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Issues:	Rate LTS Class Cost Of Service
Witness:	Donald Johnstone
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Noranda
Case Number:	ER-2007-0002
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AmerenUE

Case No. ER-2007-0002

Prepared Surrebuttal Testimony of

Donald Johnstone

Competitive Energy DYNAMICS

On behalf of

Noranda Aluminum, Inc.

February, 2007

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-2007-0002

Affidavit of Donald Johnstone

State of Missouri)
) ss
County of Camden)

Donald Johnstone, of lawful age, on his oath states: that he has reviewed the attached written testimony in question and answer form, all to be presented in the above case, that the answers in the attached written testimony were given by him; that he has knowledge of the matters set forth in such answers; that such matters are true to the best of his knowledge, information and belief.

Donald Johnstone

Donald Johnstone

Subscribed and sworn before me this 27 th day of February, 2007

Carolyn Neporadny

Notary Public

CAROLYN NEPORADNY
Notary Public - Notary Seal
STATE OF MISSOURI
Commissioned for Camden County
My Commission Expires: August 30, 2009
Commission Number 05452654

AmerenUE

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Prepared Surrebuttal Testimony of Donald Johnstone

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Before the
Missouri Public Service Commission

AmerenUE

Case No. ER-2007-0002

Prepared Surrebuttal Testimony of Donald Johnstone

Q **PLEASE STATE YOUR NAME AND ADDRESS.**

A My name is Donald Johnstone and my address is 384 Black Hawk Drive, Lake Ozark, Missouri, 65049.

Q **ARE YOU THE SAME DONALD JOHNSTONE THAT SUBMITTED DIRECT AND REBUTTAL TESTIMONIES IN THIS PROCEEDING?**

A Yes. My qualifications and experience are set forth in Appendix A to my direct testimony.

Q **WHAT ARE THE PURPOSES OF YOUR TESTIMONY?**

A I will respond to Mr. Hanser, to the Staff rebuttal testimonies of Mr. Roos and Mr. Busch, and recap my rate recommendations.

SUMMARY OF TESTIMONY

Q PLEASE SUMMARIZE YOUR TESTIMONY.

- Mr. Hanser proposes a residential rate cap to be funded by a subsidy from the business customers of Ameren.
  - Mr. Hanser's claim that the rationale for Cap/Subsidy proposal is accepted is unsupported and disingenuous.
  - The Cap/Subsidy proposal fails Mr. Hanser's own test that he applies to the subsidy proposal of Mr. Quinn.
  - The Cap/Subsidy proposal undeniably burdens the business community and contradicts the stated economic development goals and policies of Governor Blunt and the DED Director Steinhoff.
- Staff's rebuttal of the Ameren and MIEC class cost-of-service study methods is in error and overlooks the shortcomings of its own method.
  - Staff's analysis and rebuttal contradicts the State's economic development goals and policies of Governor Blunt and Director Steinhoff.
  - Staff overlooks the fact that its method, unlike the Ameren or MIEC methods it criticizes, discriminates against native load off-peak consumption in favor of off-system sales - to the benefit of states that compete with Missouri.
- The OPC class cost-of-service study methods, like those of the Staff, are flawed and produce biased results that should not be approved or relied upon in any way.
- The role of Staff on matters of class cost-of-service should be as a neutral party providing the Commission with information that will assist in informed decisions.
  - The "fair" balancing of interests is the job properly reserved for the Commission.
- The Commission should establish a cost-based LTS rate based on the Ameren class cost-of-service study method as revised.
  - The Ameren method falls in the middle of all studies.
  - If the overall increase is so large that it creates an impact problem for the residential class, there should be a phase-in of the residential increase funded by the residential class or by Ameren.

MR. HANSER'S RATE CAP/BUSINESS SUBSIDY PROPOSAL

Q HAVE YOU REVIEWED THE REBUTTAL TESTIMONY OF MR. HANSER IN REGARD TO HIS PROPOSED RESIDENTIAL RATE SUBSIDY?

A Yes. Mr. Hanser defends his proposal for a 10% limit on the residential rate increase, and he also defends his proposal to collect the shortfall (an overt subsidy) from other customers including the business community served by Ameren. Briefly stated, his rationale is that business customers of Ameren have a better ability to absorb the impact of a rate increase and that a 10% cap on the residential increase is appropriate bases on several different yardsticks.

Q DOES MR. BRUBAKER ASSERT THAT MR. HANSER'S RATIONALES ARE NOT ACCEPTED IN THE INDUSTRY?

A Yes.

Q DOES MR. HANSER OFFER A PERSUASIVE RESPONSE?

A No. Instead, he attempts to join a simple statement of disagreement with disingenuous assertions that his rationales are recognized as "…affecting utilities' customer programs for energy efficiency, demand-side management and so on…" Conspicuously absent from his list is a rate cap and subsidy proposal.

At best Mr. Hanser's merely argues that his "rationale" has been considered for other purposes because customer impact is a consideration.

That is a long way from relying on his rationale in the context of a rate cap and subsidy proposal, particularly in the face of his own testimony that his proposed rate cap is less than each of the measures he offers for comparison.

Q ARE YOU AWARE OF ANY OTHER COMMISSION THAT HAS CONSIDERED SIMILAR FACTS AND DETERMINED TO LIMIT THE INCREASE IN A RESIDENTIAL RATE AT THE EXPENSE OF THE NON-RESIDENTIAL CUSTOMERS?

A No, I am not. Mr. Hanser's claim for his rationales is very misleading. In fact, his five points do not even support the arbitrary cap as reasonable. To the contrary, the proposed cap is less than every yardstick he sets out.

