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January 31, 2001

VIA FEDERAL EXPRESS

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Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

Ameren

Re: Case No. EM-96-149 – In the Matter of the Monitoring of the Application of Union Electric Company for an Order Authorizing: (1) Certain Merger Transactions Involving Union Electric Company; (2) The Transfer of Certain Assets, Real Estate, Leased Property, Easements, and Contractual Agreements to Central Illinois Public Service Company; and (3) In Connection Therewith, Certain Other Related Transactions.

Dear Mr. Roberts:

Enclosed please find for filing an original and nine copies of Union Electric Company's filing pursuant to Section 7g of the Stipulation and Agreement, dated July 12, 1996, and approved by the Commission by Report and Order, issued February 21, 1997 in the above styled case.

This filing includes a pleading entitled "Recommendations of Union Electric Company Concerning the Continuation of the EARP", and an attached document, entitled "White Paper on Incentive Regulation: Assessing Union Electric's Experimental Alternative Regulation Plan." Both documents are to be considered Union Electric Company's filing in compliance with section 7g.

Kindly acknowledge receipt and filing of these documents by date stamping the extra copy of this cover letter, and returning it to me in the enclosed stamped envelope.

Sincerely yours,

James J. Cook
Managing Associate General Counsel

Enclosure
Cc: Counsel of Record

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CASE NO. EM-96-149
Verified: January 31, 2001

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the list this 31st day of January 2001.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Monitoring of the Application of Union Electric Company for an Order Authorizing: (1) Certain Merger Transactions Involving Union Electric Company; (2) The Transfer of Certain Assets, Real Estate, Leased Property, Easements, and Contractual Agreements to Central Illinois Public Service Company; and (3) In Connection Therewith, Certain Other Related Transactions	Case No. EM-96-149

RECOMMENDATIONS OF UNION ELECTRIC COMPANY CONCERNING THE CONTINUATION OF THE EARP

PRELIMINARY STATEMENT

Pursuant to section 7.g of the second experimental alternative regulation plan ("EARP"), AmerenUE ("UE") respectfully submits these Recommendations and the attached *White Paper on Incentive Regulation: Assessing Union Electric's Experimental Alternative Regulation Plan* (the "*White Paper*") prepared by the Brattle Group and Prof. David Sappington. Under section 7.g, the signatories to the EARP are to submit "recommendations with the Commission as to whether the [EARP] should be continued as is, continued with changes (including new rates, if recommended) or discontinued." EARP, § 7.g. Though the Commission cannot order a continuation of the EARP, it can agree with UE and the other non-governmental signatories to such a continuation. We believe that, when all the dimensions of the Commission's political and regulatory responsibility for the safe, reliable, and efficient provision of electricity to the residents of Missouri are thoroughly considered, the most prudent course in the best interest of all Missourians is clear: the EARP should be continued with some changes. To do otherwise would truly be to snatch a sizable defeat from the jaws of victory.

Based on their response to our discovery, we anticipate that the Staff will urge the Commission to take an extraordinarily cramped view of this matter, focusing simply on UE and its economic health at this moment. Even with such an arbitrary narrowing of the Commission's vision, a fair consideration of the facts shows that the EARP has been a great benefit to UE and its customers. But if the Commission adopts the Staff's narrow perspective, it does so at its – and indeed all of our – peril. The events in California in recent weeks serve to underscore once again the danger of failing to take the long view, the danger of failing to account for the explosion of competition in the wholesale market ignited by FERC, and the danger of maintaining an outdated regulatory micromanagement that simply cannot pilot a utility through the rapid metamorphosis of electric power generation, transmission, and distribution in our country.

We engaged the Brattle Group, a prestigious economic consulting firm headquartered in Cambridge, Massachusetts, and Prof. David Sappington, one of the nation's leading scholars of incentive regulation, to prepare the *White Paper* because we are acutely aware of the need for the Commission to have a broad perspective in evaluating the future course of electric power regulation in Missouri, and hope that the information provided by these leading lights in the field will illuminate the Commission's consideration of the relevant issues.

