STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

AMEREN ILLINOIS COMPANY	)	
	)	Docket No. 11-0279
Proposed general increase in electric delivery service rates.	)	
	)	
	)	(Cons.)
	)	
AMEREN ILLINOIS COMPANY	)	
	)	Docket No. 11-0282
Proposed general increase in gas delivery service rates.	)	

<u>DRAFT ORDER OF</u>
<u>THE PEOPLE OF THE STATE OF ILLINOIS</u>
<u>THE CITIZENS UTILITY BOARD, AND AARP</u>

Dated: October 26, 2011

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Pursuant to the direction of the Administrative Law Judges, the Case Management Order and the Rules of Practice of the Illinois Commerce Commission ("ICC" or "Commission"), the People of the State of Illinois, by and through Attorney General Lisa Madigan ("AG" or "People"), the Citizens Utility Board ("CUB") and AARP hereby submit their Draft Order in the above-captioned matter.

II. RATE BASE

C. Contested Issues

2. ADIT – FIN 48

AG/CUB/AARP aver that the Commission should eliminate the ADIT debit balances related to FIN 48 from the balance of ADIT deducted from plant in service. They stated that it is not disputed that FIN 48 liability represents non-investor supplied funds. AG/CUB Ex. 4.0 at 9. AG/CUB/AARP noted Ameren Witness Mr. Warren agrees that the FIN 48 balances represent cash that has been procured from the government by claiming certain tax deductions and that this represents a loan from the government. Ameren Ex. 37.0 at 4. They further noted Staff Witness Hathhorn also agreed that FIN 48 funds are funds that have not yet been paid to the taxing authorities and as such, are funds that are available to Ameren until they are paid to the taxing authorities. Tr. at 251-52.

In response to Ameren Witness Mr. Stafford's argument that the FIN 48 amount to be repaid is uncertain and as such, the rate base should not be reduced by those funds, AG/CUB/AARP argued the very uncertainty surrounding the ultimate disposition of FIN 48 funds weighs in favor of deducting them from the rate base as long as the funds are available to the company until they are actually repaid. AG/CUB/AARP argued Ameren nor Staff was able to articulate an estimate of when these taxes will have to be repaid, the likelihood that any tax deductions might be disallowed, or the likelihood that the taxes will have to be repaid significantly before they reverse in the normal course of business. Instead, they said, Ameren proposed (and Staff accepted as reasonable) an alternative to not seek recovery from its ratepayers of any interest or penalties on the FIN 48 amounts that Ameren may have to pay in return for the Commission allowing Ameren to keep FIN 48 balances in its rate base.

AG/CUB/AARP contended this alternative proposal allows Ameren to recover a return on a balance that it does not have a right to recover (*i.e.* FIN 48). This is not a reasonable alternative to the proper disposition of FIN 48 funds in this case in the opinion of AG/CUB/AARP. They stated FIN 48 funds should be deducted from the rate base because they are non-investor supplied funds that are substantively no different than ADIT. AG/CUB/AARP pointed out that in addition to ADIT, other non-investor supplied funds that may have to be repaid such as customer advances and customer deposits (which also accrue interest) are also deducted from the rate base, a fact that was confirmed by Staff Witness Hathhorn. Tr. at 252.

AG/CUB/AARP stated there is no reason to treat FIN 48 funds any differently as long as they have not actually been repaid to the taxing authorities. AG/CUB/AARP agreed that any interest accrued on FIN 48 funds should be included in the cost of service, as interest or penalties are the cost that Ameren has to pay for the use of these funds. Therefore, AG/CUB/AARP argued for deducting FIN 48 funds that have not been repaid to the taxing authorities from the rate base and allow Ameren to recover from its ratepayers any interest accrued on FIN 48 funds in its cost of service.

4. Accrued OPEB Liability

AG/CUB/AARP took the position that test year balances of accrued OPEB liabilities should be deducted from plant in service in the calculation of the Company's rate bases in the present cases. With regard to OPEB, AG/CUB/AARP stated ratepayers have supplied funds for future obligations; therefore, a source of cost-free capital has been provided to the utility, which should be recognized in the revenue requirement as a reduction from rate base.

In response to the Company's statements about the novelty of this issue, AG/CUB/AARP stated he analysis presented by the Company in might appear to differ in certain particulars from what the Company presented in the last rate case, but it has the same general structure and purpose. In other words, there is nothing of substance in the Company's analysis in the present case that is new. AG/CUB/AARP averred the OPEB issue in this case, particularly regarding the Company's control of rate payer supplied OPEB funds, is similar to the accrued OPEB issue in other cases, where the Commission has definitively addressed the matter:

- In a Northern Illinois Gas Company ("Nicor") case, ICC Docket No. 95-0129, the Commission determined that so long as the companies continue to control the ratepayer-supplied OPEB funds, the OPEB deduction should be recognized in the determination of rate base. ICC Docket No. 95-0129 Final Order at 10.

