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February 1, 2001

Mr. Dale Hardy Roberts
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FILED
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Missouri Public
Service Commission

RE: Case No. EM-96-149

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and eight (8) conformed copies of **STAFF'S REPORT REGARDING THE EXPERIMENTAL ALTERNATIVE REGULATION PLANS OF UNION ELECTRIC COMPANY** and **STAFF'S FILING REGARDING THE EXPERIMENTAL ALTERNATIVE REGULATION PLANS OF UNION ELECTRIC COMPANY**

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

[signature]

Steven Dottheim.
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cc: Counsel of Record

256+257

FILED
FEB 1 2001
Missouri Public
Service Commission

**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

STAFF'S FILING OF ITS REPORT REGARDING THE EXPERIMENTAL ALTERNATIVE REGULATION PLANS OF UNION ELECTRIC COMPANY

Comes now the Staff of the Missouri Public Service Commission (Staff) and files with the Missouri Public Service Commission (Commission) the Staff's Report Regarding The Experimental Alternative Regulation Plans Of Union Electric Company, d/b/a AmerenUE. In support thereof the Staff States as follows:

1. Section 7.g. of the Stipulation And Agreement in Case No. EM-96-149 which the Commission accepted in its Report And Order dated February 21, 1997 states that by February 1, 2001, UE, the Staff and the Office of the Public Counsel (OPC) will file and other signatories may file their recommendations with the Commission as to whether the experimental alternative regulation plan then in effect should be continued as is, continued with changes (including new rates, if recommended) or discontinued.

2. The Staff herewith files its report wherein it recommends that (1) the Case No. EM-96-149 experimental alternative regulation plan (second EARP) not be continued as is and (2) that whatever follows as a result, whether it be another experimental alternative regulation plan negotiated by UE, the Staff, OPC and other parties, or traditional cost of service regulation, a rebasing of UE's Missouri retail rates must occur.

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3. The revenue requirement cost of service audit which the Staff is in the process of performing preliminarily indicates that UE's earnings are substantially in excess of its cost of service and warrants the Staff filing an excess earnings complaint case upon the conclusion of the Case No. EM-96-149 EARP. The Staff's present conservative estimate is that UE's earnings on an annual basis are more than $100 million in excess of its cost of service.

4. Based upon the terms of the Stipulation And Agreement accepted by the Commission in its February 21, 1997 Report And Order in Case No. EM-96-149, the Staff believes that the Commission has authorized the Staff to file an excess earnings complaint case upon the conclusion of the Case No. EM-96-149 EARP should the Staff believe that such an action is warranted. The Staff plans to proceed in such a manner unless otherwise directed by the Commission.

Wherefore pursuant to Section 7.g. of the Stipulation And Agreement accepted by the Commission in its February 21, 1997 Report And Order in Case No. EM-96-149, the Staff herewith files Staff's Report Regarding The Experimental Alternative Regulation Plans Of Union Electric Company, d/b/a AmerenUE .

Respectfully submitted,
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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 attached service list this 1st day of February 2001.

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Service Commission

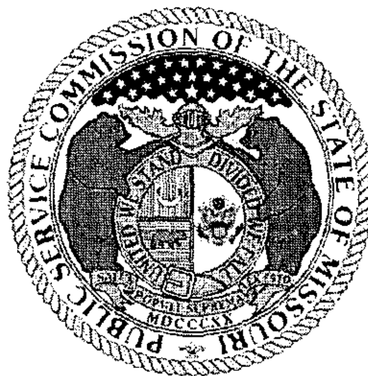
MISSOURI PUBLIC SERVICE COMMISSION STAFF'S

REPORT REGARDING THE

EXPERIMENTAL ALTERNATIVE REGULATION PLANS

OF UNION ELECTRIC COMPANY, D/B/A AMERENUE

CASE NO. EM-96-149



February 1, 2001

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AMEREN/UE COMPANY

CASE NO. EM-96-149

INTRODUCTION

The existing experimental alternative regulation plan (EARP) applicable to Union Electric Company, d/b/a AmerenUE (Company or UE) was adopted by the Missouri Public Service Commission (Commission) in a Report And Order issued on February 21, 1997 in Case No. EM-96-149 to be effective beginning March 4, 1997. At that time, there was an EARP already in effect respecting UE, which had been filed with the Commission on June 12, 1995 in Case No. ER-95-411. The current EARP was negotiated within the context of Case No. EM-96-149, wherein UE sought Commission approval for certain merger transactions involving UE and CIPSCO, Inc. (CIPSCO), the parent of Central Illinois Public Service Company (CIPS). The current EARP was an extension of the previous EARP adopted by the Commission through a Stipulation And Agreement filed on June 12, 1995, in Case No. ER-95-411.

The term of the first EARP was from July 1, 1995 to June 30, 1998. The term of the Case No. EM-96-149 EARP is the three-year period from July 1, 1998 through June 30, 2001. The Stipulation And Agreement in Case No. EM-96-149 pursuant to Section 3.g. provided that the Commission Staff (Staff), Office of the Public Counsel (OPC), UE, and other signatories to the Stipulation And Agreement may file with the Commission by February 1, 2001, whether the Case No. EM-96-149 EARP should be continued as is, continued with changes (including new rates, if recommended) or discontinued. This report contains the Staff's current recommendations regarding the continuation of the EARP.

BACKGROUND

As a result of the Callaway nuclear generating station going into commercial operation, the Commission ordered a phase-in of the costs associated with that generating plant commencing in April 1985. Under the phase-in, UE's rates would increase in April in the years 1985 through 1990 with rates frozen in years 1991 and 1992. As a result of the Tax Reform Act of 1986, UE agreed to smaller increases for the years 1987 through 1990. As a result of an excess earnings complaint case filed by the Staff in 1987, the Commission lowered UE's phase-in rate increase for 1998 to 0.38% and terminated the phase-in for years 1989 and 1990. Thus, since 1987, in Case No. EC-87-114, UE has neither requested nor received any increase in its Missouri electric rate levels. In fact, UE agreed to reduce its rates twice, in 1990 and 1993, in response to Staff-initiated excess earnings reviews. To resolve questions raised by another earnings review that the Staff initiated in the second half of 1994, UE, the Staff, OPC and other parties entered into a Stipulation And Agreement in Case No. ER-95-411 that, among other items, called for the following: (1) a permanent rate reduction of $30 million for UE's Missouri retail electric customers, (2) a one-time credit paid to UE's Missouri retail electric customers of $30 million, and (3) implementation of the EARP to effectuate the sharing with its Missouri retail electric customers of its earnings above a certain return on equity (ROE) based on an agreed upon ROE grid, with sharing to start at 12.61% for three, one-year periods from July 1, 1995 through June 30, 1998.