In sum, we believe that, upon reviewing the record of the last five years in Missouri and neighboring states, it becomes apparent that the continuation of the EARP (with certain changes) is the most sensible course to meet the future challenges of providing electric power to Missouri:

- ✓ The EARP has delivered over $400 million in direct benefits to UE's customers in the form of rate reductions and credits, with no reliable evidence that cost-of-service regulation could have delivered such benefits in a

comparable time.

- ✓ Average rates of UE's customers were 4.8 percent *lower* in 1999 than they were in 1994, before the EARP was implemented, while average rates of electric utilities in the West-North-Central Region[1] over the same time *increased* by 0.5 percent and those in the East-North-Central Region[2] decreased by only 2.3 percent.

- ✓ The EARP induced a reduction in UE's cost of service, while traditional cost-of-service regulation would have only *penalized* such a reduction.

- ✓ Under the EARP UE maintained its perceived quality of service, which has long been well above the national average.

- ✓ Unlike cost-of-service regulation, under which a utility is regulated based on retrospective portrayals of its economic health, frozen in time and often outdated as soon as new rates are set, the EARP provides a dynamic, future-oriented regulatory mechanism that allows management to creatively and efficiently plan for the challenges that will be confronting UE, especially its needs for increased capacity.

- ✓ Forms of incentive or performance-based regulation ("PBR") for electric utilities like the EARP are in place in 16 states, and the favorable opinion of regulators familiar with it, along with its even more well-established use in telecommunications regulation, strongly suggests widespread support for PBR. As FERC has put it, "we believe that PBR, especially if accompanied by explicit and well-designed incentives, may provide significant benefits over traditional forms of cost-of-service regulation."[3]

- ✓ A new EARP should take advantage of the lessons learned during the first two EARPs. Ambiguities in the calculation of UE's ROE should be clarified; procedures for resolving disputes should be simplified; and provisions should be added for the prompt payment of undisputed credit amounts, with interest paid on disputed amounts, when there are disputes. A reasonable one-time credit and permanent rate reduction should also be part of a new EARP.

- ✓ In an era when an increasing number of average Americans have been able to become investors and participate in the growth of our economy, the EARP made UE's customers participants in its profitability, expanding the class of true stakeholders in this enterprise to Missourians who might otherwise never have an opportunity to invest.

- ✓ UE's risks, its opportunity to profitably reduce its costs, and its general operating environment -- and so its cost of capital -- are fundamentally

[1] This region includes all utilities in Iowa, Kansas, Minnesota, Missouri, and South and North Dakota.
[2] This region includes all utilities in Illinois, Indiana, Michigan, Ohio, and Wisconsin.
[3] FERC, *Order 2000* at 538, quoted in *White Paper* at 27.

different under the EARP than under traditional cost-of-service regulation. Accordingly, transitioning back to a traditional cost-of service regime will raise a range of complicated and time-consuming rate-setting issues, many of which will have constitutional dimensions. Adopting a new EARP will avoid such thorny and costly issues.

DISCUSSION

The *White Paper* sets out in some detail the specific benefits of the EARP, explaining why performance-based or incentive regulation like the EARP produces such benefits. Such results, in turn, explain why incentive regulation has a long history in telecommunications – more than 40 states use incentive regulation to govern the operations of local exchange carriers – and regulators are increasingly using incentive regulation with respect to the electric power industry. Accordingly, in setting out our recommendations, we will echo the basic points made in the *White Paper*, but not fully reiterate them here.

It seems to us that the common sense of the issue of whether the EARP should be continued rests on two essential questions. First, what did the EARP do, and was that good or bad? And second, compared to what? This second question is important because no regulatory structure is perfect, and failing to continue the EARP means that some other structure will be used with its own distinctive problems, most probably traditional cost-of-service regulation. (Indeed, in preparation for the filing of their recommendations, over the last number of months the Staff has been undertaking a kind of cost-of-service audit of UE.) In making this comparison to cost-of-service regulation, it is important to consider not only the outcome that such an approach can achieve, but also the time and costs of getting to that outcome.

I. Under the EARP, UE's Customers Enjoyed Greater Reductions in Average Electricity Rates Than Customers of Other Midwest Utilities.

