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** Tariff No. YE-2007-0007

AARP's Post-hearing Brief

COMES NOW AARP, by and through counsel, and pursuant to the Public Service Commission's (Commission's) March 30, 2007 Notice Regarding Briefing Schedule, hereby submits its Post-hearing Brief.

AARP continues to support the December 29, 2006 Overearnings Complaint, filed by the Staff of the Commission (Staff) in this case, based on the overwhelming competent and substantial testimony entered into the record. AARP supports the specific revenue requirement reduction recommended by the Office of the Public Counsel along with the Stipulation and Agreement on rate design implementation to which AARP is a signatory.

The most important unresolved issue in this case is AmerenUE's proposal for an unlawful and patently unfair Fuel Adjustment Clause (FAC). This post-hearing brief summarizes the reasons why AARP believes that such a mechanism would be detrimental to its members and why an FAC is particularly ill-suited to AmerenUE

operations. The Commission should carefully review the testimony of its expert on this matter, former public utility commissioner Nancy Brockway. Exhibits 750 and 751.

This case is unique in the amount of overwhelming testimony collected from the ratepaying public during the local public hearings held in January 2007. AARP urges the Commission to review all of the sworn testimony in the record from these witnesses. The concerns expressed therein about AmerenUE's electric rates and the quality of service received by its customers is compelling and must be considered together with the rest of the relevant evidence in this case.

Lest the Commission forget, the law requires it to keep these consumers foremost in its mind when making a decision on utility rates. The Public Service Commission Act is designed primarily "to serve and protect ratepayers". State ex rel. Capital City Water Co. v. PSC, 850 S.W.2d 903, 911 (Mo. App. 1993). While consumer protection is to be balanced against the rights of utility shareholders, the courts have stated that those interests are secondary: "The protection given the utility is incidental." State ex rel. Dail v. PSC., 240 Mo. App. 250, 251 (Mo. App. 1947).

Fuel Adjustment Clause—"*Should AmerenUE's proposed fuel adjustment clause be approved and, if so, with what modifications or conditions?"*

A. AmerenUE's proposed FAC is procedurally barred under Missouri law.

As AARP has repeatedly pointed out, AmerenUE's FAC proposal was filed in a rate schedule months after the rate schedule tariffs that were suspended to initiate Case No. ER-2007-0002, and thus was procedurally out of time. Therefore, AmerenUE's

FAC proposal may not be lawfully considered by the Commission, and approval of such would constitute reversible error. Allowing AmerenUE to initiate a new rate request in a separate "rate schedule" after it has already initiated a "file and suspend" rate increase tariff proposal violates the requirements of sub-section 386.266.4 RSMo Supp. 2006. A general rate case proceeding that has already been initiated by a tariff filing may not have its scope further enlarged after the suspension period has begun. Without belaboring this legal issue, AARP will incorporate herein the arguments it has made in previous motions.

B. Approval of AmerenUE's proposed FAC would be unlawful in that its particular application to AmerenUE's electric operations would be inconsistent with the new statute—Section 386.266.

Subsection 386.266.4(1) RSMo. Supp. 2006. requires that any fuel adjustment mechanism approved by the Commission must be designed to provide the opportunity for a "fair rate of return". Because the Commission is tasked with balancing the interests of shareholders and consumers, such a return must be fair to both sides.

AmerenUE simply has not met the legal burden to proving that it would face any significant threat to its financial viability without a mechanism that gave it 100% reconcilement of variability fuel and purchased power in-between rate cases. As the testimony of Staff witness Warren Wood, State of Missouri witness Michael Brosch, and Public Counsel witness Ryan Kind each exposed in detail, AmerenUE does not need

any such mechanism in order to have an opportunity to earn a fair and reasonable rate of return.

