Q What is your second comment about the Company's margin-sharing proposal?

A My second observation arises from Mr. Baxter's testimony about the merits of the Company's margin-sharing proposal. Recall that his basic message is that the sharing mechanism would be a way to pass through volatile sales margins to customers while maintaining incentives for the company to be efficient.

My observation is this: the exact same comments can be made about an FAC that employs a sharing mechanism. If we simply exchange "volatile sales margins" for "fluctuating power costs" and switch the roles of the utility and its consumers, the very same formulation applies. Mr. Baxter would have to agree that a properly designed sharing mechanism for the *FAC* can retain some of the same desirable incentives that would otherwise be jettisoned if an FAC were set up to track exactly the Company's expense levels.

IV. Changes to the FAC Proposal

Q Mr. Binz, please summarize your testimony to this point concerning the Company's FAC proposal.

A In general, I think the Commission should not authorize automatic cost adjustment mechanisms such as the FAC. While these mechanisms might superficially be said to track a utility's costs more accurately, their effects can be much larger and more injurious to consumers than that simple description. Adjustment clauses such as the FAC significantly reduce the pressure on a utility to be efficient, in its fuel and purchased power operations, but more generally in all its operations. Simply put, the "cure" offered by an FAC can be worse than the "disease".

For these reasons, I think the Commission should conclude that there is no compelling reason to approve the FAC proposal. Since an FAC will likely increase consumer costs in the longer run by reducing efficiency incentives for AmerenUE, the Commission should reject the use of an FAC.

Q Assuming, instead, that the Commission decides to authorize a version of the FAC, what modifications would you recommend to the AmerenUE proposal?

A If the Commission decides to approve a version of the FAC despite these reservations, it should modify the Company's proposal. The Missouri statute governing Cost Adjustment Mechanisms contains several qualifications on a CAM, which are designed to protect consumers. These are useful and should be (must be) included in the design of any FAC.

But there is another way in which the statute can be used by the Commission to design an FAC for AmerenUE that lessens some of the negative effects that could otherwise accompany an FAC. I am speaking, of course, about incentives to efficiency for the Company. The statute clearly gives the Commission authority and discretion on this point, and if any FAC is adopted, I think the Commission must exercise that discretion.

I've already hinted that the testimony of AmerenUE witness Baxter concerning the margin-sharing proposal provides some guidance for how structure a "pass-through" mechanism so that it contains correct incentives. The important point is that a mechanism should induce the utility to remain efficient, using a combination of risk and reward. There is a very simple approach to doing this and a variety of more complex approaches.

Q What is the simple approach to retaining incentives while adopting an FAC?

A Recall that current regulation incorporates an estimate of fuel and purchased power costs in base rates. If actual costs are lower, the utility earns more money; if actual costs are higher than the base rate increment, the utility earns less. None of the variation from the base is added to or subtracted from base rates. Thus, current regulation is the ***0% Pass-Through Case.***

In contrast, the FAC proposed by AmerenUE would track every penny of differences between base rates and actual power costs. Whether over or under, the entire variation is passed through to customers in the form of an increment on the monthly bill. The AmerenUE proposal is the ***100% Pass-Through Case***.

Between these extremes are infinitely many middle-ground cases. It is perfectly reasonable for the Commission to apply the FAC to exactly 50% of the over/under deviation from base rates.

Q Does this mean that the utility will recover only 50% of its power costs?

A No. If the Commission approves a ***50% Pass-Through FAC***, the vast majority of AmerenUE's power costs will still be collected in base rates. The 50% fraction applies only to the variation from that base amount. And since the fraction applies symmetrically to cost differences, the utility will sometimes over recover, sometimes under recover, at half the rate that happens today.

Q If the Commission applies the FAC to 50% of the variation in power costs from base rates, is it systematically making rates inexact?

A No more than rates are only estimates of future costs today. By using the 50% rule, the Commission would strike an exact middle ground between the type of regulation that has existed since 1979 in Missouri and the type of regulation proposed by AmerenUE in this case.

But it would be unfair to call the 50% proposal simply a middle ground. This approach maintains the same incentives for efficiency that traditional cost of service regulation provides to utilities. When faced with the choice of acting to lower its expenses, AmerenUE would know that it will be allowed to "keep" half of the costs savings in this approach. In contrast, under the 100% FAC proposed by the Company, any efficiency gains are taken away from AmerenUE at its next FAC filing.

The same logic applies in reverse. Unless a utility's bad behavior is found to be imprudent (a very high standard) it faces no consequence for incurring excess costs under the FAC. Excess costs will simply be passed through in the next FAC filing. On the other hand, if the utility is sharing its over/under power cost results, the utility faces a disincentive for bad behavior that results in higher costs because only half of such higher costs are passed through the FAC, with the balance absorbed by the Company.

Q Please describe more complex approaches to retain incentives in the context of a cost adjustment mechanism.

A A more sophisticated adjustment mechanism that maintains efficiency incentives may involve a "tapered" sharing formula and possibly a "dead band" in which there is no sharing.