I must emphasize that Mr. Hanser's attempt to justify the rate cap is unique. There is simply no support to be taken from the notion that either his rationale or his specific proposal represents an approach that is commonly considered or approved by regulatory commissions.

Q WHAT ARE THE MEASURES OF CUSTOMER IMPACT USED BY MR. HANSER?

A Mr. Hanser offers five different yardsticks as a measure for the impact of a residential rate increase. They are:

1. The impact of a 10% increase would be ***less than*** the increase in prices from the typical market basket of goods.

2. The impact on the residential class would be ***less than*** the increase in nominal wages for the period 2002 through 2005.

3. The impact is ***less than*** any increase in the core inflation rate.

4. The residential increase would be ***less than*** the increase in prices of other energy resources in the Midwest [By comparison Mr. Hanser offers a 60% increase in gasoline prices, a 95% increase in fuel oil prices, and a 71% increase in natural gas prices for the period from 2002 through 2005.]

5. The increase would be ***less than*** that of residential rates in other states including both those that have restructured and those that have not. [emphasis and supplementation added]

In short, pursuant to his rationale Mr. Hanser proposes a subsidy to be paid by the non-residential customers including everything from eleemosynary institutions, to religious structures to the business community so that the resulting residential rate would be less than every standard for measure that he identifies.

Q WHICH OF MR. HANSER'S 5 DIFFERENT MEASURES RELATE TO THE COST OF THE SERVICE PROVIDED TO AMEREN'S RESIDENTIAL CUSTOMERS?

A None do. Of course, the problem and the point is that the measures have nothing to do with the cost of the services provided to residential customers. The equity of rates based on the cost of service is ignored.

Q IS THERE AN IMPACT ON THE CUSTOMERS THAT WOULD SUBSIDIZE THE RESIDENTIAL COST OF SERVICE UNDER MR. HANSER'S PROPOSAL?

A Yes. Mr. Hanser's proposal leads to substantially higher rates for all of the non-residential and business customers.

Q HAS MR. HANSER FAILED TO CONSIDER AND IDENTIFY RATIONALES THAT COMMISSIONS HAVE CONSIDERED THAT COULD LEAD TO A DIFFERENT RESULT?

A Yes. It is widely recognized that good jobs are essential to a healthy economy. As such, Commissions are often presented with evidence of the importance of economical energy to the business community. Mr. Hanser would have the Commission move in the opposite direction. This is not consistent with the goals of the State of Missouri.

MISSOURI ECONOMIC DEVELOPMENT POLICY

Q HOW DOES THE IMPACT OF MR. HANSER'S CAP/SUBSIDY SQUARE WITH THE ECONOMIC DEVELOPMENT POLICY OF THE STATE OF MISSOURI?

A Mr. Hanser proposes to handicap the business community with large costs that belong to the residential rate. The impact is large, offensive to economic development, and seriously at odds with the goals of the State of Missouri.

Q WHAT IS THE ECONOMIC DEVELOPMENT POLICY OF THE STATE OF MISSOURI?

A Schedule 1 consists of several pages from the State of Missouri website. On the opening page for the Department of Economic Development there is a statement by Governor Blunt. In part the Governor states:

> The dynamic and aggressive new approach our Department of

> Economic Development has taken to attract new business and business expansion to our state sends a clear message that Missouri is open for business.

Later in the same paragraph the Governor states,

> This administration and particularly the Department of Economic Development will continue to work to increase economic opportunities for all our citizens and bring high quality, high paying, family supporting jobs to Missouri.

Unfortunately, Mr. Hanser's proposal flies in the face of the State's policy direction established by Governor Blunt. In contrast to an aggressive "open for business" approach, Mr. Hanser would send a signal that Missouri is unconcerned about the cost of doing business in the State. Hanser's proposal would do this by increasing the energy costs for business, even though the only purpose would be to achieve a result for the residential rate that is not only below cost, but also less than the average increase by every one of the five "yardstick" measures identified by Mr. Hanser.

Q DOES THE STATE OF MISSOURI WEB SITE ALSO PROVIDE A STATEMENT BY THE DIRECTOR OF THE MISSOURI DEPARTMENT OF ECONOMIC DEVELOPMENT, MR. GREGORY STEINHOFF?

A Yes. Mr. Steinhoff states:

> . . . as Director I am committed to improving this State's business climate in support of economic and entrepreneurial growth.

Again, there is an obvious concern for the business climate in the State of Missouri. Mr. Steinhoff is committed to improving the business climate while

Mr. Hanser would have the Commission take the business climate in the opposite direction. (Please see the Schedule 1 for the complete statement of Mr. Steinhoff.)

Q ARE THERE ANY ADDITIONAL STATEMENTS ON THE STATE OF MISSOURI WEBSITE?

A Yes. There is a "Business Solutions" section. One of the more relevant statements is the following;

> The state is also working to strengthen the competitiveness of its traditional industries such as communications, transportation, non durable and durable manufacturing, wholesale trade, health services and construction.
>
> Missouri is an affordable place to do business. The cost of many key operating expenses such as office space, electricity and natural gas are well below the national average.

The price of electricity is important because it can either help or hurt Missouri attract new business. Furthermore, in my experience the retention of existing industry and existing well paying jobs is just as important as the recruitment of new jobs. (Again, the entire statement is included in Schedule 1.)

MR. HANSER'S TARGETED SUBSIDY TEST

Q ARE THERE ANY OTHER ASPECTS OF MR. HANSER'S REBUTTAL TESTIMONY RELEVANT TO MR. HANSER'S CAP/SUBSIDY PROPOSAL?

A Yes. Mr. Hanser criticizes the essential services rate proposal of Mr. Quinn for four reasons. The four reasons are:

1. Mr. Quinn fails to substantiate the need.
2. The proposal is not well targeted.
3. The proposal subsidizes all residential customers, not just those in need.
4. The proposed rate may or may not reflect cost, depending on the time of use of the energy.