In November 1995, UE filed with the Commission an application to merge with CIPSCO, the parent of CIPS, an electric and gas utility located in Illinois. The application established Case No. EM-96-149. In the Stipulation And Agreement, reached in that case resolving all issues concerning the proposed merger application, it was agreed by the parties to establish a

second, three-year EARP, from July 1, 1998 through June 30, 2001. Most of the details of the original EARP agreement were retained, though a modification was made to the sharing grid.

Earnings for each sharing period during the second EARP are shared with UE and its customers based on the following sharing grid:

Earnings Level (Missouri Retail Electric Operations)	Sharing Level UE	Sharing Level Customer
1. Up to and including 12.61% Return on Equity (ROE)	100%	0%
2. That portion of earnings greater than 12.61% up to and including 14.00% ROE	50%	50%
3. That portion of earnings greater than 14.00% up to and including 16.00% ROE	10%	90%
4. That portion of earnings greater than 16.00% ROE	0%	100%

Other facets of the Stipulation And Agreement include the following: (1) UE would not seek recovery of any asserted merger premium in rates in any Missouri proceeding respecting CIPSCO; (2) actual prudent and reasonable merger transaction and transition costs were to be amortized over 10 years beginning the date the merger closed with no rate base treatment of the unamortized costs; (3) a rate reduction equal to the average annual total revenues credited to customers during the three years of the first EARP, adjusted to reflect normal weather; (4) Missouri Commission jurisdictional rights relative to the Federal Energy Regulatory Commission (FERC) and the Securities Exchange Commission (SEC) were addressed; (5) a System Support Agreement; and (6) other Staff conditions. As previously noted, the Commission approved the Stipulation And Agreement in Case NO. EM-96-149 on February 21, 1997.

Operating results for 12-month periods beginning July 1, xxxx and continuing through June 30, xxxx of the next year are utilized for each "sharing period." At the expiration of the second EARP (June 30, 2001), UE will have operated in six sharing periods

During the first four sharing periods of the incentive plans, UE's operating results generated credits to be flowed to UE's Missouri retail electric customers. The table below depicts the credits that have been generated over the two EARPs:

Sharing Period	Credits (000s)	Achieved ROE	Rate Reduction (000s)
First EARP/First Year July 1, 1995-June 30, 1996	$43,662	14.629%	
First EARP/Second Year July 1, 1996-June 30, 1997	$17,897	13.651%	
First EARP/ Third Year July 1, 1997-June 30, 1998	$28,375	14.121%	
Rate Reduction Based On The Average Of The Weather Normalized Sharing Credits For The Above Three Years			$15,951 effectuated $370 stayed
Second EARP/First Year July 1, 1998-June 30, 1999	$20,214	13.355%	

The achieved ROE is based on the average capital structure, the average rate base and the booked earnings, as adjusted, during the particular one-year sharing period. Once UE earns a 12.61% ROE, there are sharing credits due the ratepayers for each year of operation of the EARPs. The beginning point of sharing continues to be a great concern of the Staff's. The appropriateness of a future sharing grid will be discussed later in this filing. However, it should be noted that a sharing of earnings beginning at a return on equity that more appropriately

reflects current financial market conditions would have significantly increased the credits for the Missouri retail electric ratepayers of UE.

When first reviewing the history of the EARPs as detailed in the table above, one might conclude the EARPs have been a success because there have been credits flowed to ratepayers in each of the sharing periods, including the credits that have or will be flowed to ratepayers for the first two sharing periods of the second EARP, even after a rate reduction occurred based upon the first EARP weather normalized credits. However, one must weigh these credits and the rate reduction in light of the alternative question of where would customer rates have been without the EARPs. Specifically, has the effect of the EARPs been to cause ratepayers to receive electric service at just and reasonable rates, or prevented ratepayers from receiving electric service at just and reasonable rates?

Only the Staff and OPC have been involved in actively reviewing UE's calculation of sharing credits and performing independent analyses regarding a determination of sharing credits. For the first sharing credit period of the first EARP, UE, the Staff and OPC discussed a number of issues concerning how certain items should be treated for credit calculation purposes. All potential issues for the first year of the first EARP were resolved without the need for Commission intervention in the calculation of the sharing credits.

For the second sharing credit period of the first EARP, the same parties alerted the Commission to the existence of issues respecting the determination of the amount of customer credits that might require resolution by the Commission. However, the parties resolved these matters before any Commission intervention was required.

For the third sharing credit period of the first EARP, a number of issues arose concerning calculation of credit amounts that ultimately required Commission determination. The issues

related to proposed Staff and OPC adjustments to booked UE earnings. UE opposed adoption of the proposed adjustments.

For the first sharing period of the second EARP, a number of issues again arose as a result of the Staff's and OPC's audits. The Staff and OPC both filed direct testimony detailing their areas of disagreement with UE. However, the parties resolved these matters prior to the need for any Commission intervention. The second sharing period of the second EARP is pending before the Commission with the Staff and OPC scheduled to file testimony with the Commission on February 15, 2001. UE's calculation of the sharing credit for the period July 1, 1999 to June 30, 2000 is $18.442 million.

Both the first and second EARPs provide/provided for conditions where UE may file for rate relief during the terms of the EARPs. UE has not encountered or invoked those conditions.

