Exhibit No.:
Issues: Other
Witness: Martin R. Cohen
Sponsoring Party: State of Missouri
Type of Exhibit: Direct Testimony
Case No.: ER-2008-0318

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

CORRECTED DIRECT TESTIMONY OF MARTIN R. COHEN

ON BEHALF OF

STATE OF MISSOURI

August 28, 2008

NP

Q. Please state your name and address.

A. My name is Martin R. Cohen. I reside at 2633 W. Sunnyside Avenue, in Chicago, Illinois.

Q. What is your position?

A. I am the sole proprietor of Martin Roth Cohen and Associates, a public policy consulting firm also located at the above address.

Q. What is your professional background?

A. From 1985 to 2005 I was employed by the Citizens Utility Board (CUB), an organization created by the Illinois General Assembly to represent the interests of residential and small business customers of investor-owned utilities in matters pertaining to the regulation of electricity, natural gas, water, and telecommunications services. I served as CUB's Executive Director from 1991 to 2005. From 2002 to 2005 I also served as an officer of the National Association of State Consumer Advocates. In September, 2005, I was appointed by Governor Rod Blagojevich to be Chairman of the Illinois Commerce Commission, the state utility regulatory agency, and I served in that capacity until November, 2005. I was appointed Director of Consumer Affairs by Governor Blagojevich in January, 2006, and served in that position through February, 2008. Martin Roth Cohen and Associates was formed in March, 2008.

Q. Have you testified in other proceedings in Missouri?

A. No. I have testified in two pending proceedings in Illinois, dockets 07-0566 and 07-0585. During my 14-year tenure as the head of the Citizens Utility Board I supervised

the development of expert testimony in dozens of proceedings, many of which implicated issues similar to those I am addressing here.

Q. What is the purpose of your testimony?

A. I address the request by AmerenUE (the Company) for imposition of a Fuel Adjustment Clause (FAC). I discuss general regulatory policies regarding rider treatment of utility costs as well as the specific circumstances of AmerenUE that pertain to its request. I respond to and/or reference portions of the Direct Testimony of Mr. Lyons, Mr. Voss, Mr. Finnell, Mr. Arora, Dr. Morin, Mr. O'Bryan and Mr. Neff.

Q. Please describe your testimony and its conclusions.

A. My testimony describes how traditional test year regulation protects the interests of consumers by providing utilities with positive incentives for cost minimization. I explain my concern about the singling out of one set of costs for special recovery and how that distorts a utility's decision making and puts consumers at risk. I lay out the criteria that should be used to determine whether or not a rate rider such as a Fuel Adjustment Clause is warranted. I discuss the many tools a utility can use to manage price risk and the lack of similar opportunities for most consumers. I examine current trends in fuel prices and show that prices have declined substantially in recent months. I describe how a new line item on bills would confuse consumers unless it is well explained.

I conclude that the FAC request of AmerenUE should be denied by the Commission. I recommend that, if the Commission decides to approve the request, certain of its terms and conditions be modified to achieve a better balance between the interests of the Company and its Missouri ratepayers.

Q. How are utility rates determined?

A. Utility rates are generally set at fixed levels based on the cost of service during a test year, as proven during a general rate case. These costs include all prudently incurred reasonable operating expenses, depreciation of plant and equipment, and taxes. A rate of return commensurate with the utility's cost of capital is applied to the "ratebase" – the net value of assets used to provide service after accumulated depreciation has been subtracted from original cost – and the sum of all the allowed expenses plus the return on ratebase becomes the revenue requirement. Rates are set at levels calculated to recover the amount of the revenue requirement.

Q. What is a test year?

A. A test year is a 12-month period, usually chosen by the utility, used to calculate all the aforementioned expenses and revenues for ratemaking purposes. In Missouri, a historic year is generally used as the test year in a general rate case. In this case, AmerenUE has chosen a 12-month period ending March 31, 2008. The Company has asked that this data be adjusted for known and measurable changes through September 30, 2008.