Since Mr. Hanser has provided four ways to criticize a subsidy proposal, it is reasonable to test his rate cap/subsidy proposal according to his own criteria.

Q TEST 1. DOES MR. HANSER SUBSTANTIATE A NEED FOR HIS CAP/SUBSIDY PROPOSAL?

A Nowhere does he establish a need for the 10% rate cap. He only suggests that business customers can better accommodate an increase, so he concocts the cap and proposes to have the subsidy paid by all non-residential customers. There are no studies to establish need in the sense of any inability to pay the Ameren residential rate. Nor are there any studies to establish any less need for a cost-based rate for the non-residential customers generally or the business customers that would pay the Hanser subsidy.

Q TEST 2. IS THE CAP/SUBSIDY PROPOSAL OF MR. HANSER WELL TARGETED?

A The Quinn proposal is intended to benefit low income customers and customers that may be close to being low income, but the proposal is to apply the rate to all residential customers. Mr. Hanser responds by talking about gas heat. The same customers that have gas heat under the Quinn proposal have gas heat under Mr. Hanser's cap/subsidy proposal. Unlike Mr. Quinn, Mr. Hanser makes no effort to establish a targeted group. Mr. Hanser simply proposes to cap the rate for every residential, regardless of need. I can only conclude that whatever problem there is in Mr. Quinn's proposal must be equally present in the Mr. Hanser's cap/subsidy proposal. The same customers have gas heat and the same customers have low income, or not, as the case may be.

Q TEST 3. DOES THE HANSER CAP/SUBSIDY PROPOSAL SUBSIDIZE ALL RESIDENTIAL CUSTOMERS, OR JUST THOSE IN NEED?

A The entire residential class receives the capped rate. There is no pretext of a target based on need. On this point Mr. Hanser states: "Subsidizing the electricity consumption of affluent customers is both unnecessary and poor policy because it reduces customers' incentive to invest in energy efficiency (*e.g.*, insulation, efficient appliances). Affluent customers, more than other customers, have the financial means to purchase energy-efficient appliances and equipment with higher initial costs but lower life-cycle costs (because of the energy savings). Such customers should not be dissuaded from making cost-effective energy investments."

To restate the obvious, Mr. Hanser's cap/subsidy fails this test.

Q REASON 4. DOES THE PROPOSED RATE REFLECT COSTS?

A No. By definition the Hanser cap is designed to ignore costs. It starts from an Ameren class cost-of-service study and distorts the results downward for every residential customer and upward for non-residential and business customers.

Q IN SUMMARY, DOES THE HANSER CAP/SUBSIDY PROPOSAL PASS OR FAIL UNDER THE SEVERAL TESTS HE APPLIES TO THE PROPOSAL OF MR. QUINN?

A The cap/subsidy proposal fails every test Mr. Hanser would apply. It is ironic that Mr. Hanser himself has provided tests for a subsidy program that, when applied to his own subsidy proposal, illustrate so well the fundamental problems in his proposal.

Q GIVEN THE PROBLEMS OF MR. HANSER'S CAP/SUBSIDY PROPOSAL, WHAT IS THE CORRECT APPROACH TO ELECTRIC RATES?

A The correct approach is cost-based rates. Although a variety of factors can be relevant in any particular situation, the cost of the services provided remains the primary and accepted basis for rates.

STAFF CLASS COST-OF-SERVICE STUDY REBUTTAL

Q HAVE YOU REVIEWED THE REBUTTAL TESTIMONY OF MR. ROOS REGARDING THE CLASS COST-OF-SERVICE STUDIES?

A Yes. Mr. Roos prepared a summary of the class cost-of-service study results submitted by the parties. The table below restates the information from Mr. Roos sorted in order of highest increase to rate LTS (Noranda) down to the largest decrease. Coincidentally or not, the order of results for the residential rate class is the exact opposite.

Table 1.
Roos class cost-of-service Summary
Sorted by Results

	Res	LPS	LTS
Staff	0.44%	15.67%	10.92%
OPC 2	1.72%	17.58%	1.76%
AARP	1.60%	17.60%	-1.26%
OPC	5.51%	11.00%	-6.90%
AmerenUE	8.40%	10.29%	-11.27%
MIEC 2	11.60%	1.00%	-19.90%
MIEC 1	14.10%	-3.06%	-26.56%
MIEC 3	15.70%	-5.50%	-30.80%

Q WHICH STUDY PRODUCED THE WORST IMPACT FOR RATE LTS?

A The Staff study stands out from all others as the worst for Noranda. It also shows the lowest increase for the residential class.

Q HOW DOES THE STAFF STUDY COMPARE TO THOSE SUBMITTED BY AARP AND OPC?

A It is worse for Noranda and better for the residential class.

Q IS NORANDA CONCERNED WITH THESE RESULTS?

A Yes. Noranda is concerned with the appearance that the Staff of the Commission is supporting a position that is 1) extreme as compared to other study results, 2) detrimental to Noranda and all other high load factor customers of Ameren, and 3) inconsistent with the economic development interests of the State of Missouri.

Q **WHY DO YOU SAY THAT THE STAFF HAS TAKEN AN EXTREME POSITION?**

A Every other party submitted a cost study that showed a decrease is in order for Noranda. In contrast, the Staff study showed an 11% increase. I note that OPC has continued to change its studies subsequent its direct testimony and has moved in Staff's direction and a little beyond.

Q **WHY ARE YOU CONCERNED WITH THE APPEARANCE THAT THE STAFF STUDY IS BIASED AGAINST HIGH LOAD FACTOR CUSTOMERS SUCH AS NORANDA?**

A The results speak for themselves. The results go beyond those of AARP and the initial results OPC. (I will address revisions later in this testimony.)