The direct dollar benefits of the EARP to UE's customers are simply indisputable. The average rates of UE's customers in 1999 were 4.8 percent lower than the average rates they paid before the EARP was implemented. *See White Paper* at 40-41. During the same time period, 1994-99, the average rates of all utilities in Iowa, Kansas, Minnesota, Missouri, South Dakota, and North Dakota (the West-North-Central Census Region) *increased* by 0.5 percent. *Id.* at 40. The average rates of utilities in Illinois, Indiana, Michigan, Ohio, and Wisconsin (the East-North-Central Census Region) for the same period decreased by only 2.3 percent. The significance of this unmistakably superior record is underscored by the fact that this decline in average rates was accomplished through rate reductions and sharing credits – totaling savings of over $400 million over the six years of the two EARPs – accomplished without the high transaction costs of a fully litigated rate case. *See id.* at 38-39. This performance by UE suggests that bills to its Missouri customers may have already declined by between *$50 million to $100 million per year more* than they would have had UE achieved only the average rate reductions of other Midwest utilities.

Equally importantly, these rate reductions were achieved in a regulatory context that did not discourage, but affirmatively encouraged, UE to take steps to further improve its profitability; that is, the EARP produced a win-win situation for UE and its customers. As a result, the EARP resulted in increased earnings for UE even while its rates were reduced, an earnings increase in which UE's customers also participated through sharing

credits totalling, through the Fifth Sharing Period, $156 million (by UE's calculation). *See id.* at 39.[4]

These very obvious benefits of the EARP, practically speaking, pose a high threshold for a political or regulatory judgment that urges abandoning the EARP at the height of its success. This is not to say that the EARP could not be improved, but whatever flaws one might perceive in the EARP, they are, compared to the bottom-line performance of the EARP, modest procedural issues that could be resolved by reasonable compromise of the interested parties. The "Compared to what?" question now comes squarely to the forefront. Surely those who would counsel the Commission to return to traditional cost-of-service ratemaking – hardly a flawless regulatory mechanism itself -- bear a heavy burden to justify such a radical break with the successes achieved in the last five years. This, they cannot do, since cost-of-service regulation cannot produce such results.

II. Traditional Cost-of-Service Regulation Simply Does Not Offer the Advantages of the EARP as a Regulatory Mechanism.

Based on the performance of other Midwest utilities, UE's extraordinary performance over the last five years cannot be seen as a matter of luck, or of general economic conditions, or even of the singular brilliance of UE's top executives. Rather, the distinctive attribute of the Commission's regulation of UE over that period is the EARP. The EARP, as a form of PBR, represents a measured combination of regulatory control and market-like incentives. The advantages of PBR (like the EARP) over traditional cost-of-service regulation are well-recognized, including superior performance

[4] There are other financial benefits growing out of the EARP that are less certain, because they involved UE abandoning efforts to seek recovery of amounts to which it believed it was entitled, as opposed to absolutely fixed sums, but these benefits cannot be completely discounted on that account. Included in this category is UE's agreement not to seek recovery of the $232 million premium from its merger with

incentives, improved rate predictability, more timely consumer benefits, lower administrative/regulatory costs, and greater compatibility with a rapidly changing industry. *See White Paper* at 9-12. As a result, a growing body of empirical evidence clearly points to a link between PBR and lower prices and higher earnings, with no reduction in service quality. *See, e.g., id.* at 30. Not only can no comparable advantages be identified in cost-of-service regulation, that regulatory model is affirmatively at war with these positive results of PBR, for it penalizes cost reductions with revenue reductions, while encouraging over-investment in plant and equipment (which raise costs and so raise revenue). *See id.* at 9.

Moreover, because cost-of-service ratemaking is, by definition, a static process, examining an artificially derived "test year" to make, by command of a public service commission, what was into what should be, the "cost-of-service" determined in such proceedings is often outdated by the time the new rate comes into effect, requiring yet another cycle of cost-of-service studies, ratemaking, and litigation. Such a rigid regulatory scheme, lurching from one off-the-mark result to another, does not make for a flexible regulatory structure that permits a utility to address unforeseen costs that may arise, or to rationally adjust its investment policies to deal with its developing needs for capacity. *See id.* at 7 n.18, and at 34, 43 (discussing pass-through provisions).