Q. Why is it important that all revenues and expenses reviewed in a rate case be based on the same time period?

A. The requirement that all data be compared over the same time period is necessary 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. The crucial purpose of defining a test year is to match income and expenses over a consistent period in order to make them comparable for the purpose of setting just and reasonable rates. Under test year principles, all costs and revenues must be looked at in their totality, without any being viewed in isolation or selected for special treatment.

As long as the overall costs and revenues remain approximately in balance, the rates that are set based on the test year provide an opportunity for a utility to earn a reasonable return on its invested capital. The actual earnings of the utility rise and fall between rate cases as the balance between revenue and expenses ebbs and flows. If overall expenses grow faster than revenue such that the authorized rate of return becomes unachievable despite its best efforts, a utility may seek higher rates by filing a new rate request with the Commission. Conversely, if revenues outpace expenses sufficiently to allow excessive utility earnings, the Commission on its own motion or any party may attempt to prove that rates should be reduced.

Q. Wouldn't it be preferable to allow rates to change automatically as utility expenses and revenues move up and down over time instead of going through the expense and effort of conducting periodic rate cases based on a test year?

A. No, periodic rate cases are well worth the effort because automatic changes in rates would remove a primary incentive for a utility to operate efficiently. The fact that rates are fixed between rate cases means that a utility has the opportunity to maximize its earnings by improving its productivity. Although this concept is sometimes disparagingly referred to as "regulatory lag," the risks and opportunities borne by utilities operating under fixed rates is the primary motivation for them to optimize their performance. The test year concept and its corollary, regulatory lag, therefore serve to align the interests of utilities and consumers to minimize the cost of service to customers while allowing utilities to realize their financial potential.

Q. Has AmerenUE made a request in its rate filing that would allow its rates to change without an examination of its overall expenses and revenue?

A. Yes. The Company has requested the imposition of a "Fuel Adjustment Clause."

Q. What is a Fuel Adjustment Clause?

A. A Fuel Adjustment Clause (FAC) is a separate line item (commonly called a rider) added to customer bills for the purpose of altering rates between general rate cases to compensate the utility for fluctuations in the costs of fuel and purchased power, without regard to overall costs and revenues. The amount of the rider would eventually be reconciled and reviewed by regulators, but not until months or even years after being paid by customers. A FAC is a form of single issue ratemaking, in

which a particular expense is taken out of context and used by itself to justify changes in rates. Single issue ratemaking is a violation of the test year principles I described earlier.

Q. Why is single issue ratemaking objectionable?

A. Under traditional regulatory principles all costs are treated equally and measured against all revenue. To set rates based on one expense alone, while ignoring potentially offsetting changes in other costs and revenue puts customers at risk of paying too much for utility service. For example, an increase in the cost of fuel could be matched or exceeded by decreases in other costs, such as the cost of debt during a period of declining interest rates. Cost increases could be further offset by increased sales revenues. If fuel costs were singled out for special recovery, customers could pay higher rates at a time when the utility is already achieving higher than authorized returns. Such a result is neither just nor reasonable, but it is a potential outcome of single issue ratemaking.

Q. Do you have concerns about the imposition of a Fuel Adjustment Clause on AmerenUE customers?

A. Yes. In addition to violating test year principles and reducing incentives for efficient utility operation, the FAC would have the effect of shifting risk for fuel and purchased power costs from the utility to its customers. A utility has many ways to manage these risks, including the following:

- A utility can protect its fuel portfolio through such activities as negotiating long-term contracts, purchasing fuel in forward markets, and employing financial hedging strategies.
- A utility can engage in long-term planning and alter its resource mix in response to changing conditions.
- A utility can upgrade its facilities and improve its operations to cut costs and save fuel.
- A utility can strive to increase its sales revenues.
- A utility can advocate rate designs that flatten load shapes and make the native load less expensive to serve.