Q **IS THE STAFF STUDY INCONSISTENT WITH THE INTERESTS OF THE STATE OF MISSOURI?**

A Based on the statements of Governor Blunt and Director Steinhoff, it is certainly not consistent with the interests of the State in economic development. This is puzzling to me and my client.

Q **WHAT IS PUZZLING ABOUT THE SITUATION?**

A Besides the statements by Governor Blunt and Director Steinhoff, Noranda has worked on economic development issues itself and understands that the State is sincere in its efforts. With this background, an anti-business approach to cost allocation from the Staff of an organization that is part of the State of Missouri Department of Economic Development is incongruous.

Noranda works hard to achieve and retain good jobs with employee benefits. It is disturbing to find the Staff working to increase its costs.

Q HOW DID THE STAFF REACH SUCH A RESULT?

A The problem is a lack of focus on recognized principles of cost causation and instead a focus on perceived "fairness."

Q ISN'T IT THE JOB OF STAFF TO BE FAIR?

A That is the job of the Commission. If Staff produces a study that is to be characterized as a cost study, it should do so objectively. It should not be skewed by any particular Staff notion of fairness.

Q WHAT IS WRONG WITH A STAFF'S GOAL OF A "FAIR" STUDY?

A The problem with Staff interjecting what constitutes "fair" into a cost study is that "fair" is often not an objective standard. "Fair" can often be in the eye of the beholder. Hence, if Staff uses a particular brand of "fair" in preparing testimony, the Commission is thwarted in its job of balancing interests.

In this case, the extreme results for Noranda help to illustrate that, whatever the intentions, the result is a study that overstates the cost to serve high load factor customers in general and Noranda in particular.

Q STAFF DID NOT RECOMMEND A REVENUE NEUTRAL RATE INCREASE FOR RATE LTS. DOES THAT SOLVE THE PROBLEM?

A No. That does not fix the cost study and it only moves Staff recommendation from extreme to somewhat less extreme. The problem remains.

Q DO YOU HAVE AN OPINION AS TO WHY THE STAFF RESULTS ARE BIASED AGAINST HIGH LOAD FACTOR CUSTOMERS?

A Earlier I mentioned a lack of focus on the principle of cost causation. In my opinion that has led to focus on results and perceived "fairness."

Q PLEASE EXPLAIN.

A I will address this two ways: first in a technical sense, and then in the sense of attitude or approach to the class cost-of-service problem.

Q WHAT IS THE PROBLEM IN A TECHNICAL SENSE?

A The Staff capacity utilization approach confuses fixed costs with variable, and confuses the use of capacity with the cost of the capacity.

Q WHY IS IT IMPORTANT TO NOT CONFUSE FIXED COSTS AND VARIABLE COSTS?

A Every industrial plant manager understands and confronts the same challenges with fixed costs. If output goes down for a month, a week or even a day the fixed costs do not go away. They remain and at the end of the month the average production cost will go up as a result any decline in output. That effect is summarized by load factor. Fixed costs are why a high load factor reduces the average costs. Low costs are good and a high load factor is therefore good[1].

Q HOW DOES LOAD FACTOR RELATE TO THE TECHNICAL PROBLEM WITH THE STAFF CLASS COST-OF-SERVICE STUDY?

A Staff badly understates the importance of peak demands in its allocation of production capacity costs and as a result allocates a major portion of the capacity costs to off-peak periods of the year and to high load factor usage. In order for this approach to be accurate, it must be true that costs will go down if capacity is not used off peak and, likewise, it must be true that costs will go up when it is used off peak. That is not reality. Mr. Busch states that the Staff approach is "fair." Perhaps the conclusion is based on the result. One thing is certain, the Staff method is not based on the principle of cost causation. The conclusion of "fairness" can only derive from an alternative unstated definition of what constitutes "fair."

As a consequence of the error, the Staff study does not reflect the principle of cost causation. Instead, the Staff study, apparently based on a notion of fairness instead of cost reality, shifts fixed costs from the on peak

[1] Some analysts argue that high load factor is neither good nor bad, but just a reality of the usage. This may be true in an academic sense, but in a business environment low costs are essential to profits and survival. Suffice to say, from a Noranda perspective a high load factor and low costs are vigorously pursued as essential to long term success.

periods of cost causation to off peak periods -- from low load factor usage to high load factor usage as is represented by Noranda.

Q HOW DOES STAFF MAKE THIS ERROR?

A Let me set some background and then I will get to the error. In a historical context, some 20 years age, Staff was looking for a method to support the development of seasonal rates. To that end it sought a method to spread production costs to the seasons[2]. Staff developed a method of spreading the fixed costs throughout the 8,760 hours of the year and called its method "Capacity Utilization."

As explained by Mr. Busch, the proponent of the Staff method in this case, utilities install base load capacity, with its higher capital cost, to meet demands through the year, not just peak demands, and for that reason, he states that costs must be allocated throughout the year. This a point on which he errs in his rebuttal of the Ameren and MIEC studies.

It is true that base capacity is expected to be used for many hours. But Staff incorrectly reasons from this that fixed costs are caused by every hour of the year. They are not.

To the extent that capacity is used at some level in every hour that is good thing because usage lowers the average cost. But using the capacity off peak is much different than creating the capacity cost. The fixed capacity

[2]See Missouri Public Service Commission Docket EO-2002-0384, Transcript of November 8, 2005 Hearing, pp. 322-323.

costs are not created by the off-peak usage and should not be allocated as such.

Q CAN YOU PROVIDE ANY ILLUSTRATION OF THE POINT THAT CAPACITY COSTS ARE NOT CAUSED BY OFF-PEAK USAGE?