- In Peoples Gas/North Shore Gas, ICC Docket Nos. 09-0166/09-0167 (Cons.), The Commission again found that OPEB liability should be deducted from rates. ICC Docket

No. 09-0166/0167 (cons.) Final Order of January 21, 2010 at 36-37 ("*2009 NS-PGL Rate Case Order*").

- In a prior Ameren rate case, the Commission found that CILCO, CIPS, and IP electric delivery service base rates should be reduced by the accrued OPEB liabilities. ICC Docket Nos. 06-0070/06-0071/06-007 (cons.) Final Order of Nov. 21, 2006 at 27.

- In the second to last Ameren rate case, the Companies agreed that the accrued OPEB should be deducted from rate base, and the Commission adopted this adjustment, finding it reasonable and appropriate. ICC Docket No. 07-0585 et al (cons.) Final Order of Sept. 28, 2008 at 7.

AG/CUB/AARP argued the Commission should adopt the adjustments for the accrued liability proposed by AG/CUB witness Mr. Effron and supported by Staff. The adjustment to rate base as proposed by AG/CUB witness Mr. Effron and Staff witness Ms. Pearce reduces the Company's rate base by $6,850,000 and $3,062,000 for electric and gas respectively.[1] Staff Ex. 21.0, Schedule 21.01; AG/CUB Ex.4.1, Schedule DJE-1 at 1. These adjustments to rate base are stated net of accumulated deferred income taxes. AG/CUB Ex. 1.0 at 5.

I. OPERATING REVENUES AND EXPENSES

C. Contested issues

2. Charitable Contributions

The AG, CUB and AARP supported Staff's adjustment to the Company's proposed charitable contributions for the test year. They argued the Company's forecasted 64% increase in the test year over 2011 contributions is unreasonable. AG, CUB and AARP agreed with Staff witness Mr. Tolsdorf that during these challenging economic times, the Company's obligation is to provide safe and reliable service at the most reasonable rate possible. Staff Ex. 22.0 at 9. AG/CUB/AARP noted the Company's claims that the 64% increase in the test year is warranted because the Company desires to increase contributions, in 2011 were under economic and budget constraints that did not allow them to contribute to the level they wanted. Ameren Ex. 28.0 at 4. However, they argued, Ameren's customers are under similar constraints, and as Mr. Tolsdorf pointed out, they do not have the same flexibility when it comes to paying their utility bills. Staff Ex. 22.0 at 8.

AG/CUB/AARP averred that while the Company may give to charitable organizations at any level it wishes, it may only recover from ratepayers reasonable amounts. 220 ILCS 5/9-227. For this discretionary expense, which does not affect the Company's ability to provide safe, reliable service, a AG/CUB/AARP stated a 64% increase is simply not reasonable. Mr.

[1] The Company pointed out certain computational errors that AG/CUB witness Mr. Effron relied upon in his direct testimony. Accordingly, Mr. Effron, in his rebuttal testimony, reflected the corrected balances of accrued OPEB on AG/CUB Ex.4.1; Schedule DJE-1 at 1.

Tolsdorf's proposal to set charitable contribution expense at the 2011 budgeted level and adjust for inflation through the test year is more reasonable, according to AG/CUB/AARP.

AG, CUB and AARP agreed with IIEC witness Mr. Gorman's arguments that including charitable contributions in cost of service makes ratepayers involuntary contributors to charitable organizations chosen by the utility. IIEC Ex. 3.0 at 73. However, AG/CUB/AARP noted Staff's statement that Mr. Gorman's position of disallowing 100% of charitable contributions is a departure from past Commission practice. Staff Ex. 22.0 at 10. At a minimum, AG/CUB/AARP argued the Commission should adopt Staff's adjustment, and should limit recovery of charitable contributions to 2% above 2011 levels.

4. Amortization of Merger Costs

AG/CUB/AARP maintained there should be no recovery of merger costs until the actual amount of costs to be recovered is known and until it can be established that expected savings from the merger are actually being realized. AG/CUB Ex. 4.0 at 6. The merger costs proposed by Ameren are estimates of the costs Ameren expects to incur in 2011 and 2012. AG/CUB Ex. 1.0 at 23. AG/CUB/AARP contended it is inappropriate to reflect the amortization of those costs in the revenue requirement until they are actually known. *Id*. at 23.

AG/CUB/AARP stated that the Company's claimed savings seem unlikely given that the Company forecasts an increase in Customer Record and Collection Expenses of 5.9% in 2012 over the actual expense charged in 2010. *Id*. at 24. That increase is of significant magnitude even if there were no merger savings; therefore Mr. Effron found that it was not clear that the Company's 2012 forecast for that account actually incorporated the savings claimed by the Company. *Id*. at 12-15.

On rebuttal, the Company eliminated the deferral and amortization of internal labor costs related to the merger from its request. AG/CUB Ex. 4.0 at 6. Therefore, Mr. Effron reduced his adjustment accordingly, which resulted in an adjustment of $1,155,000 for electric and $503,000 for gas. AG/CUB Ex. 4.1 at 1.