EVALUATION CRITERIA

The current EARP contains no stated performance measures or evaluation criteria on which to judge the success or failure of the EARPs. In the Commission's Report And Order in Case No. ER-95-411, the Commission accepted the Stipulation And Agreement that established an alternative regulation plan and noted that an alternative regulation plan would provide stability for UE's rates for three years and allow UE to remain a strong company. Determining if the plan actually allowed UE to remain a strong company over and above what otherwise would have taken place under traditional regulation cannot be measured. This is particularly true since the parties have not agreed upon a standard by which to judge the plan, or established the actual goals to be accomplished. There is also the question whether the degree to which the EARP

allowed UE to remain a strong company over and above what otherwise would have happened under traditional regulation occurred at the detriment of UE's ratepayers.

The EARPs resulted from Stipulation And Agreements that involved multiple parties. The Staff assumes that each party will view the success or failure of the plan from a different perspective and based upon individual interests. This may cause commenters to view the same aspect of the plan, e.g., the sharing grid ROE triggers, but judge differently whether that aspect is a positive or negative facet of the EARPs.

The first and second EARPs, which are characterized as experiments, do not specify in the two Stipulation And Agreements any goals or objectives that were agreed upon as intended to be achieved. Therefore, it is not practical to evaluate EARP results against any purported mutually agreed upon expected or planned accomplishments. Although the first EARP was not proposed and adopted in the context of a merger proceeding, to which the "not detrimental to the public" standard would have applied, the second EARP was. Staff assumes that the first and second EARPs were intended to be "not detrimental to the public." To this end, 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. The EARPs would be deemed to be successful, and extension would be looked upon favorably by Staff, if customers are evaluated as having fared better under the EARPs than they would have absent the EARPs. The present EARP would not be a candidate for extension if customers would have been much better off absent the EARPs. At a minimum, if customers would have been better off absent the EARPs, modifications to the present EARP would be necessary for the EARP to be continued.

The question arises whether there can be an objective determination whether the EARPs have been a success or failure since no agreed-upon goals, objectives or expectations exist by

which to meaningfully measure the performance under the EARPs against traditional regulation. UE's performance respecting customer service, return on equity, and other areas of operation since the last case can be examined but this information cannot provide the answer to whether the EARPs caused the performance level obtained.

In order to properly judge whether the EARPs have been successful, one should consider some of the following questions:

1. What are UE's rates in relation to UE's cost of service revenue requirement?
2. What have been the benefits, for example in terms of rates, credits, services and quality of service from the EARPs?
3. Has UE significantly improved the efficiency of its operations as a result of the EARPs?
4. What stakeholders have benefited from the EARPs and to what degree have they benefited as a result?

Although the above list is not exhaustive, it does provide an outline for evaluating performance and setting performance measures or evaluation criteria on which to judge the success or failure of any future EARP. However, as has been stated previously, the endeavor of setting performance measures or evaluation criteria was not performed for purposes of UE's first two EARPs.

REPORT FORMAT

This report is divided primarily into four broad sections. In addition to the *Introduction*, which covered the background and preliminary matters necessary to put this report in context, the report contains a section which discusses the various regulatory options available to the parties. The report will also contain a section briefly outlining the Staff's work to date on its

evaluation of UE's earnings and a section that describes the Staff's work during the EARPs regarding quality of service. As the Staff's audit work continues during the remaining year of the current EARP, the Staff's positions may be amended.

REGULATORY ALTERNATIVES

Section 7.g. of the Stipulation And Agreement in Case No. EM-96-149 states in part: "By February 1, 2001, UE, Staff, and OPC will file, and other signatories may file their recommendations with the Commission as to whether the New Plan should be continued as is, continued with changes (including new rates, if recommended) or discontinued."

The above options are available to the parties and ultimately to the Commission at the conclusion of this current EARP. The Staff believes the Commission may be presented with any one or a combination of the following options. Although the Staff does not believe that certain of these options are appropriate, the Staff wants to be very clear that it is willing to talk with the parties about any of these options:

- Continue the EARP as is with no modifications;
- Continue EARP with modifications including a negotiated rebasing of UE's rates or after an excess earnings complaint case and/or rate increase case presented under traditional ratemaking methods filed on or after July 1, 2001;
- Resume traditional revenue requirement cost of service regulation after June 30, 2001, by deciding any excess earnings complaint case or rate increase case presented under traditional ratemaking methods filed on or after July 1, 2001; or
- Utilize another alternative regulation framework substantially different from the present EARP including a negotiated rebasing of UE's rates or after an excess

earnings complaint case or rate increase case presented under traditional ratemaking methods filed on or after July 1, 2001.

The Staff does not purport to list every conceivable option. There may be others presented that the Staff has not considered. A discussion of these options, along with the Staff's recommendation regarding each option, is presented below.

The Staff would note the Commission's statements in Re Southwestern Bell Telephone Co., Case Nos. TC-93-224 and TO-93-192, 2 Mo.P.S.C.3d 479, 572, 574, 583(1993):

> . . . The Commission has concluded that it has the necessary authority to approve a reasonably structured alternative regulation plan, as described in this Report And Order, and that a company may voluntarily agree to operate under such a plan.

2 Mo.P.S.C.3d at 572.

> Even though SWB has stated rather bluntly that the Commission must accept its alternative regulation proposal or it will return to traditional regulation, the Commission believes that SWB should accept a reasonably structured alternative plan. Regardless of SWB's stated position, it must be aware of the Commission's statutory obligations and it cannot convincingly argue that it expected to continue to be allowed to retain earnings into the future based upon an experimental plan using 1989 financial data. Despite SWB's most optimistic and contentious position, it must have realized that the realities of Missouri law and the almost complete opposition of all interested parties would require an earnings investigation before any alternative regulation plan could be considered.

2 Mo.P.S.C.3d at 574.

> . . . The Commission, though, concludes that it has the requisite statutory authority to approve an alternative regulation plan such as the AMP for SWB once it has reached a decision concerning SWB's revenue requirement. Several parties, including the Attorney General and MCTA, have challenged this authority.