A One illustration is provided by the economic dispatch process.

Q ARE FIXED CAPACITY COSTS A PART OF THE ECONOMIC DISPATCH OF THE AMEREN PRODUCTION CAPACITY?

A No. It would violate the premise of economic dispatch to do so. Economic dispatch process is the method used find the most "economical" (lowest cost) means of serving the native load given the generation system, its capabilities, and its limitations. Economic dispatch is a dynamic series of decisions with the goal of achieving the lowest total operating cost.

Only those costs which increase as the result of an increase in the production of electricity are included – those would be the variable costs. By definition, fixed costs are excluded because they do not change whether capacity is used or not. If the fixed costs changed as a result of usage throughout the year they would need to be included in these models. Neither Ameren nor Staff includes fixed costs in their economic dispatch models.

Q DOES OFF-PEAK USAGE MAKE A DIFFERENCE WHEN IT COMES TO PLANNING THE SYSTEM?

A It makes no difference on a system like Ameren's. There are sufficient hours at high loads to justify a capacity mix with an abundance of base load capacity. Further, due in large part to the seasonal nature of the load, in the vast majority of the hours there is more than enough base load capacity. Consequently, neither the current level of use in off-peak hours nor any additional use in off-peak hours creates the need for additional base capacity.

Q IS THERE A DIFFERENCE BETWEEN THE COSTS USED ECONOMIC DISPATCH AND THE COSTS THAT ARE THE BASIS FOR THE CLASS COST-OF-SERVICE STUDIES?

A Yes. Economic dispatch is based on incremental costs while the class cost-of-service studies start with booked costs, which can also be thought of as the average costs. The two are not interchangeable.

Q WHAT ARE THE IMPLICATIONS OF DIFFERENCE BETWEEN INCREMENTAL AND AVERAGE COSTS FOR YOUR POINT REGARDING CAPACITY COSTS?

A The economic dispatch example illustrates that there are no incremental capacity costs created by usage. While economic dispatch is based on incremental costs, it is also true that off-peak usage does not create capacity costs in the context of the class cost-of-service studies where the focus is on the cause of costs in the planning sense.

Q DOES OFF-PEAK USAGE MAKE A DIFFERENCE WHEN IT COMES TO PLANNING CAPACITY FOR THE SYSTEM?

A It makes no difference on a system like Ameren's. The hours at the high load levels justify a capacity mix with an abundance of base load capacity. As a practical matter, due in large part to the seasonal nature of the load, this leads to a situation in which there is more base capacity than is needed to serve the load in most hours of the year. There is no capacity cost whether or not production capacity is used to produce energy in these hours. Consequently, usage in off-peak hours did not, does not, and will not create capacity costs in a planning sense.

Sometimes it seems as though the basic economics of the system are lost in all of the sophisticated models and discussions. The basic economics are this. Due to the high cost of natural gas and oil, the fuels for peakers, peaking capacity is economical only when used for a relatively few hours per year. Intermediate capacity can pick up some additional hours. But for most loads base capacity is the choice. It turns these economics upside down and perverts the result when Staff starts with the premise that all hours create capacity costs. Capacity costs have never been created by usage in all of the hours, but rather are created due to usage during the peak hours.

Q MR. BUSCH ASSERTS AN ERROR BECAUSE THE MIX OF CAPACITY TYPES AND COSTS HAS NOT RESULTED IN ABOVE AVERAGE CAPACITY COSTS FOR HIGH LOAD FACTOR CUSTOMER CLASSES IN THE AMEREN AND MIEC PRODUCTION COST ALLOCATION METHODS. IS HE CORRECT?

A No. It is of course accurate to state that there are multiple capacity types with difference capacity costs. But this point has no merit for the reality of a class cost-of-service study. Consider these several realities:

- First reality: the cost of base load capacity on the Ameren system has been depreciating for many years. The Callaway plant came on line in the eighties and the coal-fired plants go back as far as the 1950s. The average cost in rate base is the net depreciated cost, not the current cost of new base load capacity.

- Second reality: all of the recent new capacity has been peakers. This newer capacity comes to the system at inflated current dollars (as compared to the dollars used to buy the older base load plants) and remains at a high net cost in rate base because accumulated depreciation is relatively small. This means that the reality capacity cost differences on the AmerenUE system are relatively much smaller than they would be if the recent capacity additions had included a new base load plant.

- Third reality: through the years studies have typically shown that about a 15% capacity factor is the breakeven point between base load and peaking capacity. Certainly this varies from time to time depending on factors such as fuel prices, interest rates, and capacity costs, but this is the typical result. This means that base load capacity would be the choice whenever the capacity factor for needed capacity exceeds roughly 15%. Thus, in the typical scenario the multitude of hours beyond the 15% capacity factor do not impact costs. The decision is always base load. But Mr. Busch allocates capacity costs to all of these hours that do not contribute to or cause any decision to build any capacity, base load or otherwise.

- Fourth reality: all customers, high and low load factor, are given the benefit of the low cost fuel mix. The low average cost is due to the preponderance of base load capacity on the AmerenUE system.

Q PLEASE INTERPRET THE IMPLICATIONS OF THESE FOUR REALITIES.

A The meaning is this: the year-round use of capacity has not caused capacity costs. Nor are there incremental base or intermediate capacity costs due to consumption during off-peak hours. Furthermore, on a practical level, the differences in the cost of capacity do not create any differences in costs that can reasonably be captured by allocating costs throughout all of the hours of the year base on usage. Finally, all customers, regardless of load factor, benefit from the low cost of the energy from the base capacity.

Mr. Busch states unequivocally that the Ameren and MIEC studies are wrong with no discussion of the above realities. In my opinion, that amounts to a one-sided rebuttal presentation of the facts.