5. State Income Tax Expense – Regulatory Asset

AG/CUB/AARP stated the Commission should not establish a regulatory asset, as the Company proposed, for the increase in the state income tax rate. AG/CUB/AARP argued that to do so would be to selectively and unfairly recognize a change that increases the Company's revenue requirement without concomitant recognition of changes that decrease the Company's revenue requirement. AG/CUB Ex. 1.0 at 25. All other things equal, an increase in state income tax rate would increase the Company's revenue requirement – but all other things are not equal, AG/CUB/AARP said, because in 2011, bonus tax depreciation equal to 100% of qualifying plant additions is available to the Company. *Id*. This bonus depreciation reduces the Company's cost of service in 2011, through accumulated deferred income taxes, and the revenue requirement effect of the bonus depreciation is substantially greater than the revenue requirement effect of the state income tax rate increase. *Id*. AG/CUB/AARP noted the Company has not proposed that the Commission defer the 2011 benefit of the bonus depreciation and credit that benefit to ratepayers prospectively . *Id*. at 26. Though the Company reflected the effect of bonus depreciation on a going-forward basis (Ameren Init. Br. at 10), it did not propose to do so going forward. The Company reflected the effect of bonus depreciation including State Income Tax ADIT Bonus Depreciation on a going-forward basis (Ameren Init. Br. at 10) but not for 2011. True "symmetry," which the Company claims it desires (*Id*. at 55), would recognize that the 2011 effect of this adjustment would be substantially greater than the revenue requirement effect of the 2011 state income tax rate increase.

AG/CUB/AARP noted the Company chose a 2012 test year, and said Ameren cannot pick and choose certain expenses from other years to include. AG/CUB/AARP noted Staff witness Diana Hathhorn's agreement that the Company should be required to follow the rules of the test year it chose, both the freedoms and constraints, on an equal basis, and IIEC witness Michael Gorman's position that Ameren has already captured the increase in the state income tax rate in its future test year, and therefore will recover the increase in its test year. IIEC Ex. 3.0 at 71. Mr. Effron, in addressing the Company's concerns about "symmetry," again noted the benefits incurred by the Company from the 2011 bonus depreciation and challenged that if anyone is advocating asymmetrical treatment with regard to changes in tax law changes, it is Mr. Nelson. AG/CUB Ex. 4.0 at 7.

AG/CUB/AARP maintained the Commission should not allow Ameren extraordinary rate treatment of this one item, and should require the Company to abide by the test year rules. They recommend that no regulatory asset for the increase in the state income tax rate should be allowed.

6. PSUP Awards

The AG, CUB and AARP supported Staff's adjustment to remove 100% of the expense associated with Ameren's Performance Share Unit Program ("PSUP"). AG/CUB/AARP argued incentive compensation costs are recoverable in rates only if the plan confers upon ratepayers specific dollar savings or other tangible ratepayer benefits. *2009 NS-PGL Rate Case Order* at58; ICC Docket No. 09-0306 et al. (cons.) Final Order of April 29, 2010 at 83 (*"2009 Ameren Rate Case Order"*). AG/CUB/AARP responded to Ameren's arguments about supposed customer benefits, stating that if simply attracting and retaining qualified executives was enough to be determined a "customer benefit," as required by the Commission, then any and all incentive compensation plans could arguably be recoverable. AG/CUB/AARP stated retaining qualified employees has no specific dollar savings, nor does it provide ratepayers a tangible benefit. Instead, the PSUP rewards employees for the Company's financial performance, thereby aligning the interests of employees with shareholders. Staff Ex. 3.0 at 19. The PSUP rewards employees when AIC is allowed rate increases by the ICC, which is strictly a shareholder benefit in AG/CUB/AARP's opinion. *Id*.

AG/CUB/AARP noted the program is based on financial targets similar to the earnings per share ("EPS") metric disallowed by the Commission in ICC Docket No. 05-0597. Staff Ex. 3.0 at 19, Staff Ex. 21.0 at 14. When the goals of the PSUP are achieved, employees receive Ameren stock. Staff Ex. 3.0 at 18. AG/CUB/AARP stated this aligns employee interests with those of shareholders, including the desire to increase Ameren's rates. *Id*. That incentive, they said, combined with a total lack of tangible customer benefits, is reason for 100% disallowance of this cost.

7. Electric Distribution O&M Expense

AG/CUB/AARP argued that the Company's forecast of 2012 test year electric distribution O&M of $230.5 million is unjustified in relation to what the Company has actually been spending in previous years. For example, in 2009, the actual electric distribution O&M expense was $190,272,000. *Id*. In 2010, the actual electric distribution O&M expense was $171,946,000. AG/CUB Ex.1.0 at 10. The 2012 forecasted O&M expense represents an increase of 21% over the actual 2009 expense, an increase of 34% over the actual 2010 expense and a 28% increase over the forecasted 2011 electric distribution O&M expenses. AG/CUB Ex.1.0 at 10-11. Company witness Mr. Pate stated that the increased expenses are necessary because "the current levels of spending are not adequate to maintain systems to the expectation of key stakeholders" *Id.* at 54.