2 Mo.P.S.C.3d at 583.

EXTENSION OF CURRENT EARP

The Staff does not recommend the extension of the EARP as currently drafted for another three-year term. After three years of the first EARP and two years of the second EARP, the Staff believes that significant problems can be observed in how the EARP has operated to date. These problems can be summarized as: (1) the ROE grid for sharing is set at a level which has resulted in UE receiving, through customer rates, revenues which are clearly excessive even after sharing (thus, the ROE grid for sharing is set at a level that does not produce customer benefits commensurate with those achieved under traditional regulation); (2) the EARP does not adequately address a long list of concerns that the Staff has identified and which are set out elsewhere in this report; and (3) the disputes between UE and the Staff and UE and OPC concerning how the EARPs are supposed to operate, have resulted in protracted litigation and delays in customers receiving the intended benefits of the operation of the EARPs.

In 1995 when the Commission approved the initial EARP, customer sharing was to start when UE's earnings exceeded a 12.61% ROE. In 1996, when the second EARP was negotiated, the parties agreed to retain the 12.61% ROE starting point for customer credit sharing purposes.

The Commission has not been called upon to determine the rate of return on common equity or overall rate of return for an electric or gas utility since March 1998 for Missouri Public Service, a division of UtiliCorp United Inc., in Case No. ER-97-394, et al., and December 1999 for Laclede Gas Company in Case No. GR-99-315. Even though the Commission has not been required to set returns on common equity or overall rates of return for an electric or gas utility since those cases, the Staff has filed return on common equity and overall rate of return determinations in several recent electric, gas and steam cases: Re St. Joseph Light & Power Company, Case Nos. ER-99-247, HR-99-248 and GR-99-249, Re St. Joseph Light & Power

Company and UtiliCorp United Inc., Case No. EM-2000-292 and Re Union Electric Company, Case No. GR-2000-512.

The Staff advised the Commission in February 2000 in a Staff Response To Commission Orders Of December 23, 1999 And January 20, 2000 that the Staff's current estimate of UE's ROE was in the range of 10.00%-10.50%. The Staff has again reviewed what it would recommend as UE's ROE. For purposes of this report, the Staff's review indicates that the Staff's ROE range estimate provided to the Commission in February 2000 is conservative as are the results that ROE range would produce. The significant difference between UE's ROE customer credit beginning sharing point of 12.61% ROE, and what UE's authorized ROE would likely be if currently determined by the Commission, represents earnings that UE is allowed under the EARP to retain in entirety that otherwise would not be considered reasonable for retention by UE under traditional regulation. UE has consistently earned over a 12.61% ROE. UE's present rates are excessive even though UE's customers receive half of the excess earnings between a 12.61% ROE and a 14.00% ROE for UE and a larger percentage above 14.00% ROE. The 12.61% to 14.00% ROE range represents a substantial amount of excess earnings of which only half must be shared by UE with its ratepayers. A further significant difference between the EARPs and traditional regulation is the period of time that UE's rates were/have not been reviewed and adjusted to remain just and reasonable.

The question is whether UE's Missouri retail electric customers are receiving or have received, under the EARPs, benefits that would not have been available to them under traditional regulation which outweigh the benefits that UE's Missouri retail electric customers would have received under traditional revenue requirement cost of service regulation had there been no EARPs. The Staff does not believe though that this is the case. Over the long term, UE has

demonstrated an ability to achieve expense savings, particularly in fuel and other generation costs as well as savings resulting from overall employee reductions. The Staff would note that UE has not received a rate increase since Case No. EC-87-114. Since that time, UE could have achieved many of the "efficiencies" that have been reflected in the EARPs. Also, the efficiencies that UE may have achieved during the EARPs may have been achieved by UE absent the EARPs.

The credits that have occurred also could be due to factors other than UE achieving efficiencies. For example, the credits for the EARPs may be due, in part, to the 12.61% ROE start for sharing of earnings being at too high a level, given the financial conditions ultimately experienced by UE, and/or due to UE experiencing abnormally hot summers the first and the third years of the first EARP. The impact of weather on UE's earnings can be seen by the fact that the rate reduction which was to occur as part of the second EARP was to be based on the three-year average of the credits from the first EARP, weather normalized. Thus, the credits for the first and third years of the first EARP decreased, as shown below when they were weather normalized, and increased as shown below for the second year, when they were weather normalized:

Sharing Period	Credits (000s)	Weather Normalized Credits (000s)
First EARP/First Year July 1,1995-June 30,1996	$43,662	$12,040
First EARP/Second Year July 1, 1996-June 30,1997	$17,897	$22,916
First EARP/ Third Year July 1, 1997-June 30,1998	$28,375	$14,007

The Staff expects that UE will argue that the EARPs have caused UE to be more efficient and productive since their implementation, thus causing the earnings that UE has shared with its customers. The Staff, however, would argue that the protection which the EARPs have provided UE from rate changes resulting from Staff excess earning complaint cases has continually put UE in a protected earnings position that has not necessarily benefited UE's ratepayers greater than traditional regulation would have. The protection produced by the EARPs will be further discussed in particular in the Earnings Investigation section of this report. The EARPs in actuality may have protected UE from flowing to ratepayers the earnings resulting from efficiencies that would have been or should have been achieved by UE absent the EARPs.

The other major problem that has occurred with the EARPs is the sharply different views of UE, the Staff and OPC concerning what the EARPs are intended to be and how they are supposed to work. For the Staff, the EARPs were intended to serve as alternatives to traditional regulation in that they were thought to be structured to lead to more timely receipt by UE's customers of reductions in UE's revenue requirement than normally possible under traditional regulation. These customer reductions would occur as the result of significant monitoring by the Staff as occurred in the one other alternative regulation plan attempted by the Commission, the Southwestern Bell Telephone Company incentive regulation experiment (SBIRE) in Case No. TO-90-1. The Staff views the EARPs as a form of continuous revenue requirement scrutiny, with procedures established to address the need for frequent full cost of service revenue requirement audits and those determination's respecting UE's revenue requirement. The scope of the difference in views respecting the EARPs extends even to the matter of what is the Staff permitted to review pursuant to Section 7.g. of the EARP. The Staff had to file a Motion To Compel to even obtain the data necessary for the Staff to make the instant filing.