Q. What can a residential or small volume commercial customer do to manage fuel and purchased power risks?

A. Very little, if anything. In a state without retail competition, such as Missouri, a residential or small volume commercial customer can attempt to use less electricity in response to higher prices, but otherwise has no effective way to mitigate the effects of exposure to electricity-related markets.

Q. Could a pass-through of fuel and purchased power costs distort the Company's decision making with regard to certain investments?

A. Yes. Automatic and immediate recovery of fuel and purchased power costs would diminish AmerenUE's incentive to invest in technology or personnel that would reduce these costs, because the Company would achieve no return of or on such investment until the next general rate case. Meanwhile, the risk of increases in fuel or

purchased power costs would be borne by customers. Therefore, the Company would be less likely to make capital investments in facilities that use no fuel, such as wind turbines, or in improving the fuel efficiency at existing power plants. And it would have less reason to optimize its hedging strategies. The FAC would allow the Company to increase earnings by shifting its investment and operational priorities to projects that would improve its productivity in areas where all of the benefits flow to shareholders. The result would be that customers pay more for electricity even as the Company makes more money.

Q. Wouldn't the required prudence review protect consumers?

A. A prudence review is not designed to catch these sorts of subtle changes in management priorities, which would be very difficult to prove and to quantify for the purpose of a disallowance. In my experience I have rarely seen a prudence disallowance of energy costs for any reason and the distant threat of such a disallowance is certainly no substitute for the incentives that are at the core of traditional regulation.

Q. Do you have additional concerns about the addition of a Fuel Adjustment Clause to customers' monthly bills?

A. Yes. A Fuel Adjustment Clause serves to make fixed rates no longer fixed. Instead, under the recovery method proposed by AmerenUE, rates may change three times per year. A new element of unpredictability added to electric bills would not be regarded by consumers as a welcome development.

In addition, a new line item would cause misunderstanding and confusion for many customers. Mr. Lyons includes a facsimile sample residential billing statement attached to his Direct Testimony showing how a "postcard" bill would reflect the Fuel Adjustment Clause (Schedule MJL-E4, Attachment A-1). The bill, which is shown as having previously contained a single line item with total amount due, now includes a second line item called "Rider FAC Adjustment," which appears on the bill without explanation. Very few customers would understand what this means. In my experience, consumers often assume that extra line items on their utility bills are government imposed taxes and surcharges. This misapprehension is reinforced by the lack of information about the line-item charge on the bill.

Q. Would the imposition of a FAC lead to fewer regulatory proceedings and decreased regulatory burdens on utilities, parties, and the Commission?

A. No. Unfortunately, the opposite is more likely. Under the Commission's rules (detailed at 4 CSR 240-3.161), the FAC would require monthly filings and complex proceedings to true-up and audit the accounts and review the prudence of costs incurred. Periodic general rate cases would still be necessary as well, to look closely at all the other costs and revenue in order to maintain just and reasonable base rates. In fact, there might be more general rate cases than in the past, because the rules require that a utility with a Fuel Adjustment Clause file a new rate case within four years.

Q. But wouldn't a Fuel Adjustment Clause reduce the need for another AmerenUE rate case in the near future?

A. No. In fact, Mr. Voss testifies that the Sioux Plant scrubber is scheduled to come on line near the end of 2009, when "the rising costs we are facing will very likely necessitate another rate case." (Direct Testimony of Thomas R. Voss, page 20, line 20). As an order in the extant case is not likely to be issued until close to the suspension expiration date of March 1, 2009, a new rate case may commence within months of the completion of this one, regardless of outcome. The fact that the Company already intends to file another rate case on the heels of this one undermines its claim that a FAC is necessary at this juncture.

Q. Are there circumstances under which a rider, such as a FAC, should be approved by the Commission, despite the fact that it is single issue ratemaking, violates test year principles, distorts incentives, exposes customers to charges that have not yet been reviewed by regulators, and may cause problems for consumers?