In response, AG/CUB/AARP pointed out Ameren can well afford to fund activities that have not been specifically included in rates. On March 31, 2011, they showed AIC had cash plus temporary cash investments in excess of $500 million on its balance sheet. Tr. at 54-55, AG/CUB Cross Ex. 2 at 1. AG/CUB/AARP further noted the Company's recent earned returns imply that there were costs that were explicitly included in rates that the company did not incur in 2010 or in the twelve months ended March 31, 2010. Mr. Nelson agreed that AIC up-streamed $133 million of cash dividends to its parent company. Tr. at 63, AG/CUB Cross Ex. 4. Additionally, AG/CUB/AARP pointed out that Ameren earned a return on rate base of 10.18 percent for the 12 month that ended March 31, 2011. Tr. at 51, AG/CUB Cross Ex.1. If a utility company is exceeding its authorized rate of return, they said, then rates necessarily must be adequate to absorb additional costs. *Id.* In other words, the Company's claim that funds for necessary increases to operation and maintenance activities were not available prior to 2012 because of financial constraints is without justification in AG/CUB/AARP's opinion. Similarly, any claim that "the current levels of spending are not adequate to maintain systems to the expectations of key stakeholders" due to "financial constraints" is also be without justification.

AG/CUB witness David Effron further noted, "in calendar year 2010, the Company earned a return on equity of 11.67% on common equity supporting its rate base (11.40% if the rate base is adjusted to include construction work in progress)" AG/CUB Ex. 1.0 at 15; AG/CUB Ex.4.0 at 2. Moreove, he found, this return was achieved even though the rate increases in the last Ameren rate case, Docket 09-0306 et al. (Cons.), were not in effect the whole year. *Id.* Mr. Effron stated the Company did even better in the 12 months ended March 31, 2011, where Ameren earned a return of 12.58% on common equity supporting its rate base (12.08% if the rate base is adjusted to include construction work in progress). *Id*. at 3.

AG/CUB witness David Effron proposes to reduce the Company's forecasted 2012 test year electric distribution O&M expenses by $25.476 million. AG/CUB Ex.1.0 at 18; Schedule DJE-2, at 1. Mr. Effron has made the following recommendations regarding Ameren's proposed 2012 test year electric distribution O&M expense:

- First, regarding substation maintenance, Mr. Effron proposed to eliminate the entire incremental O&M expense of $2.9 million for the 2012 test year, since there is no evidence of such increase actually taking place. AG/CUB 1.0 at 17.

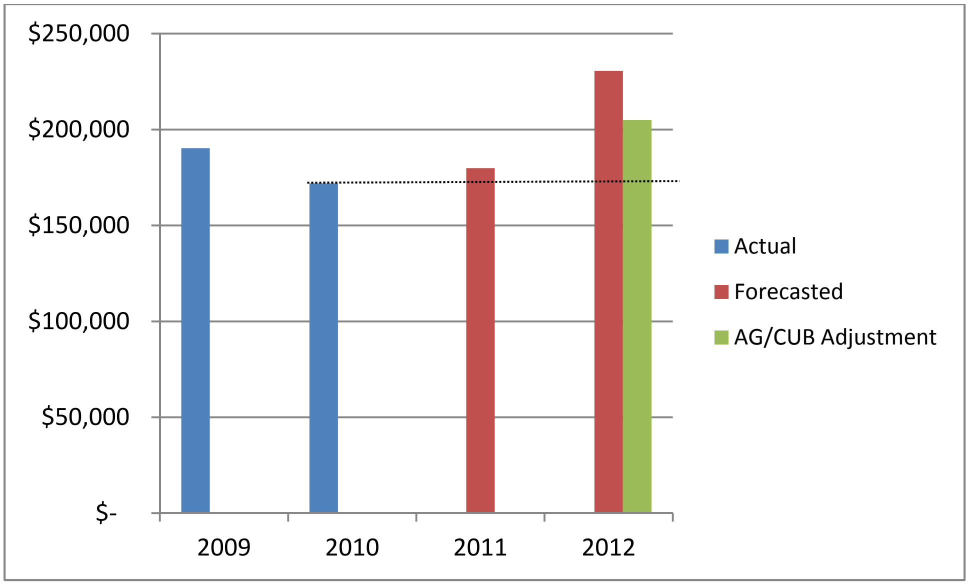
- Second, regarding circuit maintenance, Mr. Effron proposed a reduction of $4 million to the Company's $6.4 million incremental expense for its 2012 test year. *Id.* Mr. Effron testified that given the Company's present earnings, there is no reason that backlog should increase in 2011, as the Company has forecasted. In fact, he said, the Company should be working that backlog down. If the backlog at the end of 2010 is reduced over five years, the annual incremental expense would be $2.4 million - $4 million less than the $6.4 million of incremental expense reflected by the Company in the 2012 test year. *Id.*

- Third, concerning vegetation management, Mr. Effron recommended a decrease of $2.836 million to the expense amount forecasted by the Company because, unlike the other items, there is some evidence that this expense is actually increasing. AG/CUB Ex. 1.0 at 17. The expense increased by approximately $2 million from 2009 to 2010, and an increase in the same order of magnitude is forecasted from 2010 to 2011. *Id.* If the actual level of spending in 2010 is projected to increase by $2 million per year from 2010 to 2012, the projected expense in 2012 is $50.149 million, which is $2.836 million lower than the expense forecasted by the Company. *Id.* at 18.