CLASS COST-OF-SERVICE - OFF-SYSTEM SALES CAPACITY COSTS

Q IS AMEREN ACTIVE IN THE OFF-SYSTEM SALES MARKET?

A Yes, it is. In fact, off-system sales are a major source of revenue and are an important issue in this docket.

Q HOW DOES AMEREN DETERMINE WHETHER OR NOT TO MAKE AN OFF-SYSTEM SALE?

A Ameren attempts to make sales when it has capacity that is available and unneeded for its native load customers. It will make the sale whenever it can obtain a price that is higher than the cost of producing the energy.

Q IS THE STAFF'S CAPACITY UTILIZATION ALLOCATION METHOD USED TO ASSIGN CAPACITY COSTS TO THE OFF-SYSTEM SALES?

A No. It is not, nor is a Staff proxy for capacity utilization or any other capacity cost allocation method used.

Q WHY ARE NO CAPACITY COSTS ASSIGNED TO OFF-SYSTEM SALES?

A Off-system sales are often characterized as opportunity sales. This means that Ameren does not build capacity for the purpose of supplying these sales. Such sales do not cause production capacity costs and, therefore, none are assigned or allocated.

Q CAN YOU DESCRIBE SOME OF THE CONDITIONS THAT MIGHT EXIST DURING OFF-PEAK PERIODS WHEN THESE SALES ARE MADE?

A Yes. It is not unusual for the sales to be made from the coal-fired capacity of Ameren. The coal-fired energy is sold off-system without capacity costs being assigned or allocated under the Staff capacity utilization theory or any other method.

Q IS IT A BENEFIT TO THE PURCHASERS TO BUY OFF-PEAK COAL-FIRED AMEREN ENERGY WITHOUT CAPACITY COSTS?

A Yes. Such transactions are voluntary and would not take place if they were not mutually beneficial.

Q DO THE RETAIL CUSTOMERS OF THE SYSTEMS THAT BUY THIS WHOLESALE ENERGY FROM AMEREN RECEIVE BENEFITS?

A Yes. The retail customers benefit rather directly if they receive a regulated service. The benefit is less direct if the generation service they receive is not regulated.

Q ARE ANY OF THE SURROUNDING STATES IN COMPETITION WITH MISSOURI ON THE ECONOMIC DEVELOPMENT FRONT?

A Yes. Neighboring states are in competition with Missouri, and the customers in the neighboring states are in competition with the Missouri customers of Ameren.

Q IF THE NEIGHBORING STATES ARE IN COMPETITION WITH MISSOURI, AND AMEREN BUSINESS CUSTOMERS ARE IN COMPETITION WITH BUSINESS CUSTOMERS IN THOSE STATES, DOES IT MAKE SENSE TO PURSUE OFF-SYSTEM SALES TO NEIGHBORING STATES?

A All parties will be better off if the costs and benefits are correctly recognized. However, if the class cost-of-service studies are not done correctly, Missouri industry, and hence economic development, could be placed at a disadvantage.

Q DOES IT MAKE SENSE TO SELL LOW-COST AMEREN ENERGY OFF PEAK AND WITHOUT CAPACITY COSTS, TO THE BENEFIT OUT-OF-STATE COMPETITORS, WHILE AT THE SAME TIME BURDENING INDUSTRIAL CONSUMERS WITH EXTRAORDINARY CAPACITY COSTS UNDER THE STAFF CLASS COST-OF-SERVICE STUDY?

A It makes no sense. Instead, Missouri regulatory policy should be taking care of business at home.

An equitable treatment for consumers that use off-peak energy can be achieved if the cost allocation method submitted by Ameren is approved and the results are implemented. Studies by MIEC also achieve this result. The correct result is obtained because of a straight fixed variable approach in which variable costs are averaged and allocated among the customer classes based on energy and in which fixed costs are averaged and allocated among the customer classes based on demand (peak demands). With this method, capacity costs are correctly associated with demands that cause them to be incurred. And, just as it is correct to sell off-peak electricity off system without allocating demand costs, it is similarly correct to do so with native load customers. Absent this result, Ameren will continue to ship electricity off-system and out-of-state for the benefit of competitors of Missouri and Missouri business, while the many business customers of Ameren bear the burden of an unreasonable capacity cost allocation.

Q IS IT CONSISTENT WITH MISSOURI ECONOMIC DEVELOPMENT POLICY TO BURDEN INDUSTRIAL CUSTOMERS WITH AN ALLOCATION OF CAPACITY COSTS TO OFF-PEAK PERIODS?

A I think not. At a time when the state is striving to maintain and expand its own business community, it makes no sense to be punishing Missouri businesses with an adverse cost allocation policy. The benefits of selling unused low-cost Ameren energy are substantial. What is needed is a straight fixed variable cost allocation method so that the off-peak usage of native load customers, like that of the off-system sales flowing out of State, is not burdened with capacity cost allocations.

PROPER ROLE OF STAFF RE CLASS COST-OF-SERVICE

Q IS IT A PROPER ROLE OF THE COMMISSION STAFF TO PRESENT A METHOD THAT IS EXTREME AND AT ODDS WITH THE ECONOMIC DEVELOPMENT POLICY OF THE STATE?

A No. I understand the role of the Staff to be that of a neutral party in matters among and between customers.

Q IN YOUR EXPERIENCE DOES THE STAFF OPERATE AS A NEUTRAL PARTY INFORMING THE COMMISSION OF THE MATTERS AT HAND?

A I have been asked that question by my clients more than once. In my experience, Staff has been effective in its audits of the energy utilities for the purpose of assisting the Commission in the determination of an overall just and reasonable level for rates.

