to the [Commission's] regulatory power. Rates established by the Commission must not be confiscatory. The utility must be able to recover its proper expenses and also a reasonable return on its prudent investment." This, UE argues, is a clear indication that prudently incurred expenses must be recovered or it is confiscatory.

The Commission does not believe this statement by the court supports UE's position. The statement follows a discussion of the general regulatory process. In the quoted statement, the Commission believes the court was merely indicating the limits of Commission authority, i.e., that rates may not be confiscatory, and restating the general rule that a public utility may recover prudent operating expenses and a fair rate of return on rate base. There is no attempt by the court to discuss the complexities of the cancellation costs issue. In fact, the court goes on to say in the same paragraph: "The Commission has the corollary authority to scrutinize the

expenditures of public utilities to determine whether they are appropriate in the rendition of utility services." 687 S.W.2d 166, supra. Thus, the Missouri Supreme Court recognizes the discretion of the Commission in setting just and reasonable rates.

UE argues further that the court limited the factual circumstances which would justify disallowance. UE contends the court limited the factual considerations to the prudence of the expenditures for Callaway II, the prudence of its abandonment, the accuracy of cost estimates, and the possibility of salvage value or retrieval, along with "other factors which are appropriate in a rate case". 687 S.W.2d, p. 168, supra. The only factors, UE contends, under which total disallowance would be available in this case would be "other factors which are appropriate in a rate case". UE argues "other factors" can only include factors similar to those specifically described. UE contends total disallowance is not a factor similar to those described, and the court would have made specific mention of total disallowance if the court had left that option available to the Commission.

Again, the Commission cannot agree with UE's interpretation of the language of the Missouri Supreme Court. The paragraph which contains the factors cited by UE also contains the statement that "[o]ur conclusion by no means dictates the allowance of Union Electric's claims, or even of any part of them." 687 S.W.2d 168, supra. This is the lead sentence of the paragraph and the Commission believes this statement indicates that "other factors" does include the possibility of total disallowance.

UE's final argument against total disallowance is that it would constitute a confiscation of shareholders' investment without due process of law, and the taking of property for public use without just compensation, in violation of the United States and Missouri constitutions. U.S. Const. amend. V and XIV, sec. 1, and Mo. Const. art. 1, sec. 10 and 26. UE argues that although the court did not address the constitutional questions directly, it did indicate total disallowance would raise serious constitutional questions.

The court indicated that constitutional problems were raised any time a utility is totally unable to recover a prudent expenditure made in good faith. The Commission agrees that those circumstances could raise the question of confiscation. The Commission, though, does not read the court's decision to prevent total disallowance by the Commission on a constitutional basis.

The court's language comes within the context of a statute (Proposition One) which would arguably have required total disallowance. The Commission interpreted Proposition One to require total disallowance. The court's comments on constitutional problems were with reference to the Commission's interpretation of Proposition One as requiring total disallowance. The court found Proposition One did not require that result and that if it did, then constitutional problems would arise. However, the court did not state that total disallowance was inherently unconstitutional.

The Commission believes a decision that disallows recovery of cancellation costs based upon the circumstances of a particular case does not present the same constitutional questions raised by Proposition One. The Commission also has considered Staff and Public Counsel's arguments concerning this issue. Staff in its brief before the Supreme Court in the Proposition One appeal and Public Counsel in its brief on remand in this case adequately address the issue of the violation of UE's due process rights and taking property without just compensation. Based upon the discussion in those briefs, the Commission concludes that this result does not violate UE's constitutional rights.

Conclusions of Law

The Missouri Public Service Commission has reached the following conclusions of law.

The Commission has jurisdiction over the matters at issue in this case pursuant to a remand from the Missouri Supreme Court. State ex rel. Union Electric

Company v. P.S.C., 687 S.W.2d 162 (Mo. banc 1985). The court remanded the issue of whether to allow the recovery of cancellation costs associated with Callaway II. The Commission had original jurisdiction over the matter pursuant to Chapters 386 and 393, R.S.Mo. 1978. UE is a public utility subject to Commission jurisdiction under those chapters.

The burden of proof of showing that proposed increased rates are just and reasonable is on the utility. The Commission must consider all facts which, in its judgment, have any bearing on a proper determination of the rates to be charged. In this case the question was the proper treatment of costs associated with Callaway II. Based upon the record, the Commission determined that there should be no recovery. The Commission concludes, based upon that determination, that the cancellation costs associated with Callaway II should not be placed in rates.

It is, therefore,

ORDERED: 1. That the $106,307,000 associated with the cancellation costs of Callaway II are not a just and reasonable expense to be placed in rates and charged to ratepayers.

ORDERED: 2. That any objection not previously ruled on is hereby overruled.

ORDERED: 3. That this Report And Order On Remand shall become effective on the 8th day of April, 1986.

BY THE COMMISSION

(S E A L)

Harvey G. Hubbs
Secretary

Steinmeier, Chm., Musgrave,
Mueller and Hendren, CC., Concur
and certify compliance with the
provisions of Section 536.080,
R.S.Mo. 1978.
Fischer, C., Not Participating.

Dated at Jefferson City, Missouri,
on this 28th day of March, 1986.