A. Yes, there are certain extraordinary circumstances under which imposition of a rider can be justifiable. A rider should only be used when:

- the costs in question are large enough that significant under-recovery poses a threat to the financial health of the utility;
- the costs are beyond the ability of the utility to control or to mitigate sufficiently through prudent risk management; and
- the costs are volatile enough that they are unlikely to stay within an acceptable range over a reasonable time period..

In order for a rider to be justifiable, all three of the above conditions must be met.

Q. Has the Commission employed standards like these in the past?

A. Yes, these standards are similar to those which the Commission used in Docket ER-2007-002 to evaluate AmerenUE's earlier request for imposition of a Fuel Adjustment Clause. In that Order, the Commission determined that "a cost or revenue change should be tracked and recovered through a fuel adjustment clause only if that cost or revenue change is:

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."[1] (Case ER-2007-0002 Order, page 20)

Q. What did the Commission decide with regard to the FAC issue in Docket ER-2007-0002?

A. The Commission rejected the request by AmerenUE for imposition of a FAC, concluding that "AmerenUE's fuel and purchased power costs are not volatile enough [to] justify the implementation of a fuel adjustment clause at this time."[2]

---

[1] Report and Order, Case No. ER-2007-0002, "In the Matter of Union Electric Company d/b/a AmerenUE's Tariffs Increasing Rates for Electric Service Provided to Customers in the Company's Missouri Service Area."

[2] Ibid, page 26.

Of course, the Commission must make its decision in this docket based solely on the evidence presented in the extant case. However, the regulatory principles and standards that should apply to this issue have not changed.

Q. Have the facts presented by AmerenUE changed sufficiently since the Order in Case No. ER-2007-0002 was issued on May 22, 2007 to warrant a different decision by the Commission in the extant case?

A. No. A revenue requirement may be set in this general rate case that includes all known and measurable cost changes, including fuel and purchased power costs, through September, 2008. While the updated costs of fuel and purchased power may be large, they can be managed by AmerenUE as they have been before, without resorting to imposition of a rider.

In Case ER-2007-0002, the Commission found that AmerenUE's fuel and purchased power costs met the "substantial enough" test, but did not find that these costs were sufficiently beyond control of management nor volatile enough to warrant rider treatment. As I will discuss further, neither the markets in question nor the capability of the Company to manage its risks have changed in such a way as to warrant a different decision by the Commission in this case.

Q. Mr. Lyon testifies that most other vertically integrated utilities in non-restructured states have FACs in place. Is that a reason for the Commission to reverse its policy with regard to AmerenUE?

A. No. The fact that other utilities, whether in Missouri or elsewhere, have seen FACs approved does not justify approval of such a rider for AmerenUE. The Company's particular costs and circumstances with regard to fuel and purchased power must be assessed by the Commission. My conclusion is that the facts do not warrant imposition of a Fuel Adjustment Clause at this time.

Q. Mr. Lyons refers in his Direct Testimony to the Commission's approval of a FAC for Aquila in Case No. ER-2007-0004. Should this case have any bearing on the request of AmerenUE for a FAC?

A. No. That the Commission approved a FAC for another Missouri utility provides no basis for approval of AmerenUE's request. Moreover, as the Commission noted in its order in ER-2007-0004, Aquila is heavily reliant on both gas-fired generation and purchased power. These facts make its situation dramatically different from AmerenUE, which as I will discuss, relies heavily on coal-fired generation and is a net exporter of power.

Q. Which cost factor has the most significant effect on the Company's fuel costs?

A. Mr. Voss testifies that more than 76% of AmerenUE's energy is generated from coal-fired plants (Voss Direct, p. 17, line 23). This makes the Company's fuel mix far more coal intensive than the national average of 49% coal, as reported by the Energy Information Administration in the "Annual Energy Outlook" for 2008.[3] As a relatively coal intensive utility, AmerenUE is less exposed than most of its peer companies to fluctuations in the price of natural gas and oil fuel.

