

**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) Case No. ER-2008-0318
Service Provided to Customers in the)
Company's Missouri Service Area.)

BRIEF OF STATE OF MISSOURI

H. Todd Iveson, MO. Bar #37650
Assistant Attorney General
Missouri Attorney General's Office
P. O. Box 899
Jefferson City, Missouri 65102
(573) 751-3640 Telephone
(573) 751-8796 Facsimile
Todd.iveson@ago.mo.gov

Attorney for State of Missouri

NP

This brief will address only the three remaining issues in which the State actively participated at the hearing: (1) Return on Equity; (2) Fuel Adjustment Clause; and (3) Callaway Unit II License. The failure to address other issues does not indicate agreement with UE's position. To the contrary, the State generally supports the Staff, OPC, and Intervenors unless otherwise stated.

I. RETURN ON EQUITY

The State endorses the testimony of Missouri Industrial Energy Consumers return on equity (ROE) expert Michael Gorman. Mr. Gorman presented the most well-reasoned, mainstream approach to the return on equity analysis.

Mr. Gorman performed three discounted cash flow (DCF) analyses, a risk premium analysis, and a capital asset pricing model (CAPM) analysis. (Ex. 600, p. 15, l. 12 – p. 37, l. 6) He arrived at a range of 9.81% to 10.55%, and recommended the midpoint – 10.2% – as the most appropriate ROE.

It is easy to get lost in the weeds of the arguments among the competing ROE experts regarding which of them used the most reasonable assumptions. But the Commission need not be blinded by the flurry of charges and countercharges. Several basic facts agreed upon among the experts can guide the Commission to the right decision.

The experts generally agreed on the analyses that are appropriate for the Commission to consider. They generally agreed that the differences in their results were largely due to the inputs they used in the agreed formulas. And they

generally agreed that the choice of those inputs is largely subjective. (*See, e.g.*, Tr. 13, p. 277, l. 4 – p. 278, l. 6; Tr. 15, p. 389, l. 12 – p. 390, l. 9) All of the ROE experts except the Company’s recommended an ROE of 10.2% or lower. Given these basic facts, the Commission must exercise its independent judgment in determining which expert’s subjective judgment appears most reasonable.

UE’s ROE expert, Roger Morin, prepared seven analyses: Two versions of the CAPM; two versions of the risk premium analysis; and four versions of the single-stage DCF. (Ex. 003, p. 65, ll. 6 – 16) He arrived at a recommended ROE of 10.9%.¹ (*Id.* 003, p. 4, l. 23 – p. 5, l. 1) A review of each of his analyses demonstrates how he used the choice of inputs to reach an out-of-the-mainstream result.

A. CAPM

The CAPM assumes that securities are priced so that the expected return equals the risk-free rate of return plus the risk premium. Stated more formally, CAPM is described by the following equation: $K = R_f + \beta(R_m - R_f)$, where K equals the cost of common equity for the security being analyzed, R_f equals the risk free rate, β is beta, which equals the company or industry-specific beta risk measure, R_m equals market return, and $(R_m - R_f)$ equals market risk premium. (*Id.*, p.30, l. 17 – p. 31, l. 3) For the risk-free rate, Morin used a 30-year Treasury rate of 4.5%. For beta, he used 0.87, and for the market risk premium, he used

¹ The recommendation if the Company does not get a FAC is 11.15%. (*Id.*)

7.4%. (*Id.* at ll. 5-7) Thus, the formula would be stated: $K = 4.5\% + 0.87 \times 7.4\%$, or 10.9%. (*Id.* p. 40, ll. 22 – 26) Each of the inputs used is problematic.