The Staff believes that a review of UE's operations at the beginning of any alternative regulation plan is necessary in order to determine the adjustments that need to be made to the books of the utility. This review would lessen and limit the need for litigation and would more accurately reflect the operations of the utility for ratemaking purposes. For example, in at least two sharing reviews, the Staff discovered that UE's institutional advertising has far exceeded the $250,000 adjustment contained in the Reconciliation Procurement attachment. The Staff has proposed adjustments to the sharing credits to reflect this much larger institutional advertising expense incurred by UE as an adjustment. If the Staff had reviewed UE's institutional advertising at the beginning of each of the EARPs, perhaps a more appropriate adjustment that was consistent with UE's advertising program would have been reflected in the Reconciliation Procedure.

The EARPs were not intended to be an abdication of Commission authority and responsibility to ensure that UE's rates are just and reasonable. The EARPs were not intended to convert the Staff, and ultimately the Commission, into mere checkers of the mathematical accuracy of UE-calculated credit amounts and auditors solely looking for possible cases of fraud. Under the positions advocated by UE, the Company becomes the sole and final arbiter of its earnings and thus the amount of credits to be returned to customers under the EARPs. For the Commission to dispute this approach means judicial review brought by UE. The principal part of the enamor of the EARPs compared to traditional cost of service regulation was avoidance of utility suspension or stays of Commission rate reduction Report And Orders. That clearly was not part of UE's view of the first and second EARPs.

For these reasons and others that are contained within this report, the Staff would again strongly recommend that a new EARP based on the same provisions of the first or second EARPs not be considered by this Commission.

EXTENSION OF CURRENT EARP WITH MODIFICATIONS

The Staff is willing to discuss with all interested parties a new EARP that could commence upon the June 30, 2001, conclusion of the second EARP or sometime thereafter. The Staff and UE have already met to discuss the possibility of creating a new EARP. Both parties have exchanged ideas. Nonetheless, the Staff is not amendable to a new EARP unless it incorporates substantial changes to the current EARPs. The following areas would need to be changed or addressed in the context of any new EARP:

1. Customer Service Measurements
2. Allocation Factors
3. Sharing Grid
4. Rate Review at Conclusion
5. Agreed Upon Adjustments to Cost Of Service
6. Monitoring Reports / Discovery of the Staff and Other Parties
7. Interest on Undisputed/ Disputed Credits
8. Future Rate Design with Third EARP

These areas will be discussed in greater detail in the following paragraphs of this report.

Customer Service Measurements

Any future EARP should contain customer service and reliability indices to help evaluate the quality of service during the period the regulatory plan is in effect. These indices or

measures would be utilized to determine the present level of service provided by AmerenUE and provide a baseline objective to measure future performance. UE performance compared to established indices would inform the Commission, Staff, OPC and UE of service deterioration or improvement during the period that an EARP would be in place. The current EARP, and its predecessor, do not include quality of service objectives.

A future EARP should also contain a response mechanism in the event that UE does not meet performance goals established by the new EARP. The response mechanism would include a requirement that UE incur in the near term the reasonable expense or investment necessary to improve its performance to the established goal and credit a like amount to its customers in recognition of its inadequate performance.

Several concerns of the Staff, regarding a third EARP, were addressed by the Commission in its Report And Order in the St. Joseph Light & Power Company (SJLP) – UtiliCorp United Inc. (UtiliCorp) merger case, Case No. EM-2000-292, and its Report And Order in the Empire District Electric Company (EDE) – UtiliCorp merger case, Case No. EM-2000-369. These include that any future EARP, at a minimum, should contain appropriate measures/indicators for specific aspects of its Call Center operations and Distribution Reliability system. Any future EARP should also contain a requirement for the Company to report its performance of these indices on a regular basis to the Staff. Specifically, any future EARP should contain baseline objectives, developed for the following indices: (1) Call Center Average Speed of Answer (ASA); (2) Call Center Abandoned Call Rate (ACR); (3) Distribution System Average Interruption Frequency Index (SAIFI); (4) Distribution System Average Interruption Duration Index (SAIDI); and (5) Distribution System Customer Average Interruption Duration Index (CAIDI) for its distribution system.

Jurisdictional Allocation Factors

The Staff has not audited or addressed UE's jurisdictional allocation factors since 1987 in Case No. EC-87-114. The jurisdictions to which UE historically allocated revenues, expenses and rate base were Missouri retail, Illinois retail and FERC wholesale. Those allocations changed over time and continue to change as UE's and now Ameren's operations changed/change. The Staff needs to review UE's allocation factors currently in effect, and each time UE updates those allocation factors, they should be subject to the Staff's review and adjustment. The Staff has indicated in meetings with UE within the context of Case No. EM-2001-233, that the increase in allocation factors to Missouri retail resulting from UE's proposed transfer of assets to AmerenCIPS is an item of concern to the Staff that needs to be addressed. Also, Ameren has publicly announced that it is entering into new unregulated business ventures. The Staff is interested in the effect on allocations that these business decisions have produced and will produce, and believes that they need appropriate recognition.

Sharing Credits Grid

As indicated previously, the Staff believes that the bands of the sharing grid of any future EARP need to be different than the bands currently in effect. A starting sharing point of 12.61% ROE is not indicative of the present financial conditions. In addition, the Staff believes that any discussions of the use of a sharing grid needs to go beyond the floors and ceilings of the sharing bands. It is the Staff's view that the sharing grid percentage distribution to UE shareholders and ratepayers should be reversed from the percentage distribution that has existed in the first and second EARPs. The ratepayers, not the shareholders as is presently the case, should receive the greater percentage of the earnings in the lower bands of sharing, and the shareholders, not the ratepayers as is presently the case, should receive the greater percentage of the earnings in the

higher bands of sharing. The efficiencies that result in increased earnings at the low-end of the sharing grid are the easiest to achieve. Therefore, the ratepayers should receive the higher percentage of these earnings. By UE receiving the higher percentage of the earnings at the upper-end of the sharing grid, UE would have an incentive to continue to increase its efficiency. Also, even if the present format of ratepayers receiving a higher percentage of UE's earnings as UE's achieved ROE rose, the Staff would also propose that no cap above which all earnings would go to the ratepayers should be utilized again. The Staff would continue to monitor UE to assure that safe and reliable service is still being provided by UE. Finally, if the Staff were to recommend to the Commission the adoption of a third EARP, the Staff would not recommend that a third EARP should last more than three years. If the Commission were to seriously consider adopting a new or combined EARP greater than three years in duration, the Staff would suggest that there needs to be a procedure available for reviewing and adjusting the sharing bands, among other things, after two or three years of the new or continued EARP.