[3] http://www.eia.doe.gov/oiaf/aeo/electricity.html

Q. How much of the Company's fuel costs are coal-related?

A. Mr. Neff testifies that the test year cost of delivered coal is approximately $556 million (Direct Testimony of Robert K. Neff, Page 3, line 10). This cost represents approximately 82% of fuel costs totaling approximately $678 million prior to normalization, as testified to by Mr. Finnell (Direct Testimony of Timothy D. Finnell, Attachment A-2). The delivered cost of coal therefore represents the largest portion of the Company's gross fuel costs.

Q. What are the most important factors influencing the delivered cost of coal?

A. The two key factors determining delivered coal costs are the commodity cost of coal and the expense of transporting it by rail from Wyoming's Powder River Basin, where 96% of AmerenUE's coal originates.[4] Mr. Lyons testifies that the cost of coal transportation represents ** [redacted] ** of the delivered price of coal (Lyons Direct, p. 18, line 11).

Q. What has been the recent trend with respect to the Company's delivered cost of coal?

A. Mr. Neff testifies that delivered costs of coal in the updated test year ending June 30, 2008 are expected to be $1.48 per million BTU, an increase of 12% over the delivered coal costs of $1.32/million BTU since the last AmerenUE rate case (Neff Direct, page 2, line 12). He further testifies that the spot price of 8800 PRB coal rose from $11.20

[4] This number is calculated from the chart on page 4 of the Direct Testimony of Mr. Neff, which shows that all but 968,000 tons of the 23,231,000 tons used during the test year is PRB coal.

on November 1, 2007 to $17.00 at the end of February, 2008 (Neff Direct, page 20, line14).

Q. What is the present trend with respect to the cost of PRB coal?

A. As reported by the Energy Information Administration, the spot price for that same PRB 8,800 BTU/lb coal was $11.00 per ton as of late August, 2008[5], a drop of about 35% over the course of those five months.

Q. What is the present trend with respect to coal transportation surcharge costs?

A. Mr. Neff identifies the Energy Information Administration's On-Highway Diesel price as determinative of the amount of fuel surcharges charged by the railroads which transport the Company's coal (Neff Direct, page 13, line 17). This price has fallen from an average nationwide high of 4.723 dollars per gallon as of late May, 2008, to 4.145 per gallon in late August[6], which amounts to a drop of 12% in three months.

Q. What is the present trend with regard to natural gas costs?

A. The Henry Hub spot price, as traded on the New York Mercantile Exchange, has fallen from about $12/MMBtu in late May, 2008, to about $8/MMBtu in late August, a drop of 33%[7].

Q. Are these price trends you cite evidence of extreme volatility that would justify approval of a Fuel Adjustment Clause?

---

[5] http://www.eia.doe.gov/cneaf/coal/page/coalnews/coalmar.html#spot

[6] http://tonto.eia.doe.gov/oog/info/wohdp/diesel_detail_report_combined.asp

[7] http://tonto.eia.doe.gov/oog/info/ngw/ngupdate.asp, EIA Natural Gas Weekly Update

A. No. I cite these recent trends to show that it is normal for these prices to move up and down over time.

Q. Is it normal for all businesses to face fluctuations in their costs?

A. Yes, all businesses, whether in regulated industries or not, face changes in the cost of inputs and must develop strategies to manage price risk. Most firms face markets in which they cannot successfully raise the prices of their own products in response to fluctuations in short term costs. Instead, they must address these costs through a combination of increased efficiency and effective hedging strategies.

Q. Does AmerenUE have effective means to address fluctuations in coal market prices?

A. Yes, the company maintains an extensive hedging program, as described by Mr. Neff. He testifies that **[redacted]** of coal purchases are hedged for 2009 and **[redacted]** are hedged for 2010. These numbers, assuming an equal amount of coal is purchased for each year, produce an average of **[redacted]** for the two-year period. More than **[redacted]** of coal purchases are already hedged through the end of 2010. The company, of course, can avail itself of the opportunity to modify its hedging strategies in response to changing conditions and prices.