- Lastly, relating to the Liberty audit, Mr. Effron proposed eliminating the entire incremental increase of $15.7 million, stating, "[t]here is no evidence that expenses are increasing to implement the recommendations of the Liberty audit." *Id.* Mr. Effron noted that Ameren has offered no plausible explanation of why the expenses are not increasing in 2011 to implement the recommendations. *Id.*

The forecasted expense after Mr. Effron's adjustments is $204.796 million, which represents an increase of $32.85 million over the actual distribution O&M expense incurred in 2010, *Id.* and an increase of $24.9 million over the distribution O&M expense of $179.896 million budgeted for 2011:

O&M Spending AIC (Actual and Forecasted) AG/CUB (Recommended) (000's)



AG/CUB Ex.4.0 at 10-11.

AG/CUB/AARP argued that the Commission should adopt Mr. Effron's adjustments and require the Company to maintain reliability.

IV. COST OF CAPITAL/RATE OF RETURN

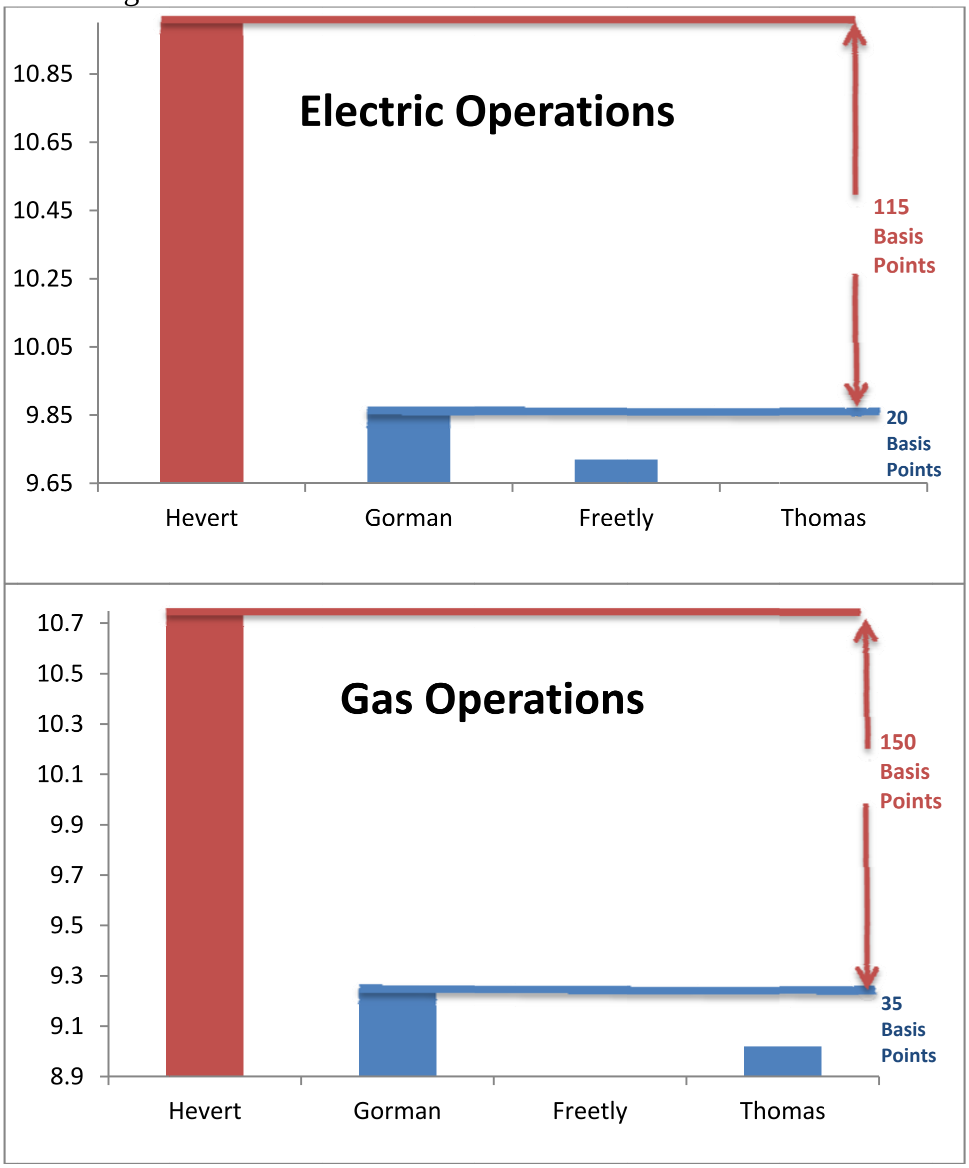
C. Contested Issues

4. Cost of Common Equity

a. Overview of Recommended Returns

AG/CUB/AARP stated Ameren witness Robert Hevert's estimation process incorporates unnecessary adjustments and inappropriate inputs – which serve to increase Ameren's proposed cost of equity estimate with the result Ameren's actual cost of equity is overstated. AG/CUB witness Mr. Christopher Thomas found that several aspects of Mr. Hevert's approach to estimating the utilities' cost of equity affect the accuracy of his results. Mr. Thomas stated that Ameren made several adjustments which serve mainly to increase the cost of capital, without any theoretical or factual support for the distortion of the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") models relied on by the Commission. These adjustments rendered Mr. Hevert's results unreliable in Mr. Thomas's opinion because they reflect a bias in the selection of input factors (like long-term sustainable growth rates or beta estimates) for both models. More importantly for the task at hand, these adjustments have the effect of increasing his cost of equity estimate. By contrast, AG/CUB/AARP argued that Mr. Thomas found objective evidence that returns on equity near or in excess of 10% are far higher than the true cost of equity capital for regulated monopoly utilities.

AG/CUB/AARP stated that the ICC should not be swayed by the rhetorical excesses presented by the Company's witnesses in their rebuttal testimony. AG/CUB/AARP noted that of the expert recommendations in this record, the one offered by the Companies' Robert Hevert (11.0% for AIC's electric operations and 10.75% for AIC's gas operations) was by far the highest -- some 115 and 150 basis points (BP) above the high end of Michael Gorman's recommended returns of 9.85% and 9.25% for AIC's electric and gas operations, respectively, the next highest estimate of record. AG/CUB Ex. 6.0, pp. 3-4. Staff's expert Janis Freetly recommends even lower returns for AIC, 9.72% for electric and 8.9% for gas operations. *Id.