The view of the California Public Utility Commission fairly captures the judgment of regulators familiar with PBR:

> Existing cost-of-service regulation has become too complex and difficult in many ways to allow us to regulate the utilities properly in this fast-moving industry. Our goal is to have an improved regulatory process that offers flexibility and encourages utilities to focus on their performance, reduce operational cost, increase service quality, and improve productivity. At the

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CIPSCO and UE's abandonment of its proposal that its shareholders receive half the approximately $760 million in merger-related savings.

> same time, we must ensure that safety, quality of service, and reliability are not compromised. *There is broad but not universal consensus that Performance Based Ratemaking (PBR) can accomplish these objectives by providing clear signals to utility managers with respect to their business decisions and helping them make the transition from a tightly regulated structure to one that is more competitive.* Under PBR, utility performance is measured against established benchmarks. Superior performance, above the benchmark, would receive financial rewards, and poor performance would result in financial penalties to the shareholders. *By providing financial incentives to utilities, we will encourage them to operate more efficiently to maximize their profits.*

See id. at 23-24 (emphases added).[5]

Beyond these advantages that produce such direct benefits for UE and its customers, PBR as manifested in the EARP has additional, perhaps more indirect benefits, but benefits which are hardly insignificant from a social, political or regulatory perspective. For example, in recent years, the broadening of the "investor class" across the nation through a variety of affordable mutual funds and the facility of online trading, among other developments, has received much favorable comment as a positive expansion of the opportunities of capitalism. *See, e.g.,* John Berlau, *The Battle Over the Investor Class: Both Parties Map Out Their Tactics*, INVESTOR'S BUS. DAILY, Aug. 3, 2000, at A24 (noting that "as much as 75 % of likely voters will be somehow invested in the market," and that a Federal Reserve study found that, as of 1998, "48.8% of all households have direct or indirect holdings").[6] Likewise, the sharing credit of the EARP, which, like a dividend, gives UE's customers the ability to share in UE's earnings, makes them modest, but real stakeholders in the Company's performance simply by virtue of the electric bill they would have to pay anyway.

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[5] It is important to point out that the price and supply problems now plaguing California are unrelated to its use of PBR, but are related to supply shortages combined with poorly designed restructuring conditions. *See White Paper* at 13 n.31.

[6] *See also* Stephen Moore, *New Investor Class in Winner's Circle*, WASH.TIMES, Nov. 15, 2000, at A17 ("The vast majority of the 85 million Americans who own stocks are . . . deeply skeptical of political rhetoric and policy proposals that could erode the wealth creation process altogether.").

Similarly, PBR as a regulatory mechanism makes for relatively simple dispute resolution, at least in comparison to cost-of-service regulation. Because PBR does not involve the retrospective review of the details of a utility's operations based on after-the-fact judgments, but focuses on agreed-upon standards by which to measure the earnings of a utility, *see, White Paper* at 31, the issues that can be disputed are relatively narrow, and do not commonly spawn the litigation monster that can arise in the fully litigated rate case. Though we appreciate the concern over aspects of the litigation in the Third Sharing Period (and indeed below propose remedies for the future), the vast majority of issues that have arisen during the EARP were settled, and the bulk of the benefits of the EARP were delivered to customers in a far more timely fashion than cost-of-service regulation could ever hope to imitate. *See id.* at 10. Even the proceedings in the Third Sharing Period were hardly as cumbersome, time-consuming, or costly as normal litigation of a rate case (particularly one with constitutional implications, as would be the case here).[7]

III. The EARP Should Be Continued With Some Modifications.

We believe the framework of the present EARP is basically sound, and so should be the foundation of a future EARP. However, both the progress achieved under the first two EARPs, and our experience operating under them, suggest certain modifications may be in order. We set out some of our general ideas below, but hasten to add that a new EARP, if there is to be one, will only come about by agreement of the interested parties. UE and every other party must be prepared to be open to other perspectives and to

[7] Though the question of regulatory transaction costs, including litigation, that can delay the delivery or diminish the value of the benefits of any regulatory approach seems to us to be a fairly obvious consideration in changing from one approach to another, the Staff, apparently, disagrees. *See* Staff's Responses to Union Electric Company's First Set of Interrogatories and First Request for Production of Documents, 21 (Jan. 25, 2001)("Staff Response")("Staff does contend that the total cost of a fully litigated

compromise where differences are clear. Thus, these ideas should not be taken as fixed positions, but as one approach to the issues that have arisen.