At the time of the hearing, the 30-year Treasury rate had fallen to 4.24%. (Ex. 502) Beta had fallen to either 0.80 or 0.81. (Ex. 005, p. 4, ll. 3 – 4; *id.* p. 29, ll. 15 – 16). Just making those changes would result in a much lower return on equity: $4.24\% + 0.81 \times 7.4\% = 10.23\%$.²

However, the market risk premium is also seriously flawed. Morin used two approaches to determine the market risk premium: an historical analysis and a prospective risk analysis. His source for the historical analysis is Ibbotson Associates, which provided both a total return of 6.5% and an income only return of 7.1%. Morin chose the higher number because “realized capital gains/losses are largely unanticipated by bond investors.” (Ex. 003, p. 36, ll. 10 – 11) He cites no authority for this counterintuitive conclusion. Nor does he explain why we should be concerned about the mindset of bond investors when what we are seeking to determine is the risk premium needed to encourage someone to invest in the Company’s publicly-traded equity.

For his prospective risk analysis, Morin applied a DCF analysis to aggregate market equity. (*Id.*, p. 38, ll. 10 – 11) He does not explain why the aggregate equity would be a reliable surrogate for this purpose. Furthermore, he projected a long-term dividend growth rate of a whopping 9.3% (*id.* at ll. 13 – 14),

² The adjusted ECAPM, discussed below, would be 10.59%: $4.24\% + (0.25 \times 7.4\%) + 0.81(0.75 \times 7.4\%) = 10.59\%$. (See Ex. 003, p. 41, l. 14 – p. 43, l. 20.)

a full 330 basis points above his estimated long-term growth in Gross Domestic Product (Ex. 004, p. 40, ll. 4 – 7),³ resulting in a prospective market risk premium of 7.7% (Ex. 003, p. 38, ll. 21 – 22). His market risk premium of 7.4% results from averaging the historical and prospective risk premiums. (*Id.*, p. 39, l. 2)

If he had simply used the lower number from Ibbotson Associates, his results would change even more dramatically. Combining all of the changes necessitated by the timing of this rate case and his absurdly high risk premium results in the following formula: $4.24\% + 0.81 \times 6.5\% = 9.51\%$. This return on equity of 9.51% is virtually identical to the recommendation of the Staff's expert's recommendation of 9.5%.

Morin also uses an ECAPM analysis. Each of the other experts criticized this approach for double counting the needed adjustment to beta and artificially inflating the return on equity. (Ex. 204, p. 16, ll. 3 – 21; Ex. 601, p. 9, l. 9 – p. 10, l. 8; Ex. 650, p. 8, ll. 1-3) It is a somewhat more complicated formula that results in an ROE of 11.2% using Dr. Morin's inputs. (Ex. 003, p. 43, ll. 15 – 20) Making the changes suggested above would lower the ROE to 9.81%.⁴ Thus, the average or the CAPM analyses performed by Morin with these adjustments would be 9.66%.⁵

³ Long-term growth is constrained by GDP growth. (Ex. 601, p. 6, l. 10 – p. 7, ll. 22) Historically, utility growth rates have been much lower than GDP growth. (Tr. 15, p. 578, l. 25 – p. 579, l. 9)

⁴ $4.24\% + (0.25 \times 6.5\%) + 0.81(0.75 \times 6.5\%) = 9.81\%$

⁵ If only the current risk free rate and beta were changed, the average would be 10.41%.

B. Risk Premium

Dr. Morin engages in two risk premium analyses: an historical analysis with a risk premium of 5.7% and a risk-free rate of 4.5%, resulting in a 10.2% ROE (*id.*, p. 44, ll. 6 – 20); and an allowed return analysis with a risk premium of 5.6% and a risk-free rate of 4.5%, resulting in a 10.1% ROE (*id.*, p. 46, l. 7 – p. 47, l. 4). By applying the risk-free rate in effect at the time of the hearing (4.24%), these ROE's become 9.9% and 9.8%, respectively. The average would be 9.85%.