Q Please illustrate this concept with an example.

A The following table is taken from the Wyoming tariff of Rocky Mountain Power (RMP), a division of PacifiCorp, which is itself a division of Mid-American Energy Holdings Company. This tariff was approved by the Wyoming PSC in May 2006.

As can be seen from the table, RMP is allowed to collect (or is required to pass through to consumers) differences in its "net power costs" according to a schedule given in the table. The company's base rates include a level of net power cost recovery (currently about $600 million) or $0.01328 per kWh for residential customers). If actual net power costs are within a "dead band" of $40 million on either side of the base amount, no adjustment is made. Outside of the dead band, the Company returns a portion of its over recovery to consumers, or passes on a portion of its under recovery to consumers. The percentages change on a sliding scale until, at the outer margin, 90% of the variations in the Company's net power costs are collected from customers or refunded to them.

Excerpt from Power Cost Adjustment Mechanism (PCAM) Tariff Rocky Mountain Power – Wyoming		
Adjusted Actual Total Net Power Costs Layer	**Customer Proportion**	**Company Proportion**
Over $200 million above Base	Company recovers 90% from Customers	Company absorbs 10%
Over $100 million and up to $200 million above Base	Company recovers 85% from Customers	Company absorbs 15%
Over $40 million and up to $100 million above Base	Company recovers 70% from Customers	Company absorbs 30%
$40 million above Base (Dead Band)	Company recovers 0% from Customers	Company absorbs 100%
$40 million below Base (Dead Band)	Company returns 0% to Customers	Company retains 100%
Over $40 million and up to $100 million below Base	Company returns 70% to Customers	Company retains 30%
Over $100 million and up to $200 million below Base	Company returns 85% to Customers	Company retains 15%
Over $200 million below Base	Company returns 90% to Customers	Company retains 10%

Q What are the advantages of an approach like this, compared to a pass-through mechanism such as that proposed by AmerenUE?

A In my view, there are several advantages. First, the presence of the dead band means that the mechanism comes into play only after there is a meaningful difference between base rate costs and actual costs. This means that the original incentives I discussed earlier remain in place within the dead band.

Second, outside the dead band, the Company would still retain real incentives to control costs. If RMP is able to lower its power costs, it retains the first $40 million (the

dead band) plus 30% of the next $60 million in savings. Similar, but opposite, incentives work in the other direction.

Third, since 90% of all variations in net power costs that exceed $200 million above the base will be recovered through the mechanism, RMP is protected against very large fluctuations in the wholesale power markets, as was experienced in the western U.S. in 2000-2001. In other words, this tariff functions as a "backstop" against serious financial damage to the utility. Again, it serves this function this without completely removing incentives for the utility to be efficient during normal markets.

Q Are there useful parallels to the situation in the AmerenUE case?

A Yes, I think so. If the Commission wishes to create a fuel and purchased power recovery mechanism that provides meaningful efficiency incentives (and not simply collects or refunds every penny of variation), I think the Wyoming tariff provides a good starting point. I noted above that the Wyoming tariff contains a base net power cost charge of $0.01328 per kWh for residential customers. This is extremely close to the base cost level contemplated by AmerenUE: in his testimony, Mr. Lyons states that the base fuel and purchase power cost total $0.01341 per kWh.

Other states have adopted fuel cost adjustment mechanisms with some of the features illustrated in the Wyoming tariff, as well as others. While the details are important and must be considered carefully, there are undoubtedly many potential arrangements of the details that would serve both Missouri consumers and AmerenUE well. I have included a complete copy of the Rocky Mountain Power PCAM tariff as Exhibit RJB-7.

Q If, despite objections of the parties, the Commission decides to consider a margin-sharing proposal in a FAC, what changes do you recommend the Commission make to the sharing proposal described in AmerenUE's testimony?

A I wish to repeat that it is perfectly defensible to continue the practice of including a fixed level of margin revenue in base rates. However, if the Commission decides to consider a margin-sharing proposal for off-system sales, it can build incentives into the structure, similar to the discussion about the FAC. Here are two considerations the Commission should make before adopting any margin-sharing proposal.

- The base level of revenue credits should be set on the basis of the best evidence of the likely future value. This level is at least $183 million in this case.[1] The Commission should not set the base amount below the likely future margins, as advocated by AmerenUE when it proposes a $120 million base credit level. Any "base" level different than the likely future level will result in an unfair and objectionable sharing mechanism.

- The margin sharing mechanism can have a different structure than the FAC: the "bands" and sharing percentages need not be the same.

To illustrate this first point, I prepared a chart comparing the AmerenUE margin-sharing proposal to the current system of simply including an estimate of future margins as fixed credit against the revenue requirement. Since AmerenUE sets the base at $120 million instead of at its own estimate of $183 million, the proposal is obviously not fair to retail customers.

[1] The level of future off-system sales is a matter of dispute in the revenue requirement portion of this case. The figure of $183 million was filed AmerenUE and is used to illustrate the concepts.