A. Most obviously, the efficiencies achieved under the EARP regime to date suggest that some reasonable rate reduction should be made. We believe that it is prudent for this rate reduction to take the form of a one-time credit and a permanent rate reduction. Exactly what this rate reduction should be we are not prepared to state at this point, believing as we do that negotiation over this issue will be more productive if the parties are not in advance locked into publicly announced positions.

However, it is clear that such a reduction should not simply reduce rates by the amount that UE's cost of service has declined as a result of the first two EARPs, if such a cost of service is calculable. Such a rate reduction would be unfair, and constitutionally problematic, as a transparent exercise in regulatory opportunism, robbing UE of the benefit of its bargain in entering the EARP. Indeed, such a rate reduction would simply mimic cost-of-service ratemaking, rewarding increased efficiencies with a revenue loss. Consequently, such a rate reduction would undermine the whole point of an EARP, setting the precedent that the benefits of efficiencies gained during an EARP will be confiscated at the end of the EARP.

B. A sufficiently long term for the EARP is essential if the EARP's incentives are to have their maximum impact. *See id.* at 33-34. We would propose that a new EARP run for five years, with the Sharing Grid updated once, after the third year.

C. We believe that the levels of the Sharing Grid should be expanded.

D. Where there is a dispute over the calculation of a credit in any particular period, the undisputed credit amount should be paid promptly, while the disputed amount

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rate case should not, or need not, be included in an assessment of whether the EARP should be continued as

should earn interest during the resolution of the dispute, with the interest going to the prevailing party.

E. Specific adjustments in the Reconciliation Procedure may need to be clarified or adjusted.

IV. Continuing the EARP Would Avoid the Difficult and Unprecedented Issues of a Transition Back to Cost-of-Service Regulation.

As of this filing, we are obviously not aware of specific positions the Staff, or any other party, may take in making these recommendations to the Commission. However, the Staff's responses to our discovery, along with our general reflections on the subject, suggest several extremely controversial and difficult issues that may arise in transitioning back to rates for UE set under cost-of-service ratemaking principles. These issues raise novel questions not only under state law, but also under the United States and Missouri Constitutions. Below we note some examples of these issues that are apparent even now.

A. In answering one interrogatory concerning the analysis they intend to offer with their recommendations, the Staff said that they "will provide a conservative estimate of the excess revenue situation that currently exists regarding UE." Staff Response No. 6. Such a statement betrays a fundamental misunderstanding of the EARP, for under the EARP "excess revenue" does not exist. The Sharing Grid determines when UE's earnings are to be shared with its customers, limiting UE's achieveable return after sharing to approximately 13.5 percent. If by "excess revenue situation" the Staff means the cost reductions and other efficiencies UE has been able to achieve under the EARP, and will propose that such "excess revenue" should be eliminated by a rate reduction, then the Staff will trigger the very serious issues of regulatory opportunism, seeking to deprive UE of the benefit of its bargain in agreeing to the EARP. Such a ratemaking

is, continued with changes, or discontinued.").

would be vulnerable not only as arbitrary and capricious agency action, but also as a violation of several Missouri and United States constitutional provisions.[8]

B. One component of a cost-of-service analysis is the cost of equity. One well-recognized aspect of the cost of equity is an investor's perception of the risk of the investment. It seems equally clear that the dramatically different features of the EARP and a cost-of-service regime entail quite different risks which would be taken into account by investors. Yet the Staff contends, "Merely changing the ratemaking methodology does not increase the overall risk of investments in a utility." Staff's Responses to Union Electric Company's First Requests for Admission, No. 14 (Jan. 25, 2001). A ratemaking that ignored the different risks of two regulatory schemes, as apparently invited by the Staff, would run afoul of well-established constitutional standards that investors in utilities are to receive a return equivalent to the return on an investment with comparable risk.[9]