Earnings Audits

Before the commencement of a third EARP, a permanent rate reduction must be implemented. The first and second sharing periods of the second EARP have resulted in sharing credits for UE's ratepayers. UE's rates were rebased after the first EARP by means of a rate reduction based on the three-year average of the weather normalized sharing credits from the first EARP. UE's rates must once again be reviewed for purposes of a possible third EARP. Regardless of whether there is a third EARP, there must be a rebasing of UE's rates as a result of the Staff earnings audit that is presently occurring. In addition, any third EARP should have as an element a permanent rate reduction at the conclusion of the third EARP based on the three-year average of the weather normalized sharing credits for the third EARP.

Adjustments to Derive UE's ROE for Purposes of A Sharing Credits Grid for A Third EARP

The following adjustments have been identified by the Staff as necessary for a third EARP with a sharing credits grid:

(a) A $250,000 adjustment, for goodwill advertising in the Reconciliation Procedure for the first and the second EARPs, is too low a number based on the Staff's recent audit experience respecting the first and second sharing periods of the second EARP. For adjustments such as this one, there should be a range within which the Staff and OPC would not make an adjustment. If UE exceeds the range, then the Staff and OPC would review the item and the range, and the Staff and/or OPC might propose an adjustment. If UE expended less than the range, then the calculation of UE's ROE would be based on the actual amount spent by UE.

(b) Concerning customer deposits, UE should be in conformance with the Commission's current policy, which uses the prime rate at December 31, plus 1.0%.

(c) Pensions and OPEBs calculations should reflect the Commission's Report And Order in the St. Louis County Water Company rate case, Case No. WR-96-263, as was followed by the Staff in UE's recent gas rate increase case, Case No. GR-2000-512, which was resolved by a Stipulation And Agreement.

(d) UE's coal inventory levels should reflect the reduced levels that for some time now have been utilized by UE, rather than the 75 day supply level in the Reconciliation Procedure of the first and second EARPs.

(e) The cash working capital offset to rate base calculation should reflect current levels achieved by UE rather than the $24 million rate base offset that was included in the Reconciliation Procedures of the first and second EARPs.

(f) The capital structure should be an average capital structure calculated based on the weighting of actual dollars associated with each component of the capital structure. UE presently uses a simple average of the percentages at the beginning and the end of the year. By weighing the actual dollars, the average components would more accurately reflect the average capital structure. Also, there should be a cap on the percentage of common equity that is used for the capital structure for sharing purposes.

(g) The Staff wants to address with UE the transaction and transitions costs item that is part of the second EARP Reconciliation Procedure.

For a third EARP, significant variations in the actual amounts of these items compared to the levels agreed to by the Staff and UE must be subject to review and adjustment by the Staff.

Monitoring Report/Discovery of the Staff and Other Parties

The reports already in existence which the Staff would want copies of as part of its monitoring of a third EARP are those indicated in the first and second EARP Stipulation And Agreements, plus Report 19607: UE Operating Expenses – Electric and any report that tracks injury and damage claims paid by UE. If any of these reports have been discontinued, the Staff would want the closest similar report that UE may be producing. In addition to the reports specifically identified in the third EARP Stipulation And Agreement, the Staff would want to be permitted to request for its monitoring activities any other report prepared by UE on a regular basis.

In any third EARP, the Staff would want language stating that Commission rule 4 CSR 240-2.090 is operable. Waiver of the rule could be requested. Any new EARP would need to address what constitutes UE developing new reports rather than UE just providing information that is already is being recorded and maintained by UE.

The language in the first and second EARPs regarding information Staff and OPC would need to perform their reviews, which is still acceptable to the Staff, is:

> *Staff, OPC and the other signatories participating in the monitoring of the New Plan may follow up with data requests, meetings and interviews, as required, to which UE will respond on a timely basis. UE will not be required to develop any new reports, but information presently being recorded and maintained by UE may be requested.*

Interest on Disputed Credits

Interest should be accrued on that portion of any disputed credit amount that is ultimately determined to be due to ratepayers. The interest rate that should be used is the prime rate at the most recent December 31, plus 1.0%.

There should be language that UE is required to effectuate the passing of the undisputed credit amount, and any disputed credit amount determined to be due ratepayers plus interest, within two billing periods of the date of the Commission's Order accepting the credit amount agreed upon by the parties or after any disputed credit amount is ultimately determined to be due ratepayers.

Future Rate Design with Third EARP

The relationship between rate design and the EARPs was specified in the separate Stipulation And Agreements to Case No. ER-95-411 and Case No. EM-96-149. At the end of the first EARP, the Stipulation And Agreement in Case No. EM-96-149 called for a rate decrease based on the average of the credits that had gone to customers in each of the first three years, subject to those credits being calculated on a weather normalized basis. The Case No. EM-96-149 Stipulation And Agreement also stated that the allocation of this rate decrease among the various retail customer classes would be the subject of a rate design case, Case No.

EO-96-15, in which class cost-of-service studies would be submitted by the various interested parties.

The results of applying this rate design were to be determined in Case No. EO-96-15. In said case, the parties agreed on how a rate reduction was to be applied. Said agreement set parameters such that the overall decrease in revenue requirements of $15.9 million, which was determined to be the uncontested portion of the rate reduction arising from calculating the average of the sharing credits for the three, one-year periods of the first EARP weather normalized was distributed among the various classes of service as follows: $3.7 million decrease for small general service; $9.7 million decrease for large general service and small primary service; and $2.5 million decrease for large power and interruptible service.