AmerenUE's Missouri electric operations in general are not prone to the concerns of the utilities which have led other public utility commissions to consider FACs. AmerenUE's power supply cost structure is not as vulnerable to changes in fuel and purchased power costs. AmerenUE's fossil fuel prices and wholesale markets are not expected to have as much volatility over the next few years as other utilities. AmerenUE also has significant control over its exposure to these costs in the short term and in the long term. AmerenUE actually has a unique capacity to control its own fuel costs. In fact, its costs are greatly mitigated by its significant opportunities for off-system sales revenues. Wood Rebuttal, p. 4; Wood Surrebuttal, p. 5. Unlike other electric utilities in Missouri, a significant portion of AmerenUE's energy needs to serve its customers are provided by nuclear and coal fired generation rather than natural gas fired generation.

AmerenUE's proposed FAC would also be inconsistent with the law in that it would remove vital incentives for the electric utility to be efficient in its fuel and purchased power practices. Here is a partial list of drivers for fuel and purchased power over which AmerenUE exercises control or influence:

- Basic choices in the utility's resource plan
- The ratio of owned generation and purchased power
- Terms of wholesale contracts
- Efficiency of system operations
- Transmission system design and operation
- Degree and type of fuel risk in purchase decisions

- Hedging activities
- Demand side choices
- Advocacy for beneficial rate design proposals

Exhibit 750, p. 13. These are the areas of control that would be impacted by the removal of incentives for efficiency.

Throughout Section 386.266, and specifically in subsection 1, the statute's focus is on "incentives to improve the efficiency and cost-effectiveness of its fuel and purchased-power procurement activities". AmerenUE's proposal would retain none of the current incentives created by the lag between rate cases that provides a direct monetary incentive towards cost efficiency and put in place no new incentives. Instead AmerenUE would have the Commission dump 100% of fuel cost variability onto ratepayers. Their proposal is clearly not balanced in that 100% of the strong built-in incentive to operate efficiently would be eliminated—directly contrary with the overall intent of the new law.

Moreover, because of the likelihood that AmerenUE will continue to experience strong earnings into the future as a result of other factors, adopting any FAC for this company would be unacceptable. It would create the very real possibility that a future FAC rate increase would occur *during the very same time period that the utility's overall cost of service was falling.* Such a danger is inconsistent with Section 386.266 and it renders AmerenUE's proposal patently unlawful and entirely unreasonable.

C. AmerenUE's proposed FAC would be generally unreasonable and contrary to the public interest.

There are several reasons why cost adjustment mechanisms for regulated monopoly electric companies are not recommended, above and beyond the legal infirmities discussed above. The balance of policy arguments weighs against cost adjustment mechanisms in most cases. Binz/Brockway Direct, Exhibit 750, pp. 11-14.

First, a cost adjustment mechanism tends to dull the incentives to efficiency that cost of service regulation provides to utilities. It has long been recognized that "regulatory lag" in cost of service regulation mimics this process in a competitive market. Pressure from cost increases requires a competitive firm to become more productive in order to maintain its profitability. It can benefit customers and the utility alike by supplying the incentives that competition provides in other industries. Id., p. 11.

The second general argument against FACs is that they tend to skew choices the regulated company must make by rearranging its economic incentives. A utility is continuously faced with short-term and long-term decisions about fuel and power purchases, whether to "build or buy," etc. To the extent that an adjustment mechanism is a "thumb on the scale" for some choices in preference to others, it may induce an electric company to make choices it might not otherwise make, to the detriment of its customers. Id., pp 12-13. In fact, there is a real danger that, by eliminating the incentive provided by regulatory lag, the imposition of an FAC would make a utility like AmerenUE less careful about the efficiency of its fuel and purchased power activities. Tr. 3855-3856.

Despite AmerenUE's assurances that the Commission should rely solely on prudence reviews to provide incentives, regulatory experience has shown that after-the-fact prudence reviews are a crude and considerably-less-than-perfect way to catch inefficiency. Brockway Surrebuttal, Exhibit 751, p. 8-9. First, the standard for finding imprudence is in practice, if not in law, higher than the standard for identifying inefficiency. Second, costly after-the-fact reviews of a management's activities are no substitute for before-the-fact alignment of management motives and consumer interests. Id., p. 9.