Q. Does AmerenUE also hedge its coal transportation costs?

A. Yes, Mr. Neff testifies that the Company's coal transportation costs are hedged for 2009 at **[redacted]** and for 2010 at **[redacted]**. These numbers produce an average of **[redacted]** for the two-year period, a similar proportion to the coal purchase hedges.

Q. Does the Company hedge its exposure to Diesel Fuel Surcharges?

A. Yes, Mr. Neff testifies that ** [redacted] ** of the Diesel Fuel Surcharges are presently hedged ** [redacted] **. The Company may elect to expand this hedging program to reduce its future exposure to Diesel Fuel Surcharges.

Q. Isn't AmerenUE exposed to volatility in the natural gas market?

A. Yes, however the effect of natural gas prices on AmerenUE's total fuel costs is very small. Mr. Finnell testifies that gas combustion turbine generation for 2007 totaled 889,692 MWh out of total generation of 50,310,199 MWh. Thus, CTG generation represents just 1.77% of the total energy output of AmerenUE, whereas natural gas fuels 21.5% of overall U.S. electricity production[8]. This is a key distinction between AmerenUE and most other utility companies that substantially reduces its exposure to high natural gas prices. And high natural gas prices tend to raise the market prices of electricity, which may increase the Company's revenue from off-system sales.

Q. Isn't AmerenUE also exposed to volatility in the market price of purchased power?

A. Yes, but because the Company both buys power and also sells it, its exposure is reduced. AmerenUE is a net seller of power, that is, its purchased power costs of $54 million are offset by off-system sales revenues of $435 million (Supplemental Direct Testimony Timothy Finnell, page 3, line 10). While the effect of off-system transactions on net fuel costs is a function of when power is purchased, when it is sold, and the variable costs including fuel at those times, it is generally the case that, because natural gas plants are often at the margin and therefore tend to set market

[8] See: http://tonto.eia.doe.gov/energy_in_brief/electricity.cfm

electricity prices, a coal-intensive generator will have opportunities for higher sales margins when natural gas prices are high. These margins would tend to reduce exposure to high purchased power costs and may be sufficient to partially offset fuel cost increases as well.

Q. Mr. Cohen, do you agree with the Company's witnesses that fuel costs are likely to be increasing over time?

A. I do not dispute that there has been an upward trend in fuel costs in recent years, and I agree that the long term trend in fuel costs may indeed be upward. But that likelihood is not justification for imposition of an FAC, which, as I have discussed, is only justifiable if short term costs are likely to be so volatile as to deny the Company an opportunity to earn a reasonable return. Only extreme fluctuation of costs that are beyond the utility's control and which cannot be effectively managed causes need for such a rider, not the magnitude or direction of overall cost trends. The Company's hedging program can sufficiently reduce its exposure to short-term market prices so as not to necessitate exposure of customers to a Fuel Adjustment Clause and all its attendant problems. Moreover, it is significant that the Company has requested that its base fuel price to be included in rates be updated to reflect changes as of September 30, 2008, which would make rates fully trued up and reflective of all known and measurable costs at that time.

Q. Have you reviewed Mr. Arora's testimony regarding his "uncertainty" analysis?

A. Yes. Mr. Arora employs a probabilistic model, "RTSim," to project a wide range of possible outcomes for future costs of fuel and purchased power and to estimate the

chances of their occurrence. He finds that the model shows significant "uncertainty" regarding future unhedged costs for the period of 2009-2012. He finds that uncertainty increases the farther out into the future the costs are projected. He finds that historical "uncertainty factors" using data from 1999-2007 are generally higher than forward looking simulated annual uncertainty factors.

Q. How do you respond to Mr. Arora's analysis?

A. It is reasonable that when uncertain variables are combined over time, the total "uncertainty factor" will tend to increase as you attempt to track it further into the future. That is the nature of uncertainty. The fact that the model shows relatively high uncertainty in recent years (for example, coal costs show a simulated annual uncertainty factor of **[redacted]** for 2012, compared to 31% for 1999-2007) indicates that AmerenUE has been able to manage its fuel and purchased power costs reasonably well during a period of high uncertainty and without a Fuel Adjustment Clause.