With respect to future alternative regulation plans, there are two considerations important to rate design changes. First, an increase or decrease in rates for one or more classes of service in relationship to an overall increase or decrease in rates is important. While rate design shifts in class cost of service revenue requirements could be implemented outside the context of a rate increase or rate decrease proceeding, this has not been the practice by the parties before the Commission or by the Commission itself. Any shift in class revenue requirements when there is no overall revenue requirement change effectuated for the particular utility, means that some class(es) will receive a rate increase while other class(es) receive a rate decreases.[1] Due to this situation, it has been the practice of this Commission to include rate design changes as a part of rate increase cases and rate decrease cases and not to seek to effectuate rate design shifts in class rates when changes in overall revenue requirements are not being made. Therefore, as a

[1] In addition, when there is an overall rate decrease, parties representing customers in various classes of service are reluctant to agree to a rate increase for any class of service. Conversely, when there is an overall rate increase, parties are reluctant to agree to a rate decrease for any class of service.

component of an alternative regulation plan, an overall rate increase or decrease moratorium over a long period of time could effectively result in a prohibition on change in rate design over that same period.

Second, when compared to a procedure that anticipates a longer period of no changes in over all revenue requirements, the division of the existing and the previous EARPs between two three-year periods with a rate change and rate design in the middle was a reasonable approach. For example, over the combined six-year period there could have been significant shifts in utility costs and in class usage patterns that would have resulted in changing allocations of those costs to the various classes. Thus, relatively long periods of time without a change in rate design is more likely to result in an inequitable distribution of costs among the various classes. Three-year rate freezes or shorter are more reasonable as a period of time over which not to expect or seek to effectuate significant shifts in class cost of service.

Forecasts of future utility costs may not be a good indicator of the potential for cost shifts. For the most part, forecasts assume that trends of the past will continue into the future and there will likely not be any significant shifts from historical patterns. However, actual events tend to be much more discontinuous than forecasts. Big changes in costs[2] can occur quickly and then tend not to change for awhile. The regulatory policy with respect to rate design needs the flexibility to respond to these changes. By allowing rate design changes at least every three years, such flexibility would be built into any alternative regulation plan that is considered by the Commission.

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[2] Such a change is evidenced by the rapid increase in natural gas prices that has occurred over the past year.

RETURN TO TRADITIONAL REGULATION

By its own terms, the current EARP expires June 30, 2001. Consequently, regulation of UE reverts to traditional methods on July 1, 2001 unless a new plan is instituted on that date or the current EARP is extended beyond its current term. For purposes of this report, in order to determine appropriate earning levels under traditional cost of service regulation, and in order to engage in any discussions with UE regarding a third EARP, the Staff is in the process of auditing UE. A separate section of this report discusses, in very broad terms, the Staff's preliminary findings. Based upon these findings, the Staff believe that the likely vehicle for the Commission to determine appropriate rates will be a complaint case brought by the Staff which could be filed as early as Monday, July 2, 2001, unless a third EARP is filed with and accepted by the Commission before that date.

Regardless of what action follows from this point forward, the Staff believes that the Commission must rebase rates to an appropriate level. The results of a complaint case could serve as the base line level for a possible new plan. The Staff does not foresee anything that should be permitted to delay the end of the present EARP on June 30, 2001 and the Staff's filing of a complaint case on July 2, 2001 unless UE, Staff and others can reach some agreement addressing the results of the Staff's present earnings audit.

OTHER ALTERNATIVE REGULATION PLANS

The Staff has not discussed internally, with UE or with any party to Case No. EM-96-149, any alternative regulation plan other than one similar to the current EARP with modifications. However, the Staff is receptive to discussing with any party another form of regulation. The Staff views that the appropriate goal of any alternative form of regulation is to provide a mechanism to ensure that earnings remain within a reasonable range and not produce a

plan that displaces the benefits associated with traditional cost of service ratemaking. Based on the experience of the two EARPs, several areas would need to be addressed in the context of any new alternative regulation plan. Specifically, any alternative discussions respecting a new alternative plan should address whether such a plan should include adoption of a sharing grid or automatic or periodic rate reductions, immediate rate reductions or customer credits; allowance for the effect of exogenous factors; etc. However, as stated above, the Staff currently has not developed another alternative regulation plan for UE's consideration.

STAFF'S REVIEW OF COMPANY OPERATIONS

STAFF'S EARNINGS INVESTIGATION REGARDING UE

Given the impending conclusion of the second EARP and the necessity of filing the instant report to the Commission, the Staff is examining UE's earnings to determine UE's current cost of service. The Staff related in its February 10, 2000 report to the Commission in Case No. EO-96-14, that the Staff estimated that UE was then in an excess earnings position in the amount of approximately $100 million dollars annually, adjusted for normal weather. The Staff's current review of UE continues to support this position. In fact, the Staff considers that the amount previously reported to the Commission is conservative if the Staff were to file an excess earnings complaint case at the expiration of the current EARP.

