BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a AmerenUE for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Company's Missouri Service Area.	)))))	**Case No. ER-2010-0036**

POST-HEARING BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

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April 23, 2010

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I. INTRODUCTION

This brief will address just two issues: Return on Equity and the Fuel Adjustment Clause. Many of the issues in the case were resolved through a series of agreements, and Public Counsel does not currently have the resources to delve into the remaining issues. Public Counsel reserves the right to address additional issues in its reply brief.

II. RETURN ON EQUITY

A. Introduction:

The appropriate return on equity (ROE) is usually one of the most contested issues in a rate case, and usually one of the issues with the biggest dollar difference between the positions of the parties. This case is no exception. In addition, the witnesses on the issue are all experts, all do more or less the same kind of analysis, and yet still end up tens of millions of dollars apart. The Commission is fortunate in this case to have not one, but two, witnesses that it has found to be objective and reliable: Public Counsel witness Daniel Lawton and Missouri Industrial Energy Consumers (MIEC) witness Michael Gorman. Public Counsel urges the Commission to adopt the recommendation of Daniel Lawton to establish 10.1 percent as AmerenUE's authorized return on equity. Mr. Lawton, testifying on behalf of Public Counsel, explains in detail in his testimony how he determined that range of ROE of 9.3% to 10.9% with 10.1% as a midpoint[1] is a reasonable estimate of AmerenUE's required return on equity. (Exhibit 304, Lawton Direct).

A summary of the witnesses' ROE recommendations, and a few simple calculations

[1] Mr. Lawton made an arithmetic mistake in his direct testimony, calculating the midpoint of 9.3 and 10.9 as 10.2 instead of the correct answer, 10.1. Staff witness Murray pointed out this arithmetic mistake in his rebuttal testimony, and Mr. Lawton made the appropriate correction in his surrebuttal testimony.

based upon those recommendations, are shown below. It is readily apparent that two of the witnesses independently arrived at recommendations very close to the "center" of the range, whether that "center" is calculated as the mean, the median, or a truncated average (dropping the highest and lowest values and averaging the remaining values). While this exercise does not definitively demonstrate that a particular recommendation or calculation is the appropriate ROE, it should go a long way toward reassuring the Commission that the two witnesses it has relied upon in the past have again produced solid, reliable recommendations.

Witness/calculation	**ROE recommendation/result**
Murray	9.35
Gorman	10.0
Lawton	10.1
Morin	10.8
Simple average	10.06
Truncated average	10.5
Median	10.08

The Commission should establish AmerenUE's ROE at a level that will permit AmerenUE an opportunity to earn a fair rate of return, sufficient to hold and attract capital, sufficient to maintain financial integrity, and comparable to other investments of similar risks. Two U.S. Supreme Court decisions are often cited as the legal standards for rate of return determination. The first is Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia, 262. U.S. 679 (1923). The Bluefield case

established the following general standards for a rate of return: The return should be sufficient for maintaining financial integrity and capital attraction and a public utility is entitled to a return equal to that of investments of comparable risks.

The second U.S. Supreme Court decision is the Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1942). In the Hope decision, the Court affirmed its earlier Bluefield standards and found that methods for determining return are not the test of reasonableness rather the result and impact of the end result are controlling.

The cost of capital is defined as the annual percentage that a utility must receive to maintain its financial integrity, to pay a return to security owners and to insure the continued attraction of capital at a reasonable cost and in an amount adequate to meet future needs. Mathematically, the cost of capital is the composite of the cost of several classes of capital used by the utility – debt, preferred stock, and common stock, weighted on the basis of an appropriate capital structure.

The ratemaking process requires the regulator to determine the utility's cost of capital for debt, preferred stock and equity costs. These calculations of cost rates, when combined with the proportions of each type of capital in the capital structure, result in a percentage figure that is then multiplied by the value of assets (investment) used and useful in the production of the utility service to ultimately arrive at a rate charged to customers. Rates should not be excessive (exceed actual costs) or burdensome to the customer and at the same time should be just and reasonable to the utility.

In summary, the objective of overall rate of return determination in the regulatory process is to compute the return such that the embedded (contractually required) cost of senior securities is recovered. In addition, a regulated utility should be provided an

opportunity to generate additional earnings that are sufficient to compensate equity investors at a level that will hold existing investors, attract new investors, and maintain the financial integrity of the utility.