C. DCF

The DCF analysis is predicated on the formula: $K_e = D_1/P_o + g$, where K_e equals the expected return, D_1 equals the expected dividend at the end of the coming year, P_o equals the current stock price, and g equals the expected growth rate. (*Id.*, p. 48., l. 17 – p. 49, l. 8) Dr. Morin performed a plain vanilla DCF analysis using two different proxy groups (*id.*, p. 50, ll. 12 – 14) and two different growth assumptions (*id.*, p. 52, ll. 4 – 8). Using this formula and his assumed dividend and growth rate, Dr. Morin calculated an ROE for each of the surrogate companies and then produced an average of all the companies in the surrogate group. (*Id.*, p. 57, l. 3 – p. 58, l. 17 & RAM-E5-2, RAM-E6-2, RAM-E7-2, & RAM-E8-2)

The problem with this analysis is that Dr. Morin uses the average ROE of his proxy companies. (*Id.*, p. 57, ll. 7 – 9, 17 – 20; p. 58, ll. 5 – 6, l. 13) However,

each of these groups contains outliers that skew the average,⁶ and Dr. Morin testified that the appropriate way to deal with outliers is to use the median rather than the average (Ex. 004, p. 50, ll. 5 – 6; *see also* Tr. 13, p. 290, ll. 10 – 17). If we follow Morin’s recommendation and use the median here, it would result in ROEs of 9.6%, 11.05%, 10%, and 10.8%. (*See* Ex. 003, RAM-E5-2, RAM-E6-2, RAM-E7-2, & RAM-E8-2) The average of these DCF analyses is 10.36%.

D. Summary of Adjusted Results

The adjusted results for Dr. Morin’s analyses are:

CAPM	9.66%
Risk Premium	9.85%
DCF	<u>10.36%</u>
Average	9.96%

Even if no adjustment is made in the CAPM models for the inflated risk premium used by Dr. Morin, the average ROE would be 10.21%, right in line with Mr. Gorman’s recommendation.

E. Flotation Costs

Dr. Morin recommended a “flotation cost adjustment” of approximately 30 basis points to compensate the stockholders for the costs of issuing stock despite the fact that there is no evidence in the record that UE sold any stock during the test year. (Ex. 003, p. 61, l. 10 – p. 64, l. 17) He bases this adjustment on the

⁶ Schedule RAM-E5-2 cost of equity ranges from 5.5% to 20.5 % with most falling between 7.1% and 11.1%; RAM-E6-2 from 8.1% to 16.5% with most between 9.4% and 12.6%; RAM-E7-2 from 5.5% to 18% with most between 8.8% and 12.4%; and RAM-E8-2 from 7.8% to 21.7% with most between 8.5% and 15.7%.

assumption that flotation costs are not expensed, despite the fact that there is no evidence in the record that the Commission does not or would not expense such costs if they were prudently incurred in the test year. (*Id.*, p. 61, ll. 14 – 15) Nor is there any evidence of the Company’s actual flotation costs that have not been expensed, if there are any such expenses. In short, this adjustment is a theoretical construct to boost ROE that is not supported by any evidence in the record.

F. Market Turmoil

Although the Company suggested that the Commission should set the ROE in this case mindful of the current financial situation, Dr. Morin did not agree. He testified that he was not recommending any adjustment at this time. (Tr. 15, p. 384, ll. 11-15) In fact, in his pre-filed testimony, he emphasized on several occasions that it was important to take the long view when calculating ROE and not be swayed by near term events. (*See, e.g.*, Ex. 003, p. 36, ll. 20 – 23; p. 37, ll. 8 – 9; Ex. 005, p. 8, l. 20 – p. 9, l. 6) Therefore, the Commission should not be influenced by the current market turmoil in determining the ROE.