Unfortunately, that is not my experience in matters of class cost of service. The class cost-of-service studies submitted by Staff in electric cases have been a continuing problem. It is impossible for me to logically explain why a part of the Staff, itself an arm of the Department of Economic Development, is pursuing studies that do not reflect the principle of cost causation and is instead supporting biased methods that, if adopted in this case, would increase industrial rates above a reasonable cost-based level.

Q IS STAFF CHARGED WITH THE RESPONSIBILITY OF ADVOCATING LOWER RATES FOR LOW LOAD FACTOR CUSTOMERS AT THE EXPENSE OF HIGH LOAD FACTOR CUSTOMERS?

A Not to my knowledge.

Q IS IT THE JOB OF THE STAFF OR THE COMMISSION TO DETERMINE A FAIR "JUST AND REASONABLE" RESULT?

A I am advised by counsel that it is the responsibility of the Commission.

Q DOES IT SERVE THE PROCESS TO HAVE FAIRNESS PREJUDGED BY STAFF?

A No. If Staff prejudges fairness, it seems to me to not serve the Commission. In effect, the Commission's ability to reach a fair result is impeded first by the presentation of biased material, and second, by the presentation of biased material being wrapped in a cloak of alleged "impartiality."

In my view, the Staff should be providing objective information that will assist the Commission in its understanding of the class cost-of-service issues for the purpose of reaching an informed decision. Staff should not be an advocate for a position that sidesteps the matter of cost causation so as to prejudge fairness.

In the end, the process is harmed and in this case, policy interests of the State could be harmed. The maintenance of current businesses and the promotion of new business will suffer.

Q ARE THE CURRENT POSITIONS OF THE STAFF ON CLASS COST-OF-SERVICE STUDY METHOD FOR PRODUCTION COST ALLOCATION NEW IN THIS PROCEEDING?

A No. The method goes back more than 20 years. Instead, the current problem is the result of a failure to rethink and reexamine the methods. The time is ripe for a reexamination.

Q HAS STAFF TAKEN A FRESH LOOK IN ANY OTHER MATTER, SUCH AS RATE DESIGN FOR A GAS UTILITY?

A Yes. I am aware of at least one such Staff testimony in the matter of Atmos Energy Corporation, Docket No. GR-2006-0387. Staff witness Anne Ross testified that all residential customers within each district should pay only a fixed charge for the LDC portion of their charges every month. This is a significant departure from the past rate design. Among the stated reasons is a new realization that the same fixed costs must be incurred, regardless of the quantity usage of a residential customer in any month. The new method was characterized by Staff as a straight fixed variable method.

The reexamination of the past practice was motivated by a desire to decouple the profits of Atmos from the volume of sales and a desire to be responsive to the conservation issue raised by SB 179. Under the historical approach to residential gas rate design, a reduced sales volume for any reason, including conservation, reduced the profit of Atmos and created a disincentive for Atmos to promote conservation. (see ER-2006-0387 Report and Order)

Q HAS THE COMMISSION ISSUED A DECISION?

A Yes. The final report and order was issued very recently, February 22, 2007, so iat this point it remains subject to review. The order conditionally approves a straight fixed variable residential rate design. In my opinion, the result was possible in large part because of the Staff testimony explaining the fixed nature of the costs of the service.

Q HOW IS THE ATMOS CASE RELEVANT?

A It is relevant in several ways. First, an open-minded reexamination of past methods was undertaken by Staff. Staff's change of position based on the reexamination is relevant because it demonstrates that long-held positions can sometimes benefit from a reexamination. A similar reexamination needs to take place in regard to Staff's method of allocating electric production costs in class cost-of-service studies.

Second, the new approach recognizes that fixed costs are real and that they do not vary from month to month. No amount of rationalization can turn fixed costs into variable costs that depend on greater or lesser use of capacity.

Third, Staff's change of position in the gas case is relevant because the substance of the position is directly on point. Whether it is a gas distribution business or an electric utility, fixed costs do not vary through the year based on monthly usage, based on off-peak usage, based on capacity utilization, or based on any other theory. Fixed costs are just as fixed in the electric industry as they are in the gas industry. Staff on the gas side has moved far.

Fourth, the Commission's recognition of the straight fixed variable method may also be relevant. In the class cost-of-service studies in this proceeding, the methods used in the Ameren and MIEC class cost-of-service study are reasonably characterized as straight fixed variable methods.

UPDATES TO CLASS COST-OF-SERVICE STUDIES

Q EARLY IN THIS TESTIMONY YOU ALLUDED TO THE FACT THAT THERE WERE UPDATES TO SOME OF THE CLASS COST-OF-SERVICE STUDIES. CAN YOU PLEASE EXPLAIN?

A Yes. As noted earlier, Table 1 appearing near the front of this testimony is a summary of the class cost-of-service study results from the rebuttal testimony of Staff witness Roos. OPC, between the time of direct and rebuttal revised its study method in a way that produced a result closer to Staff's. That change is not reflected in Table 1. OPC's rebuttal study has now apparently been superseded by yet another study in supplemental testimony prefiled just a few days before this testimony was due. Given the timing, I cannot be sure of what constitutes the current OPC concept of the cost of service.

Q ARE YOU AWARE OF ANY OTHER REVISIONS TO THE CLASS COST-OF-SERVICE STUDIES THAT MAY BE COMING?

A Yes. Ameren in rebuttal testimony acknowledged the appropriateness of the change I recommended in the treatment of off-system sales margins. Parties have been advised informally that Ameren will be submitting a revised study as a part of its surrebuttal testimony.

Parties have also been advised informally that Staff intends to make a corresponding change in the treatment of off-system sales margins. Unfortunately, I have no reason to believe that the other fundamental biases in the staff study that operate against high load factor consumers will be remedied.