The third argument against the use of cost adjustment mechanisms relates to their fairness. Cost adjustment mechanisms shift the balance of risk between utilities and their customers; more generally, they change the balance of equities embodied in cost of service regulation. Exhibit 750, p.13. It would be a rare utility that would propose a cost mechanism to track decreasing costs. Id., p. 13. By removing an upward-trending cost and tracking it with a cost adjustment mechanism, the balance of fairness in ratemaking is changed. Id., p. 13.

It is a common misconception that utility regulation is a "cost-plus" exercise and that a regulator's duty is to ensure that companies "recover" their costs. This is factually incorrect. Id., p. 17. Under cost of service regulation, past costs are not "recovered;" they are simply used as a guide to the future costs that new rates attempt to match. In fact, "recovering" past costs, absent a specific exception, is retroactive ratemaking. Id., p. 17. An FAC distorts the traditional ratemaking equation and essentially inoculates a future rate request of a utility from a claim of retroactive ratemaking with respect to the subject costs. Id., p. 18. *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". Id., p. 23.

Finally, it is unreasonable to shift 100% of the risk of any potential cost fluctuation in this one cost onto consumers, who do not have the same wherewithal to manage such volatility. AmerenUE witness Lyons stated that he doubted that the typical AARP member had the same ability to manage fuel cost variability as does the electric company. Tr. 578. AmerenUE has the ability to financially hedge against fuel cost volatility as well as to make the resource planning decisions which physically mitigate its risk. Consumers have no such control over the utility's operations. In this regard, it is entirely unreasonable to shift 100% of the utility's risk in this area onto consumers. After all, normal ratemaking already calculates a reasonable return on equity into what the consumer is expected to pay in recognition of the risks that the utility experiences.

D. The FAC is particularly ill-suited for use by AmerenUE.

As discussed previously, AmerenUE has a unique capacity to control its own fuel costs. In fact, its costs are mitigated by its significant opportunities for off-system sales revenues. Unlike other electric utilities in Missouri, a significant portion of AmerenUE's energy needs to serve its customers are provided by nuclear and coal fired generation rather than natural gas fired generation. Therefore, an FAC that eliminated the current

built-in incentive of cost of service regulation would carry with it particular dangers of inefficiency with regard to AmerenUE.

An FAC should only apply to an electric company with fuel costs that fluctuate significantly and which are also outside the utility's control. Exhibit 750, p. 14. With regard to fuel cost fluctuation, AmerenUE has not offered any evidence in support of its FAC proposal that shows AmerenUE's power costs are expected to change *rapidly* or in any particularly *volatile* manner in Missouri. While the record may contain some evidence that fuel costs may increase over time, this does not indicate that a FAC is justified. To the extent that increases in cost cannot be offset by productivity gains, increased sales, etc., the utility always has the alternative to request an increase in rates. This type of pressure on a utility to become progressively more efficient is actually a *good thing*: good for customers and companies alike. Id., pp. 14-15.

The second part of the recommended standard is that an FAC should only apply to an electric company that has fuel costs which are also outside the utility's control. Id., p. 14. AmerenUE is neither passive nor powerless in the face of changing fuel and power costs. The Company shapes its power cost future by the numerous choices it makes in these areas. The Commission should tread carefully when changing the way it regulates these activities and the basic incentives provided to AmerenUE. Exhibit 751, p. 8. To the extent the fuel adjustment clause moves the risk of substandard performance in these areas effectively to the customer, away from the utility (i.e. further down the line from 0% reconciliation of fuel costs and rates to 100%, as would be the case in the company's proposed FAC), the company has fewer incentives to manage its operations and planning in a fuel-prudent way. Id., p. 8. AARP opposes the adoption of

any FAC for AmerenUE because of the damage that it would do to this resource planning decision-making.