II. FUEL ADJUSTMENT CLAUSE

Traditional rate case principles disfavor any mechanism that is designed to address only one item in the vast number of income and expense items any company will have. (Ex. 500, p. 2, ll. 10 – 14) All data must be compared over the same time period to avoid a mismatch of revenue and expenses which could allow rates to be set at a level that would provide an excessive return to the utility. Both costs and revenues are constantly in flux and neither can ever be predicted

with certainty. Some costs may be going up, while others may be going down. Revenue may be higher or lower than forecast due to shifts in customer usage, abnormal weather, and other factors. Test year regulation prevents any cost or revenue factor from being considered in isolation. (*Id.*, p. 4, ll. 1 – 8)

A. The Company Has Not Satisfied the Commission’s FAC Standards

Although fuel adjustment clauses have become relatively commonplace, that does not mean every utility needs one. The Commission has laid out a three-part test to determine when a fuel adjustment clause is appropriate. A fuel adjustment clause may be allowed if fuel costs are:

1. Substantial enough to have a material impact upon revenue requirements and the financial performance of the business between rate cases;
2. Beyond the control of management, where utility management has little control over experienced revenue or cost levels; and
3. Volatile in amount, causing significant swings in income and cash flows if not tracked.

(ER-2007-0002 Order at 20) UE has not met this standard.⁷

No party disputes that the Company’s fuel costs are substantial.⁸ But the

⁷ The Company has argued that there is also a statutory standard, that the FAC “[i]s reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity.” § 386.266.4(1), RSMo. However, the statute makes clear that this is a requirement: The Commission “*may* approve” a FAC if it fulfills that requirement, and may not if it doesn’t. *Id.* (emphasis added) The statute is silent on how the Commission is to exercise its discretion.

⁸ The Staff disputes whether the changes in fuel costs are substantial enough to meet this standard. (Tr. 26, p. 2625, l. 15 – p. 2626, l. 2)

Company does have substantial control over those costs and the vast majority of such costs are not sufficiently volatile to cause “significant swings in income and cash flows.”

More than **[REDACTED]** of UE’s energy is generated from coal-fired plants (Ex. 001, p. 17, l. 23 – p. 18, l. 1) Coal represents approximately 82% of all of the Company’s fuel costs. (Ex. 031, Attachment A-2) As a relatively coal intensive utility, AmerenUE is less exposed than most of its peer companies to fluctuations in natural gas and oil fuel prices. (Ex. 500, p. 13, ll.19 – 21) The percentage of gas-powered generation is relatively small and does not affect the overall magnitude of uncertainty. (Ex. 022, p. 12, ll. 20 – 23)

A very large percentage of the Company’s costs of coal are hedged. (Ex. 500, p. 16, l. 9 – p. 17, l. 3) Therefore, the Company has exercised effective control over the largest portion of its fuel costs. It has not met its burden on the second prong of the test.

The Company attempts to meet the third prong of the test by extensive testimony regarding the “uncertainty” of projected fuel costs. Of course projections of future fuel costs are “uncertain” – that is the nature of projections. No one can know what the future will bring, therefore no one can ever be certain of the future. This tautology is the sum and substance of the Company’s testimony.

But the Commission’s standard does not reference “uncertainty.” Instead, it focuses on volatility, *i.e.*, whether the prices fluctuate rapidly and create

significant swings in income and cash flows. Although the Company's witnesses attempt to equate "uncertainty" with volatility, there is simply no evidence that price fluctuations in the cost of fuel have created swings in income and cash flows.

The evidence does establish that there have been steadily rising fuel costs over the past few years. It may be that such costs will continue to rise – or not. Regardless, rising fuel costs do not justify a fuel adjustment clause. The Commission's view of this argument was succinctly stated in its ER-2007-0002 order: ". . . rising, but known, fuel costs are the worst reason to implement a fuel adjustment clause." (p. 23)

B. The Company's Proposed Sharing Mechanism Provides Insufficient Incentives

If the Commission does determine that a fuel adjustment clause is appropriate, it should ensure that the Company has appropriate incentives to minimize its net fuel costs. The 95/5 sharing mechanism proposed by the Company does not achieve this objective.⁹ The Company's exposure is immaterial when compared to its total revenues and expenses.

A number of the Company's witnesses testified that the Company's incentive compensation worked to focus employees on the Company's goals and motivated them to achieve those goals. (Tr. 13, p. 109, ll. 19 – 21; p. 10, ll. 16 – 21; Tr. 18, p. 1410, l. 17 – p. 1411, l. 11; Tr. 25, p. 2180, ll. 12 – 19; Tr. 26, p.