Noranda is reserving its rights to oppose the admission of some or all of the studies into the record and other remedies that may be appropriate.

NORANDA RATE RECOMMENDATIONS

Q DO YOU CONTINUE TO RECOMMEND COST-BASED RATES ON BEHALF OF NORANDA?

A Yes, I do.

Q WHAT IS THE CLASS COST-OF-SERVICE?

A A wide variance remains between the revenue requirements claimed by Ameren and those supported by the several other parties that have addressed the revenue issues. Absent a resolution of those issues, it is impossible to reach definitive dollar amounts in answer to the question. Therefore my answer at this time must be that I do not know.

Q DO YOU HAVE ANY RECOMMENDATIONS AS TO WHICH CLASS COST OF SERVICE METHODOLOGY SHOULD BE ADOPTED BY THE COMMISSION?

A Yes. The Staff method has been shown to be at odds with the principle of cost causation. It bears the label "cost" study, but the study allocates production capacity costs to off-peak periods where there is no separate responsibility for such costs. It should be rejected. There is a time-of-use study prepared by the Office of Public Counsel in some level of revision which is cut out of the same cloth, and for same reasons that study must be rejected.

Once beyond these most extreme studies, there is a range of studies with the Ameren study in the middle. For the purposes of this proceeding, I recommend the method of the Ameren study (including the acknowledged adjustment to properly account for the margin from off-system sales). I specifically reserve the possibility of improvements to the Ameren method in future cases, and I also reserve the possibility of the several changes to the Ameren class cost-of-service study suggested by Mr. Brubaker. That said, the Ameren class cost-of-service study is sufficiently focused on the cost causation principle and should be adopted to define the class cost-of-service method for this proceeding.

Q DO YOU RECOMMEND THAT THE IMPACT ON THE RESIDENTIAL CLASS OF AMEREN CUSTOMERS BE DISREGARDED?

A No. Fundamentally, the cost of service provided should dictate the result. However, at this time the size and even the direction of the overall rate change remain unknown. Consequently, whether or not there will be a residential impact to be dealt with remains to be seen.

While I disagree with the rate cap/subsidy proposal of Mr. Hanser, his analysis nevertheless reveals that the residential customers have enjoyed relatively low and stable electric rates. Residential electricity emerges from his analysis as a relative bargain -- as measured against his yardsticks ranging from inflation, to wages, to other electricity prices, to other energy prices. By all of these measures his 10% rate cap proposal is unnecessary and inappropriate, particularly in consideration of the costly impact on those he would tax with the subsidy.

If the cost of service result, in the opinion of the Commission, produces an increase that is unreasonable for the residential class, I recommend a phase-in of the increase for the residential rate class, a possibility that I raised in my earlier testimony. To avoid any subsidy and harm to economic development the cost of the phase-in must come from the residential class or from Ameren.

Q DOES THIS CONCLUDE YOUR TESTIMONY?

A Yes.

MISSOURI DEPARTMENT OF ECONOMIC DEVELOPMENT

Gregory A. Steinhoff, Director

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Matt Blunt
Governor
State of Missouri

"The dynamic and aggressive new approach our Department of Economic Development is taking to attract new business and business expansion to our state sends the clear message that Missouri is open for business. However, I believe the Show Me State has just scratched the surface in showing the world what we are capable of achieving. Thanks to strong and accountable new economic incentives, elimination of regulatory barriers and new reforms that my administration has enacted, Missouri is now in position to compete for new business with any state in the nation. This administration and particularly the Department of Economic Development will continue to work to increase economic opportunities for all our citizens and bring high quality, high paying, family supporting jobs to Missouri."

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- Missouri Film Commission

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Blunt Announces Youth Opportunities Program Tax Credits for Several Missouri Organizations

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Welcome from Director Steinhoff

Welcome to the Missouri Department of Economic Development's Web site, your portal to quick and comprehensive information about our programs, services and other important functions.

The Department is Missouri's lead agency for economic, community, workforce and tourism development. Through our regulatory divisions, we also work to safeguard the public interest by ensuring safe and sound financial institutions, just and reasonable utility rates and ethical services by licensed professionals.

As your partner for progress, we are eager to strengthen the public/private partnerships that have always united our great state – the partnerships that are critical in our efforts to move Missouri forward as a leading state in the 21 st century.

Furthermore, as director I am committed to improving the state's business climate in support of economic and entrepreneurial growth. The practical business experience I have gained over the years as a private-sector business owner has prepared me to better understand and meet the challenges facing Missouri's employers and entrepreneurs.

Under my leadership, the Department will work closely with Governor Blunt to chart a new course for economic development in Missouri: a direction that will create more new family-supporting jobs, improve Missouri's competitive advantage, and produce better economic conditions across the state.

Gregory A Steinhoff, Director

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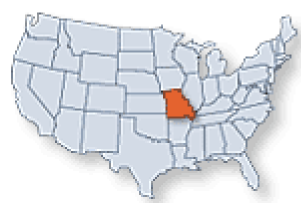
Located in the nation's heartland, Missouri offers a strong, stable and diverse economy that is essential to the success of both large and small businesses. Missouri offers one of the most diverse economies in the nation, meaning that the economic environment is both robust and resilient.

As Missouri makes its transition into the new technology-based economy, the state is building strong clusters in the plant and life sciences, information technology and advanced manufacturing industries. The state is also working to strengthen the competitiveness of its traditional industries, such as communications, transportation, non-durable and durable manufacturing, wholesale trade, health services and construction.



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Missouri is an affordable place to do business. The cost of many key operating expenses such as office space, electricity and natural gas are well below the national average. Missouri ranks 38th in the nation in state and local taxes as a percentage of personal income.

Business and Community Services
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