Q. Please describe your understanding of how the FAC would work.

A. As Mr. Lyons describes it in his Direct Testimony, the general rate case would establish a test year net base fuel cost level equaling the sum of all normalized fuel, purchased power and related costs, less the normalized off-system sales revenues. This amount would be divided by the normalized energy sales to derive a per kilowatt-hour rate that would be the net base fuel cost. Total net deviations from the net base fuel cost accrued over four-month periods would flow through in overlapping

12-month recovery periods. The sum would appear on customer billing statements. Annual true-ups would account for any over or under-collections.

Q. Would the full amount of any deviation from net base fuel costs flow through the Fuel Adjustment Clause?

A. No. AmerenUE proposes to flow through 95% of any deviations from net base fuel costs. The remaining 5% would be "eaten" by the Company if actual fuel costs are higher than net base fuel costs and "kept" by the Company if actual fuel costs are lower than net base fuel costs.

Q. Would the adjustments include interest payments?

A. Yes, the Company would accrue interest on any actual net fuel costs that are above the net base fuel costs, while customers would be paid interest in the opposite case. In either case, the interest rate would equal AmerenUE's cost of short-term debt, which Mr. O'Bryan testifies is an annual rate of 3.384% (Supplemental Direct Testimony of Michael G. O'Bryan, page 4, line 18).

Q. Is a typical customer's cost of short term debt equal to the Company's cost?

A. No. The typical customer has a cost of short-term debt equal to the interest paid on credit card debt. The average rate for such debt is 12.26% as of August 13, 2008, according to Indexcreditcard.com, a credit card monitoring service, a rate that is almost four times as high as the Company's cost of short-term debt. I am aware that under Section 386.266 of the Missouri Revised Statues, the interest rate for rider true-up is set at the utility's cost of short-term debt. However, the fact that this amount is

not commensurate with customers' actual costs means that the Commission should be cautious when constructing a FAC mechanism.

Q. Without a Fuel Adjustment Clause in place, customers would receive no credit whatsoever when actual costs are less than base fuels costs. Aren't consumers better off getting something than getting nothing?

A. The possibility of a portion of fuel savings being passed through to customers by operation of the FAC is a potential benefit that is overwhelmed by the potential harm that accompanies wholesale transference of risk from the Company to its customers.

Q. Do you agree that if the Commission were to approve a FAC, it should include less than full pass-through of deviations from net base fuel costs?

A. Yes. I have testified earlier as to how the establishment of a FAC would remove a key incentive for the utility to minimize its fuel and purchased power costs, and why on balance it should not be approved by the Commission. But in the event a FAC is established, a mechanism should be included that attempts to provide incentives for optimized procurement and efficient operation. Indeed, the law authorizing the Commission to establish cost-tracking mechanisms such as a FAC specifically allows "features designed to provide the electrical corporation with incentives to improve the efficiency and cost-effectiveness of its fuel and purchased-power procurement activities." As I will discuss, however, the incentive mechanism proposed by the Company is inadequate to the task and unfair to consumers.

Q. Please describe your additional concerns with regard to the specific attributes of the FAC as proposed?

A. I am concerned that for AmerenUE to be responsible for absorbing just 5% of any costs it incurs above the net base fuel costs would provide insufficient incentive. For example, Mr. Lyons testifies that in 2009, the delivered cost of coal (the Company's largest fuel expense) is expected to increase by [redacted]** (Lyons Direct, page 10, line 18) over the test year. If the company is responsible for 5% of that amount, its costs at risk are limited to **[redacted]**. That amount represents **[redacted]** of the $334 million earnings recommendation of Dr. Morin, and just **[redacted]** of the Total Revenue Requirement recommended by Mr. Weiss (Schedule GSW-E19). To put this in perspective, it is the equivalent of someone with an annual gross income of $50,000 being at risk for about ** [redacted]**.