⁹ Despite the Company's repeated statements that most FACs are 100% pass through, there is evidence to the contrary. (Tr. 15, p. 587, l. 22 – p. 588, l. 10; Ex. 244, p. 3.)

2458, ll. 7 – 16; p. 2493, l. 5 – p. 2494, l. 21) In fact, Ms. Bauer even testified that highly motivated individuals would voluntarily forego fixed compensation that would guarantee them the same amount as they could earn from incentive compensation. (Tr. 18, p. 1449, ll. 1 – 8)

At the officer level, the percentage of incentive compensation begins at 35% for Vice Presidents and goes to 90% for Mr. Rainwater. (Id., p. 1438, l. 21 – p. 1439, l. 24) Clearly, the Company realizes that in order to motivate these individuals it is important that they have “substantial skin in the game.” *In re: Union Electric Company’s 2008 Utility Resource Filing Pursuant to 4 CSR 240-Chapter 22*, EO-2007-0409, Tr. 2. p. 21, l. 17 – p. 22, l. 9.

Despite requiring a much higher percentage of “skin in the game” from its officers, the Company argues that a 5% share in the costs is ample incentive. Mr. Cohen provided an example where that would not be the case, and which would almost certainly evade discovery on a prudence review. (Ex. 501, p. 10, l. 6 – p. 7, l. 18) More importantly, Mr. Lyons – the Chief Financial Officer of UE – testified that \$8 million dollars is “not very material in the context of AmerenUE’s overall fuel budget.” (Ex. 042, p. 35, ll. 11 – 12) To reach an \$8 million dollar impact on a 95/5 share, the Company’s net fuel costs would have to increase by 80%. (Tr. 26, p. 2538, l. 15 – p. 2539, l. 14) This is not a meaningful incentive.

The fact that the Commission approved a 95/5 share in both Aquila and Empire does not support granting the same sharing mechanism in this case. Under the Company’s plan, the impact on earnings per share would be three to four times

greater on Empire and Aquila than on UE. (*Id.*, p. 2540, l. 22 – p. 2541, l. 12; Ex. 607, Sched. MEB-FAC-2) Therefore, a sharing percentage four times greater, as suggested by Messrs. Cohen and Brubaker, would be reasonable.

III. Callaway Unit II License

The Company has filed little testimony attempting to justify inclusion of the amount spent on applying for a license to construct and operate a second nuclear power plant in its cost of service. The only justification the Company has offered is that the license application is an asset that has value. Their witness could not identify what that value was and had no knowledge of any sale of a license application. (Tr. 18, p. 1320, ll. 15 – 21)

Furthermore, even if the application has value, the Company does not provide any evidence why this asset should be treated differently from any other construction work in process. If the Company purchases a gas turbine for generation, that asset has value (a much more certain value than the speculation regarding the application). Nevertheless, it does not go into the rate base until it is used and useful. (Tr. 13, p. 252, l. 24 – p. 253, l. 7) Why should the license application be treated any differently? The Company provides no answer.

Finally – and most importantly – section 393.135, RSMo, prohibits inclusion in rate base of any “cost associated with owning, operating, maintaining, or financing any property before it is fully operational and used for service.” Callaway Unit II does not even come close to complying with the statute.

Therefore, the amount spent on the license application cannot legally be included in the cost of service.

Respectfully submitted,

JEREMIAH W. (JAY) NIXON

/s/ H. Todd Iveson

H. Todd Iveson
Assistant Attorney General
MBE #37650

P. O. Box 899
Jefferson City, MO 65102
Telephone (573) 751-3640
Facsimile (573) 751-8464
Todd.Iveson@ago.mo.gov

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was mailed electronically this 8th day of January, 2009, to all counsel of record.

/s/ H. Todd Iveson

H. Todd Iveson