B. Public Counsel witness Lawton's position:

Mr. Lawton performed four separate analyses: a Constant Growth Discounted Cash Flow (DCF) model; a Two-Stage DCF model; a Risk Premium model; and a Capital Asset Pricing Model (CAPM). This section of this brief will describe each of these analyses, in the order listed in the previous sentence.

In his DCF analysis, Mr. Lawton used comparable companies for his analyses that are similar to those used by AmerenUE witness Morin. In his direct testimony, Mr. Lawton explains why:

> For my cost of capital analyses I have employed a 31 company comparable group as a proxy for AmerenUE. The Company as a subsidiary of Ameren Corporation has no publically traded stock or other published financial measures for which a study can be performed. The goal is to establish an equity return for the AmerenUE Missouri operations. Therefore, I have developed a 31 company group of electric utility companies that are followed by Value Line.
>
> I employed the same comparable companies as employed in Company witness, Dr. Morin's, analysis. These two groups are sufficiently large such that no individual company results will bias the group average. **Moreover, by employing the same proxy companies, the differences between my proposals and the Company's on return are limited to the analyses presented.** (Exhibit 304, Lawton Direct, page 17; emphasis added).

At least in part because of Mr. Lawton's decision to mirror Dr. Morin's comparable company group, the salient difference between Mr. Lawton's and Dr. Morin's (and MIEC witness Gorman's) recommended ROE is the growth rate used in the DCF model. Dr. Morin testified to this at hearing: "I think the differences between Lawton, Gorman and myself is

the choice of growth rate inputs in the DCF model." (Transcript, volume 27, page 1840). And Mr. Lawton freely admits: "The calculation of investor growth expectations is the most difficult part of the DCF analysis." (Exhibit 304, Lawton Direct, page 22). It is critical that the growth rate used in an analysts DCF model accurately match investors' expectations. Too low a growth rate and the authorized return will be lower than that required by investors, and too high a growth rate and the utility will have the opportunity to earn windfall profits. In his direct testimony, Mr. Lawton explains the careful process he used to arrive at the growth rates he used, and in particular those he used in the single stage DCF:

> Investors generally have good information on the economic and financial variables outlined above. All of this information is available quickly, especially in recent decades with easy access to the worldwide web. This information influences return expectations and, as a result, the maximum price an investor will pay for various securities.
>
> Like the information available on the general economy, investors also have access to a wealth of information about particular types of securities, industries and specific company investments. This information is also factored into investor expectations and therefore the stock price individuals are willing to pay.
>
> Common earnings growth rate forecasts and historical growth rate data may be found in the Value Line Investment survey ("Value Line") publication. These Value Line earnings estimates are five year projections in annual earnings. Again, Value Line is widely available to the public, and is a good source of earnings projections. Other earnings estimates are forecasted by Zacks as well as First Call projections, widely available on the internet at Zacks.com and Yahoo Finance respectively. Those earnings projections along with other stock specific financial data provide a range of estimates of earnings and are readily available at no cost.
>
> …
>
> I have included in my Schedule (DJL-5) the growth rates I have reviewed in my analysis. Along with historical growth rates, the first set of growth rates is the Value Line forecasted growth rates in earnings per share ("EPS") for each company in the comparable group. The second set of growth rates examined is the Zacks forecasted growth rates in earnings. The third growth estimate considered is the first Call growth rates which are readily available to investors at Yahoo Finance.
>
> The growth rates described above provide a range of estimates for each of the comparable companies. The resulting range of average and median

> forecasted growth rates for the companies in and the comparable group is from 5.0% to 5.9%. Relying on the combined forecasted earnings per share estimates, the growth rate average range can be narrowed to 5.40% to 5.75% as shown in Schedule (DJL-5). (Exhibit 304, Lawton Direct, pages 22-23).