The Staff anticipates that UE will argue that the reason it is currently and has previously been in a position of sharing earnings with its customers is due to efficiencies gained by UE during and as a result of the EARPs. The Staff, however, would argue that the existence of the EARPs has shielded UE from certain Staff adjustments to cost of service that have been effectuated on other utilities operating in the state of Missouri. Specifically, the Staff would note

that at present, the major items which form the basis for the Staff's excess earnings estimate respecting UE are derived primarily from the following areas:

a. Return On Equity

b. Depreciation

c. Pensions/OPEBs

Return on Equity

The Staff believes that the sharing grid floor of 12.61% ROE is too high now and has been too high for quite some time when any objective analysis is performed of current and past market conditions. The table below lists the excess revenues that would have been generated each year of the EARP if the actual capital structure at that time had been utilized rather than what had been agreed to in the two EARP Stipulation And Agreements:

Sharing Period	Credits (000s)	Excess Revenues* (000s)
First EARP/First Year July 1, 1995-June 30, 1996	$43,662	$172,000
First EARP/Second Year July 1, 1996-June 30, 1997	$17,897	$167,000
First EARP/ Third Year July 1, 1997-June 30, 1998	$28,375	$174,000
Second EARP/Fist Year July 1, 1998-June 30, 1999	$20,214	$133,000

(*Not weather normalized)

The excess revenues listed above are compared to the credits that were given to customers in order to illustrate the magnitude of the revenues that the EARPs shielded UE from potentially having to recognize. The Staff is not attempting to suggest that all of these excess revenues

would not or should not have been paid by ratepayers under traditional cost of service regulation. However, the Staff does contend that under traditional cost of service regulation, a large portion of these revenues would have been subject to critical review and ratemaking determination. The provisions of the EARPs prevented such reviews and ratemaking determination.

Depreciation

UE has been shielded from Commission accepted depreciation policy decisions. Removal of cost of removal/salvage from UE's major investment accounts would create a large negative revenue requirement for UE (approximately $22.0 million). Due to the provisions of the EARP, UE has been able to continue to accrue the anticipated recovery of cost of removal/salvage and not recognize the actual cost of that activity in its rates. The Commission most recently affirmed the Staff's position in this area in Re Laclede Gas Company, Case No. GR-99-315, Report And Order, pp. 21-22 (December 14, 1999).

Pensions/Other Post Employee Benefits (OPEBs)

Finally, the Staff would note the existence of the two EARPs has precluded the Staff from proposing adjusting UE's cost of service for Staff's current position on Pensions/OPEBs. The impact on UE's cost of service revenue requirement has not been calculated presently for purposes of this report. However, the cost of service impact on UE likely is substantial.

The above cost of service adjustments would represent at present the major components of the Staff's current estimate of UE's excess earnings and represent the bulk of the excess earnings that UE has retained during the two EARPs.

POSSIBLE RATE DESIGN ADJUSTMENTS

Given the Staff's estimate of UE's excess earnings, the Staff reviewed UE's rate design, and the Stipulation And Agreement in the rate design Case No. EO-96-15 that was established as a result of the Case No. ER-95-411 Stipulation And Agreement respecting the first EARP. Based on that review, Staff offers the following paragraphs as its present thinking regarding an appropriate rate design to follow the conclusion of the second EARP and a rebasing of UE's rates.

The Stipulation And Agreement in Case No. EO-96-15 determined the distribution of the revenue reduction and rate design changes that would be made following the end of the third year of the first EARP. One of the cornerstones of the Case No. EO-96-15 Stipulation And Agreement was that in effectuating the rate reduction, no class's revenue requirements would be increased. This restriction caused the implementation of the revenue reduction to result in an inability to fully achieve the following two rate design goals established in that agreement:

1. Moving class revenue requirements closer to class cost of service by applying the first $25.0 million of the rate reduction to only the non-residential, non-lighting classes.

2. Setting the rate differential between the Large General Service rate and the Small Primary Service rate at the cost of service differential.

The rate design goals set out in Case No. EO-96-15 Stipulation And Agreement, to which the parties are not bound in this proceeding, should attempt to be fully accomplished in implementing a rate reduction rebasing of rates following the third year of the second EARP. Specifically, the following rate design changes should be made:

1. The remainder of the first $25.0 million of the rate reduction contemplated in the rate design case (approximately $8.7 million), should be distributed to the non-residential, non-lighting customer

classes by an equal percentage of weather-normalized current rate revenues.

2. The rate reduction to the Large General Service/Small Primary Service Class should be applied first to the Large General Service Rate Schedule to adjust (a) its demand charges to be $0.20 higher than the corresponding Small Primary Service Rate Schedule demand charges and (b) its energy charges to be 1.01% higher than the corresponding Small Primary Service energy charges.

After satisfying these goals, the remainder of any rate reduction should be applied as an equal percentage reduction to each rate component, except the customer charges, of each rate schedule.

EVALUATION OF UE'S QUALITY OF SERVICE

During the second EARP, the Management Services Department of the Staff performed a customer service review of UE that resulted in a report entitled: Review of AmerenUE Customer Service Operations. This informal review addressed a variety of customer service functions including work orders, meter reading, customer billing, customer payment remittance, credit and collections, disconnect/reconnects and the customer service center.

Twenty-eight recommendations for improvement resulted from the review. The report addressed a number of areas for improvement including that UE develop and utilize realistic performance measures for Call Center personnel and develop a series of objectives for critical Call Center performance goals. There was a recommendation to ensure that field personnel are properly trained, and another recommendation addressed further education of field personnel so that they use available computer technology.

The Staff performed a follow-up review of UE during the fall of 2000 regarding its progress toward achieving the recommendations. UE is in the process of addressing the recommendations and has indicated that several recommendations will be implemented when the

proposed new Customer Service System (CSS) is made operational during the fall of 2002. Future implementation review work will be conducted by the Staff to verify UE's progress.

The Staff believes the areas of review detailed in the above indicated report should form the basis for evaluating UE's quality of customer service in the future. Furthermore, these customer service areas should be addressed and monitored on an ongoing basis if a new EARP is developed.

SUMMARY

With this report, the Staff has attempted to comply with Section 7.g. of the Stipulation And Agreement in Case No. EM-96-149, regarding the various options available respecting the future regulation of UE. The Staff is fully aware that the Commission has previously held that any form of regulation that departs from traditional cost of service regulation must be agreed to by the affected utility. The Staff would merely recommend that whatever form of regulation ultimately is applied to UE, a complete rate review and rebasing of UE's rates must occur. The Staff would note that it started, and is continuing, its earnings audit of UE in part so as to be in a position to engage in discussions with UE about whether a third EARP should follow the conclusion of the second EARP on June 30, 2001. The Staff believes that the Commission's Report And Order dated February 21, 1997 in Case No. EM-96-149 authorizes the Staff to file an earnings complaint case respecting UE, after June 30, 2001.