The Company argues that being "on the hook" for 100% of any costs above the net base fuel costs (as it is today and has been for a long time) will make it almost impossible to achieve its authorized rate of return. If the Commission agrees, then the question should be: What percentage below guaranteed 100% recovery will provide an opportunity for the company to achieve its authorized return while protecting consumers from all the negative consequences of a FAC that I have discussed earlier? Clearly this is a judgment call with no way to calculate the perfect number. But in my opinion, limiting the Company's maximum exposure to 5% of the increase over base fuel costs does not leave enough of its "skin in the game" to counter the perverse incentive that the FAC would provide for the Company to skimp on investments and

operational efficiencies that would reduce net fuel costs and focus its attention instead on other ways to grow earnings.

Q. What is a perverse incentive?

A. Because regulators cannot and should not attempt to manage the operations of utilities, effective regulation includes the application of incentive mechanisms designed to align the interests of customers with those of utility shareholders and reduce the cost of service. Such positive incentives reward a utility with higher earnings if it acts in the interests of customers. Earlier I described the positive incentives for cost minimization and efficiency that are inherent in fixed rates and the operation of regulatory lag. A perverse incentive occurs when a regulatory mechanism inadvertently serves to misalign the interests of customers and shareholders, and encourages the utility to increase its earnings at the expense of customers rather than through improved productivity.

Q. Do you have recommendations for improving the FAC mechanism, should the Commission decide to approve a Fuel Adjustment Clause for AmerenUE?

A. Yes. As I have explained, my core recommendation is that the Commission deny AmerenUE's request to establish a Fuel Adjustment Clause at this time. However, if a FAC is approved, I would make the following recommendations:

1) Modify the incentive mechanism:

A. Make the Company retain responsibility for 20% of deviations from net base fuel costs, with customers covering 80%.

B. Alternatively, make the risk sharing feature asymmetrical. In the event that actual net fuel costs exceed the base rate, give the company responsibility for 85% of such deviation. In the event that actual net fuel costs are lower than base costs, leave the 95% customer portion as proposed.

2) Require the Company to provide regular information to consumers explaining the FAC. This information should accompany the billing statements, or be printed on the billing statement itself, as might be necessary in the case of a postcard bill.

Q. Why should the incentive mechanism proposed by AmerenUE be altered?

A. If the Commission sees fit to approve a FAC, it should seek to retain to the greatest extent possible the positive incentives inherent in traditional cost of service regulation. Today, the Company bears 100% of the risk of changes in fuel costs between rate cases. I have explained why I believe that is appropriate, given the nature of the costs and the tools the Company can employ to manage them. To reverse this policy overnight and transfer 95% of the fuel risk to consumers, who have no way to manage it, goes too far in the opposite direction. The Company ought to bear a portion of any costs above the net base fuel costs sufficient to provide it an opportunity to earn a reasonable return while leaving it with enough responsibility to eliminate the perverse incentives associated with a pass-through FAC. Implementation of Recommendation 1(A) above would effectively remove 80% of the Company's "problem" while imposing less of a burden on consumers. Thus it

would more fairly balance the interests of AmerenUE and its customers than the Company's proposal.

My alternative recommendation 1(B) would leave AmerenUE with reasonable incentives to keep a lid on fuel and purchased power costs, while responding to the concern I described earlier that customers' cost of debt is generally far higher than the Company's. If the Commission approves the FAC, then it presumably agrees with the Company's contention that fuel and purchased power costs are beyond the Company's control. Allowing the Company to retain 5% of savings if the Company achieves costs lower than base rates and bear 15% of additional costs would provide a more effective incentive to AmerenUE to drive fuel and purchased power costs as low as possible, while not excessively rewarding it for being the beneficiary of falling market prices.

Q. Mr. Cohen, does this conclude your Direct Testimony?

A. Yes.