In addition to the single-stage DCF, Mr. Lawton used a two-stage DCF analysis to calculate AmerenUE's required return on equity. The two stages are sometimes used because the constant growth rate assumption inherent in the single-stage DCF is often not consistent with investor expectations. Mr. Lawton explains:

> As an example, it is often the case where short-term growth estimates are not consistent with long-term sustainable growth projections. In those instances, where more than one growth rate estimate is appropriate, a multi-stage non-constant growth model can be employed to derive a cost of capital estimate. In other words, the constant growth model is adjusted to incorporate multiple growth rate periods, assuring a constant growth (long-term) rate is estimated for a longer period. (Exhibit 304, Lawton Direct, pages 24-25).

The results of Mr. Lawton's two-stage DCF are consistent with, but somewhat lower than, his single stage DCF analysis.

Mr. Lawton also performed a risk premium analysis. The risk premium analysis is based on the differences between the average authorized equity returns and the average corporate bond yields for each year to estimate the indicated risk premium. Mr. Lawton described some of the advantages and disadvantages of the risk premium analysis in his direct testimony:

> The risk premium approach is useful in that the analysis is based on current market interest rates, that is, the current observable cost of debt capital. But, the risk premium approach is not without its problems and drawbacks. In practice, there is considerable debate as to the time period to analyze in the determination of the bond/equity return risk spread. Historical debt/equity risk spreads measured over many decades may not be relevant to current capital market requirements. Others argue that a long-term analysis is necessary, since the goal is to measure investors' long-term expectations. (Exhibit 304, Lawton Direct, page 27).

As his fourth approach to estimating AmerenUE's cost of equity, Mr. Lawton used a Capital Asset Pricing Model (CAPM). The CAPM approach is similar to the risk premium approach, in that both calculate the increased risk of equities as compared to a less-risky base. In the CAPM approach, the base is a theoretically risk-free interest rate such as a three-month Treasury bill rate. Because the CAPM is similar to the risk premium approach, it shares some of the same infirmities:

> Like the risk premium discussed above, the CAPM is subject to measurement uncertainties. First, the general problem of how to measure the equity risk premium and the time period for which the premium is analyzed is subject to considerable debate. This problem and associated criticisms is generic to all variants of the risk premium model. Second, measures of beta are often unstable from period to period and may not reflect the equity risk spread measure. (Exhibit 304, Lawton Direct, page 27).

The results of each of the four return on equity analyses are reflected in the chart below:

Model	**COMPARABLE GROUP Range**
Constant Growth DCF	10.9% - 11.1%
Two-Stage DCF	10.2% - 10.4%
Risk Premium	9.3% - 10.6%
CAPM	8.9% - 10.3%

From these results, Mr. Lawton finalized his ROE recommendation. He concluded that the relevant range of results should eliminate the highest and lowest results, and thus is 9.3% to 10.9%. The midpoint is 10.1%, and this is the recommendation for AmerenUE's required

return on equity.

C. MIEC witness Gorman's position:

Missouri Industrial Energy Consumers (MIEC) expert witness Michael Gorman's independent opinion that the just and reasonable rate of return on common equity for AmerenUE is 10.0% strongly supports Mr. Lawton's 10.1% recommendation.

Like Mr. Lawton, Mr. Gorman performed a number of analyses to calculate AmerenUE's required return on equity. For the most part, these analyses are consistent with those used by Mr. Lawton. Mr. Gorman used several models based on financial theory to estimate AmerenUE's cost of common equity. These models are: (1) a constant growth DCF model using analyst growth data; (2) a sustainable growth DCF model; (3) a multi-stage growth DCF model; (4) a CAPM; and (5) a risk premium model. Again like Mr. Lawton, Mr. Gorman applied these models to the same electric utility proxy group used by Dr. Morin.

Mr. Gorman integrated the results of these analyses in a slightly different manner than Mr. Lawton did his analyses. Mr. Gorman in effect averaged the three DCF approaches, and then averaged the DCF average with the results of the risk premium and the CAPM analyses. Thus his integration comprised two steps summarized in the following tables. The first table shows the calculation of the DCF average:

Model	Result
Constant Growth DCF (analysts' growth)	11.02%
Constant Growth DCF (sustainable growth)	10.20%
Multi-stage DCF	10.16%
DCF average	10.46%

The next table shows the second step of Mr. Gorman's integration, wherein he averages the DCF average with the results of the risk premium and CAPM analyses:

Model	Result
DCF average	10.46%
Risk premium	10.06%
CAPM	9.54%
Recommended ROE	10.0%