* As shown on the tables below, all three witnesses, all presenting different analyses, calculated results within a 20 to 35 basis point spread. Mr. Gorman and Ms. Freetly recommended ROEs at the top of the range of reasonable results that Mr. Thomas identified.



AG/CUB/AARP contended Mr. Thomas' analysis fits right within the range identified by Staff and IIEC, with returns of 9.65% and 9.02% for AIC's electric and gas operations, respectively. AG/CUB Ex. 6.0 pp. 3-4. Mr. Thomas based this assessment on his experience testifying before this Commission on the cost of equity for regulated utilities, and his specific conclusions that:

- Risk premiums of 6-7% are excessive in relation to the riskiness of the public utility business;

- Application of the DCF model requires growth rates that are reasonable for the low growth utility industry; and

- Application of the CAPM must be done in a manner consistent with the way the model is used by financial professionals outside the rate setting process.

To limit the scope of the cost of equity debate in this case, Mr. Thomas narrowed the range of issues addressed in his analysis. Instead of conducting a completely separate analysis, Mr. Thomas reviewed Mr. Hevert's analyses and data, and suggested corrections based on prior Commission orders, the governing legal precedents and the evidence presented by the Company. In particular, Mr. Thomas:

- Corrected Mr. Hevert's DCF analyses to set the long-term sustainable growth rate in a manner that is consistent with the Commission's Final Order in the Company's last rate case, Docket No. 09-0306 (consolidated).

- Corrected Mr. Hevert's DCF analysis to remove his inappropriate and unsupported assumption that dividend payout ratios will increase.

- Corrected the beta estimates used in the CAPM to reflect observations from more than one financial reporting source.

- Corrected the CAPM market risk premium to reflect a balance of historic risk premiums and projections presented by Mr. Hevert.

- Examined Mr. Hevert's additional proposed analyses which were previously rejected by this Commission, including the "Bond Yield Plus" risk premium analysis and proposed flotation cost adjustment.

AG/CUB/AARP noted the Commission has typically relied on averages of the DCF and CAPM, something that they argued is appropriate to do again here with the DCF results marking the upper boundary of reasonable returns. Using this framework, Mr. Thomas concluded that for the AIC Gas operations, reasonable results range from 7.41% to 9.02% with an average of 8.22%. For the AIC Electric operations, reasonable results range from 8.47% to 9.65% with an average of 9.06%.