The presence of regulation in a market shapes the behavior of the market participants. While utility regulators might want to limit their role to being a substitute for the competition that is missing in these industries, it is rarely possible to limit regulation's effects that way. Exhibit 750, p. 16. AmerenUE has operated in Missouri without a power cost adjustment mechanism since 1979. This has created a desirable risk/reward proposition for consumers *and* for the Company. Id., p. 16.

Under the current regulatory regime for AmerenUE, fundamental decisions such as whether to "build or buy," whether and how to hedge power costs, choices of fuel acquisition strategies, and even rate design choices are shaped by the fact that differences between projected and actual power costs accrue to the benefit or detriment of shareholders between rate cases. Id., p. 16. A FAC mechanism alters in a fundamental way the risk analysis that AmerenUE executive will consider when making those decisions. Id., p. 16-17.

AmerenUE has a unique capacity to control its fuel costs. In fact, its costs are mitigated by its significant opportunities for off-system sales revenues. Wood Rebuttal, p. 4; Wood Surrebuttal, p. 5. Unlike other electric utilities in Missouri, a significant portion of AmerenUE's energy needs to serve its customers are provided by nuclear and coal fired generation rather than natural gas fired generation.

E. <u>If the Commission chooses to consider a FAC, despite all legal deficiencies and policy arguments to the contrary, modifications should be made to at least mitigate identified harms of such a mechanism.</u>

If in fact the Commission chooses to adopt any FAC mechanism in this case, it should reject the AmerenUE proposal in lieu of adopting a modified FAC that shares the risk of fuel and purchased power variability fairly between the utility and the consumers. In designing a just and reasonable FAC mechanism, by far the most important element is the percentage of cost variability that will be recognized in the FAC portion of rates. Subsection (2)(C) of the Commission's Rule 4 CSR 240-20.090 requires the Commission to determine the cost components of any FAC, including what "portion of prudently incurred fuel and purchased power costs may be recovered in a RAM and what portion may be recovered in base rates."

Current regulation incorporates an estimate of total 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***, retaining a strong incentive for AmerenUE to act prudently. Exhibit 750, p. 25. 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 and risk would be passed through to customers in the form of an increment on the monthly bill. The AmerenUE proposal is the ***100% Pass-Through Case***. Exhibit 750, p. 25.

Between these extremes are infinitely many middle-ground cases. If the Commission chooses to adopt some version of an FAC for this utility, against all of the serious objections raised, it is perfectly reasonable for the Commission to apply the FAC to 50% of the over/under deviation from base rates. Id., p. 25. If the Commission approves a ***50% Pass-Through FAC***, the vast majority of AmerenUE's power costs will still be collected in base rates. It is important to understand that 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. Id., p. 25.

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. Id., p. 26. This is what the Missouri Legislature had in mind when it granted the Commission the ability to "approve, *modify* or reject" any FAC proposal. Subsection 386.266.4 RSMo Supp. 2006. (emphasis added). This 50% approach would retain 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. Id., p. 26.

There are other examples of fuel adjustment mechanisms in other states that are more sophisticated than AmerenUE's proposal, such as the Wyoming tariff of Rocky Mountain Power, approved by the Wyoming PSC in May 2006. See Exhibit 750, pp. 27-

31; Attachment RJB-7. Given the weak incentive that prudence reviews alone provide, and the particular dangers of overearnings with AmerenUE, the Commission should at least retain some of the strong incentive that current regulation provides in any FAC that it might adopt.

AARP is not interested in the "soft cap" modifications to an FAC offered by some parties, which would simply defer certain increases to future periods with interest, and likely with a greater rate shock. However, AARP would consider a reasonably designed "hard cap"—a modification that actually limits FAC increases in any given period, as opposed to "cap" than deferred increases accumulating them for later imposition on consumers.

WHEREFORE, AARP respectfully requests that the Commission order an electric rate reduction pursuant to the Overearnings Complaint and consistent with the revenue requirement recommendations of the Office of the Public Counsel, and further reject AmerenUE's proposed FAC.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to counsel for each of the parties on the service list for this matter on this 20th day of April 2007.

/s/ John B. Coffman

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