D. AmerenUE witness Morin's position:

AmerenUE witness Dr. Roger Morin testified, in his prefiled direct testimony, that AmerenUE should be awarded a whopping 11.5% return on equity. To make matters worse, Dr. Morin only got down to 11.5% by calculating ROE in his direct testimony in a way that is inconsistent with the way he calculated it in his rebuttal testimony. Even giving Dr. Morin the benefit of the doubt and considering 11.5% to be an accurate calculation of ROE based

on his analysis,[2] Dr. Morin's 11.5% recommendation is so far above any reasonable ROE level that the entire analysis is suspect. As Public Counsel witness Lawton noted:

> Dr. Morin's recommendation of an 11.5% return on equity, which is driven in large measure by his discounted cash flow ("DCF") results of 12% to 12.5%, is so extreme relative to the equity returns currently being granted by regulatory authorities; little, if any, consideration should be afforded his analysis.

And MIEC witness Michael Gorman testified that, at the time Dr. Morin recommended that AmerenUE should be awarded an 11.5% ROE, Mr. Gorman would have recommended an ROE in the range of 10.2-10.3%. (Transcript volume 27, page 1956).

In his rebuttal testimony, Dr. Morin calculated his recommended ROE by using the **median** of all his analyses. (Exhibit 112, Morin Rebuttal, page 55). But in his direct testimony, Dr. Morin set out all the same analyses, and used the **average**, not the median. (Exhibit 111, Morin Direct, page 56). Dr. Morin testified that he used the median in his rebuttal because the CAPM numbers were such outliers. (Transcript, volume 27, pages 1921-1922). MIEC witness Gorman agreed that under such circumstances, using the median instead of the average will much better approximate the central tendency of the data. (Transcript, volume 27, page 2007).[3] Why then did Dr. Morin use the average when calculating his recommended ROE in his direct testimony? Not because the CAPM numbers were closer; he testified that the CAPM numbers were statistically even more outliers in his direct testimony than in his rebuttal testimony. (Transcript, volume 27, page 1924). And not because Dr. Morin did not understand the "palliative" effect of using the median; he used it

[2] As shown below, Dr. Morin's recommended direct testimony ROE, when calculated consistently with the approach Dr. Morin took in rebuttal testimony, is an eye-popping 12.1%.

[3] See also Exhibit 410, Gorman Rebuttal, page 3.

in intermediate calculations like those on his schedule displaying his DCF analysis. (Exhibit 111, Morin Direct, Schedule RAM-E5, page 2; and Exhibit 111, Morin Direct, page 49).

If Dr. Morin had used the median in his direct testimony to calculate the recommended ROE in exactly the same way he calculated the ROE in his rebuttal testimony, his recommended ROE would have been 12.1% -- way outside any zone of reasonableness, a concept that Dr. Morin discusses immediately after calculating the average of 11.5% rather than the median of 12.1%. In his direct testimony, Dr. Morin posits a zone of reasonableness of 9.6-11.6%. (Exhibit 111, Morin Direct, page 58). The average of 11.5% just barely falls within this zone; the median of 12.1% is well outside of it.

The record does not reveal why Dr. Morin used the average in direct and used the median in rebuttal, but the record does reveal that Dr. Morin believes the use of the median is more appropriate. (Transcript, volume 27, pages 1921-1922). We cannot know whether the calculations were done differently simply because of an arbitrary change in approach, or whether the average in Dr. Morin's direct testimony was used to lower the recommendation to fall within the zone of reasonableness. In either case, whether arbitrariness or artifice, the Commission should carefully consider this inconsistency when deciding how much weight to give to AmerenUE's recommended ROE.

Public Counsel does not believe that the Commission should recalculate every witness' ROE recommendation as AmerenUE attempted to do in cross-examination of witnesses Lawton and Gorman. But in this instance, the recalculation is based on the witness' own approach, and there was even more reason to take that approach based on the data in the direct testimony than there was based on the data in the rebuttal testimony. If nothing else, Dr. Morin's illogical and inconsistent use of medians and averages in direct and

rebuttal testimony should cause the Commission to question the reliability of either recommendation.