C. We see a puzzling arbitrariness in the approach the Staff apparently will urge the Commission to follow in evaluating whether the EARP should be continued. In response to our interrogatories, the Staff claims that "the EARPs can be evaluated using the standard of how customers fared under the EARPs compared to what customers would have experienced without the EARPs." Staff Response No. 23 (a). Assuming for argument's sake that this is a reasonable standard, exactly *how* one can do this, the Staff does not say. Clearly, it cannot be assumed that UE's cost of service would have been the same under a traditional regulatory regime, since the incentives for cost reduction of the EARP would have been absent. Nothing in what UE actually did during the years of

[8] *See, e.g.,* U.S. Const. art. I, § 10, cl. 1; U.S. Const amend. V; Mo. Const. art. 1, §§ 13, 26.
[9] *See, e.g., FPC v. Hope Natural Gas Co.*, 320 U.S.591, 603 (1944).

the EARP really indicates what it would have done under the dramatically different regime of cost-of-service regulation. One common-sense approach that might at least provide some helpful information would be to identify similarly situated utilities operating under traditional cost-of-service regulation during the same time period to assess their performance in comparison to that of UE. Yet the Staff expressly denies that such an assessment should be done, apparently because one can never have perfect knowledge of what is a "similarly situated" utility or whether that utility's performance really would have been like the performance of UE under cost-of-service regulation. Staff Responses Nos. 26, 27. By rejecting such an approach, the Staff dooms their standard for evaluating the EARP to the realm of pure speculation, neither a responsible nor lawful basis on which this Commission should conduct its business.

D. All regulatory action, including changes in regulatory policy, must be justified; in the familiar legal phrasing, regulatory action cannot be arbitrary and capricious. A change in regulatory course as momentous as abandoning the EARP to return to cost-of-service ratemaking will obviously be subject to close scrutiny under this standard. True though it may be that the EARP was an experiment, it was an experiment that the Commission entered twice, and after exercising its considered judgment that such an experiment was in the public interest. The mere fact that the experiment is nearly at its end does not excuse the Commission from its responsibility to justify whatever course it will now take. Indeed, the EARP's provision that the parties make these recommendations concerning the future of the EARP reflects this responsibility.

Given the achievement of the EARP, concerns with the mechanics of its operation, as we have noted earlier, amount to minor irritants that can readily be addressed, and certainly do not provide the substantial justification for not continuing the

EARP that the law expects. In truth, what may be the engine that drives some to urge a return to cost-of-service ratemaking are the very "excess earnings" that have been achieved under the EARP, and the prospect of a massive rate cut to extract such earnings simply by changing regulatory methodologies. Such a course is not only bad policy for the long-term health of UE and the availability of cheap, reliable electricity for its customers, but raises the specter of protracted litigation of constitutional magnitude. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 315 (1989) ("[A] State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions.").

At the end of the day, the Commission can decide to abandon the EARP and return to traditional cost-of-service ratemaking; the EARP is not a kind of legal "gotcha." Without a doubt the Commission has the power to continue the EARP and it has the power to return to cost-of-service regulation. But the Commission exercises that power within the bounds of certain legal and constitutional principles. In making this unprecedented choice, it must exercise reasoned judgment in the face of the novel issues involved. And, if the Commission ultimately chooses to return to cost-of-service ratemaking, it must take care to do so prospectively, and not take away the benefits achieved by the bargain of the EARP.

CONCLUSION

In the end, the record of UE's achievements under the EARP cannot be disputed. Indeed, the very fact that the Staff can claim that UE produced "excess earnings" under the EARP regime is itself a testament to those achievements. This Commission cannot rationally plan a course into the future without understanding why such success occurred

under the EARP, and what a radical change in the present course, if urged on the Commission by any party, may bring. Switching back to a traditional cost-of-service methodology simply to "recoup" these "excess earnings" in the form of a massive rate cut is not only shortsighted and irrational, but also unlawful. Clearly, a sizeable burden is on those who would try to persuade this Commission to abandon the EARP.

We believe that good-faith discussions, with reasonable compromise on all sides, can produce a new EARP, revised to address the lessons we have learned, but that offers to continue the success we have achieved over the last five years in providing our customers with what is among the cheapest, most reliable electricity anywhere in our nation.

Date: February 1, 2001

Respectfully submitted,

AmerenUE

By: _____

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