Even apart from the change in approach between direct and rebuttal, Dr. Morin's analysis suffers from numerous flaws. For example, Dr. Morin fails to account for AmerenUE's relatively equity-rich updated capital structure. Public Counsel witness Lawton states:

> Moreover, AmerenUE, with a 51.126% equity ratio, has a higher equity ratio than the average of the comparable risk companies. Also, AmerenUE's updated capital structure has a higher equity ratio than the average electric utility reported in the Regulatory Research Associates Regulatory Focus January 8, 2010 report for January – December 2009. Dr. Morin never addresses the lower financial risk (higher equity ratio) in his rebuttal. Thus, his 10.8% updated return on equity estimate is not conservative.

In conclusion, the Commission should continue to rely on the testimony of Public Counsel witness Lawton and MIEC witness Gorman in this case as it has done in the past. The Commission should give little weight to the recommendation of AmerenUE witness Morin.

III. FUEL ADJUSTMENT CLAUSE

On February 17, 2010, the Commission issued an order entitled "Order Directing the Parties to Submit Testimony Concerning the Appropriateness of AmerenUE's Current Fuel Adjustment Clause." In that order, the Commission stated that:

> The Commission wants to hear from the parties concerning the appropriateness of AmerenUE's current fuel adjustment. To that end, the Commission will establish a procedural schedule for the filing of additional testimony regarding this issue. The Commission would like the parties in their testimony to review AmerenUE's current fuel adjustment clause and advise the Commission whether the current 95 percent pass through mechanism: 1)

> affords AmerenUE a sufficient opportunity to earn its authorized return on equity, and/or 2) provides AmerenUE with a sufficient financial incentive to be prudent in and take reasonable efforts to minimize its fuel and purchased power costs? If any party believes the answer to either of these questions is no, then they are directed to substantiate that position and recommend an alternative pass through-plan.

The Commission is concerned about the arbitrary nature of the 95% pass-through of changes in fuel and purchased power costs, and rightly so. There is no evidence in this case that having a mere 5% "stake" gives any kind of a compelling incentive. Public Counsel witness Ryan Kind testified that:

> Public Counsel believes that, from a general perspective, the FAC mechanism currently in place for UE does not provide sufficient incentive for the Company to minimize UE's fuel procurement costs and maximize the margins gained from off-system sales (OSS). OPC believes that, at a maximum, UE should be able to recover 80% of its variations from the baseline level of fuel costs (net of OSS margins) that was set in the Company's most recent rate case. Unless UE has at least this much "skin in the game" (i.e. 20%), ratepayers cannot be assured that UE is making its best efforts to minimize its fuel procurement costs and maximize its OSS margins. Ratepayer confidence that UE is making its best efforts to minimize fuel costs is especially important under the current circumstances where UE's customers are once again faced with the prospect of a double digit rate increase at the same time many of these same customers are experiencing the impact of global economic problems on their household budgets.

In the Report and Order in Case No. ER-2007-0002, AmerenUE's 2007 rate case, the Commission noted its concern with the effect a FAC has on a utility's incentives to effectively manage its fuel costs:

> The good effect of regulatory lag is that it provides the utility with a strong incentive to maximize its income and minimize its costs. If, however, a fuel adjustment clause is in place, the utility has less financial incentive to minimize its fuel costs because those costs will be automatically recovered from ratepayers.[4]

In the next AmerenUE rate case, Case No. ER-2008-0318, the State of Missouri's

[4] Case No. ER-2007-0002, Report and Order, page 18.

witness stated: “we need to retain as much as possible the incentives inherent to traditional rate of return regulation in designing a fuel clause mechanism.” (ER-2008-0318 transcript page 2593). This is still absolutely a sound policy for the Commission to follow in this case.

MIEC witness Brubaker addressed the issue of incentives in his testimony regarding the fuel adjustment clause, and highlighted how much less effective after-the-fact prudence reviews will be for electric utilities as compared to gas utilities:

> One of the dangers with an automatic adjustment clause is that the utility becomes less attentive to managing its costs because of the directly reimbursable nature of these costs under an FAC. Of course, utilities are held to the prudency standard, but it is very difficult to conduct a detailed audit of all of the decisions that go into a utility’s procurement of fuel and purchased power, the maintenance of its generating fleet, and other factors that influence the level of these costs. The complexity of auditing the utility’s generation function is overwhelming in comparison to the more limited analysis required for the Purchased Gas Adjustment (PGA) filings of the gas utilities. The number of decisions required to be investigated in the case of a PGA is relatively small. However, in the case of an electric utility, there are hourly transactions involving purchases and sales, decisions respecting acquisition of various kinds of fuel supplies in different markets, preventive maintenance practices, speed and cost of recovering from forced outages and similar decisions and actions. Thus, a rigorous audit of electric utility generation and purchased power costs is much more difficult to accomplish than a PGA audit. (Exhibit 413, Brubaker Additional Direct, Attachment 1, pages 6-7)

In his testimony, Mr. Brubaker emphasizes another very important point: the 95/5 approach has **never been based upon any** analytical approach. (Exhibit 413, Brubaker Additional Direct, Attachment 2, page 6). It was adopted arbitrarily in an Aquila, Inc. rate case (ER-2007-0004), and has since been extended to FACs used by The Empire District Electric Company and AmerenUE. An approach that never had any valid foundation does not become less arbitrary simply by repetition. Mr. Brubaker, like Public Counsel witness Kind, recommends a much stronger incentive, allowing 80% of changes in fuel and purchased power costs to flow through the FAC.

As the moving party in this rate increase case, AmerenUE has the burden of proof.[5] It is thus incumbent upon AmerenUE to prove that 95/5 is the appropriate approach, and that it will result in just and reasonable rates. It cannot meet its burden by simply pointing out that this approach has been used in the past, since there is no counter to the testimony of Mr. Brubaker that the 95/5 approach has never had an analytically sound foundation.

The evidence in this case demonstrates that, with respect to incenting its employees, AmerenUE believes that a much bigger stake than 5% is necessary. Witness after witness from AmerenUE testified that the portion of their pay that is contingent on performance is much higher than 5%. And not a single one of them has ever suggested that a 5% stake is plenty to incent superior performance.

AmerenUE witness Barnes testified that she has 35% of her pay at risk based upon her own performance and that of the company as a whole. (Transcript, volume 29, page 2416). AmerenUE witness Neff testified that the portion of his pay that is at risk based upon performance is 40%. (Transcript, volume 29, page 2451). AmerenUE witness Hairo testified to the same level as Mr. Neff. (Transcript, volume 29, page 2469). AmerenUE witness Irwin testified that the portion of his pay that is at risk based upon performance is only 10-15% (Transcript, volume 29, page 2471), still two times or three times higher than the percentage currently in AmerenUE's FAC. AmerenUE witness Massman, like Ms. Barnes, testified that he has 35% of his pay at risk based upon performance. (Transcript, volume 29, page 2483). AmerenUE witness Finnell testified that the portion of his pay that is at risk based upon performance is 20% (Transcript, volume 29, page 2489), just exactly the percentage that Public Counsel and the MIEC proposed be used in the FAC.

[+]

AmerenUE argues generally that the Commission should not change the FAC so soon after the Commission put it in place, because such an action might spook investment analysts. (Exhibit 122, Barnes Additional Direct, pages 7-8). Public Counsel offers two responses. First, the Commission must be starting to tire of utilities suggesting that the Commission's most important duty is placating credit rating agencies. If the Commission determines that AmerenUE has failed to meet its burden of proof to show that 95/5 is appropriate and will result in rates that are no higher than necessary, then the analysts' reactions should be of little concern, if any. Second, if the FAC had been in effect for years at the 95/5 level and the Commission sought testimony on its modification, one suspects that AmerenUE would argue that analysts would be spooked by the Commission considering change to a long-standing approach. It seems unlikely that a utility would ever find a time when they would not raise the possibility that analysts or investors would be spooked by the Commission making changes to a pro-utility practice. The point is that the Commission should not be influenced by speculation on possible negative reaction by investment analysts, but rather should make its decision based upon whether AmerenUE has met its burden of proof.

WHEREFORE, Public Counsel respectfully offers this Post-hearing Brief and prays that the Commission conform its decision in this case to the arguments contained herein.

Respectfully submitted,

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I hereby certify that copies of the foregoing have been emailed to all parties this 23rd day of April 2010.

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