Corrected Hevert Results					
DCF	**30-DAY AVG. PRICE**	**90-DAY AVG. PRICE**	**180 -DAY AVG. PRICE**	**Low**	**High**
Electric Group	9.51%	9.51%	9.65%	9.51%	9.65%
Gas Group	8.80%	8.87%	9.02%	8.80%	9.02%

CAPM	Historic	Sharpe Ratio Derived	Market DCF Derived	Low	High
Electric Group	8.47%	9.35%	10.16%	8.47%	10.16%
Gas Group	7.41%	8.07%	8.68%	7.41%	8.68%
Range of Reasonable ROEs (DCF is the Upper Boundary)					
	Low	**High**	**Average**		
Electric Group	8.47%	9.65%	**9.06%**		
Gas Group	7.41%	9.02%	**8.22%**		

AG/CUB/AARP argued that Ameren has not presented any objective basis for the ICC to adopt their recommendation. Instead, they said, Ameren warns that the Commission should be concerned about Wall Street's reaction if its determination, no matter how well-founded, doesn't align with the decisions of other state commissions. AIC Ex. 23.0, p. 7; AIC Ex. 36.0, pp. 6-15. AG/CUB/AARP averred Ameren would rather the Commission focus on investor expectations than deriving the Company's real cost of capital from objective market data:

> The main concern with the Commission adopting a draconian position [apparently the position of anyone other than AIC] in this proceeding is that it will communicate several very negative impressions to investors, including: (1) that the Commission is not concerned about the volatility and operational / financial difficulties created for AIC; (2) that the Commission has little regard for regulatory certainty and stability in Illinois; (3) that the Commission does not believe AIC deserves the opportunity to earn a fair return on capital.

AIC Ex. 36.0 at 6.

AG/CUB/AARP contended three different Ameren witnesses tried to focus the Commission away from the models it has always relied on and towards credit rating agency expectations. AIC Ex. 3.0E, pp. 45-49; AIC Ex. 36.0, p. 12; AIC Ex. 4.0E, pp. 18-22. AG/CUB/AARP argued such testimony overlooks two things: this Commission has already given its perspective on that approach: in ICC Docket 10-0138, the Commission questioned whether "appealing to investors" is "something that is within this Commission's purview or even within its statutory jurisdiction." Order, ICC Docket 10-0138, p. 49. This is even before the record evidence in this case that credit rating agencies have been widely criticized for their investment-grade ratings of subprime mortgage backed securities, which are seen as the major issue precipitating the economic crisis of 2008. AG/CUB/AARP pointed out even the United States Congress has directed the Securities and Exchange Commission to erase references to credit ratings from some regulations and to replace those metrics with more objective criteria.[2] Within Illinois, AG/CUB/AARP argue, there is no evidence that Ameren's credit rating have

[2] http://dealbook.nytimes.com/2011/07/26/s-e-c-removes-credit-ratings-from-regulations/ (accessed Aug. 11, 2011).

been negatively impacted when the Commission awarded the utility significantly less than the Company requested. In Ameren's last rate case, Docket No. 09-0306, the Commission granted an increase of $4.75 million, an amount significantly less than the utility's original $162 million request.[3] AG/CUB/AARP noted this action did not negatively impact the utilities' credit ratings. Tr. 1812, ICC Docket 10-0467 (Jan. 18, 2011).

AG/CUB/AARP responded to Ameren's arguments that other parties' estimates were unreasonable as compared to other jurisdictions by stating that the fact that this Commission does not compare favorably to some other state regulatory commissions in similar positions is merely demonstrative of this Commission's efforts on behalf of the consuming public to ensure that all costs that are passed on to the general rate-paying public are reasonable. *See* Order, ICC Docket 10-0138, p. 49.

AG/CUB/AARP argued he Commission should base its determination of a fair return on the relative riskiness of the regulated company. They contended the Commission should adopt a cost of equity that is appropriate based on the record evidence presented, and not on adjustments or approaches previously rejected by the Commission.

b. DCF Model Estimates

AG/CUB/AARP stated the DCF model assumes that investors who purchase stock are paying a price that reflects the present value of the cash flows they expect to receive from the stock in the future, and rests on two basic principles:

- First, the current market price of a financial asset, such as a share of common stock or equity, is equal to the present value of all future cash flows that investors expect to receive from the asset. Future cash flows to investors come from either future dividend payments or the sale of the stock. This means that the rate of return investors require for the risk they take in their investment is the discount rate at which the present value of all future cash flows from an asset are equivalent to the current market price of the asset.

- Second, the DCF model recognizes that a dollar received today is more valuable than a dollar received at some point in the future because an investor could realize a return in future periods by investing that same dollar today. If the investor receives that dollar in the future, she will have missed the opportunity to invest today. The investor's required rate of return, or a company's cost of capital, is the return on the deferred payment that would induce the investor to wait.

Mr. Hevert relies on a multi-stage DCF Model. AG/CUB/AARP stated that while the Commission has previously accepted multi-stage DCF models using analysts' growth forecasts in the short-term, transitioning to the long-term growth rate in GDP over time, the Commission

[3] http://www.pjstar.com/news/x457997575/Ameren-upset-by-reduced-rate-increase (accessed Aug. 11, 2011).

in this case must correct the long term growth rate that Mr. Hevert used in his analysis to conform with prior practice, and to be consistent with current implied growth rates in GDP. The Commission must also remove the inappropriate and unsupported adjustment that Mr. Hevert made to the Company's dividend payout ratio. Mr. Thomas used the same sample groups and analysis used by Mr. Hevert, which he corrected by using an appropriate long term growth rate of 4.825% and by removing the assumption that dividend payout ratios will revert to anything other than their current levels. These corrections result in DCF Results for the Electric Sample that range from 9.51% to 9.65%, and DCF Results for the Gas Sample that range from 8.80% to 9.02%. If these corrections are made, Mr. Hevert's DCF provides a reasonable range of return on equity for Ameren, as shown below:

Corrected Hevert DCF Results				
Electric Group Company	**Ticker**	**30-DAY AVG. PRICE**	**90-DAY AVG. PRICE**	**180 -DAY AVG. PRICE**
American Electric Power	AEP	9.97%	9.92%	10.09%
Cleco Corp.	CNL	8.31%	8.36%	8.55%
DPL, Inc.	DPL	9.87%	9.80%	9.84%
Great Plains Energy Inc.	GXP	10.31%	10.37%	10.52%
Hawaiian Electric	HE	10.11%	10.03%	9.98%
IDACORP, Inc.	IDA	8.25%	8.32%	8.41%
NextEra Energy, Inc.	NEE	9.47%	9.30%	9.39%
Pinnacle West Capital	PNW	9.50%	9.50%	9.72%
Portland General	POR	9.16%	9.32%	9.51%
Southern Co.	SO	10.03%	10.07%	10.31%
Westar Energy	WR	9.59%	9.67%	9.85%
MEAN:		***9.51%***	***9.51%***	***9.65%***
Gas Group Company	**Ticker**	**30-DAY AVG. PRICE**	**90-DAY AVG. PRICE**	**180 -DAY AVG. PRICE**
Atmos Energy	ATO	8.85%	9.01%	9.11%
Laclede Group	LG	9.80%	9.96%	10.05%
New Jersey Resources	NJR	8.03%	8.22%	8.40%
Northwest Nat. Gas	NWN	8.70%	8.66%	8.75%
Piedmont Natural Gas	PNY	9.18%	9.22%	9.41%
South Jersey Industries	SJI	7.86%	7.99%	8.17%
Southwest Gas	SWX	7.87%	7.99%	8.16%
WGL Holdings Inc.	WGL	10.10%	9.96%	10.11%
MEAN:		***8.80%***	***8.87%***	***9.02%***

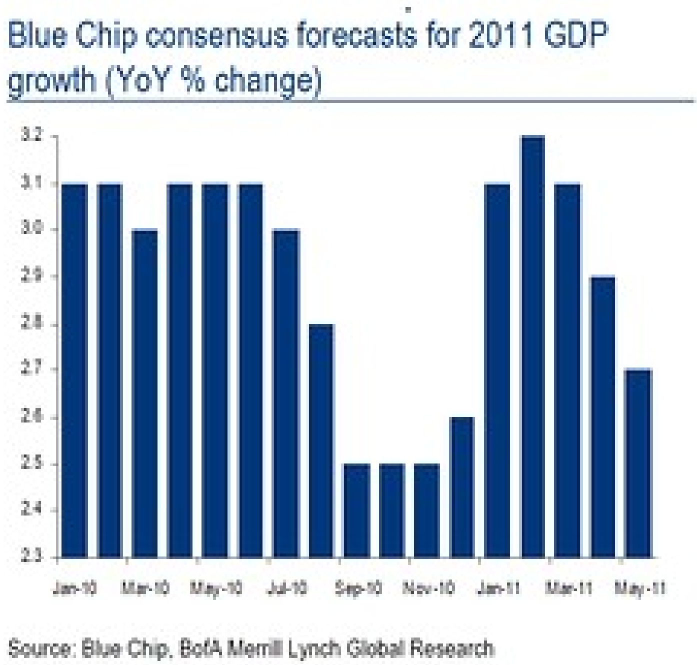
(i) Growth Rates

AG/CUB/AARP stated the growth component of a DCF represents the sustainable growth that investors expect in their investment due to increases in a company's earnings. The rate used has to be consistent with, and supported by, the economic conditions and dividend payout policies expected to occur. Since both Mr. Thomas and Mr. Hevert relied on a multi-stage DCF model in their analyses, the growth rate is assumed to change over time. Empirical reviews of analyst growth rates previously relied on by the Commission show a pattern of upwardly biased analyst growth rate forecasts in comparison to the actual requirements of investors reflected in stock prices. Mr. Thomas noted in his testimony that several empirical studies have documented optimistic bias in analysts' earnings forecasts, indicating that the DCF model must be adjusted downward. AG/CUB Ex. 3.0, p. 13; James Claus and Jacob Thomas, Equity Premia as Low as Three Percent?, 56 J. Finance 1662 (Oct. 2001). As a result, when looking beyond two years in the future, the "best forecast of earnings growth is the historical average growth rate."[4]

AG/CUB/AARP demonstrated Mr. Hevert's long-term sustainable growth rate is overstated. They showed that he relied on a long-term growth rate of 5.72% based on real chain weighted GDP growth of 3.28% and a 2.37% estimate of inflation based on Blue Chip Financial Forecasts and the Energy Information Administration's ("EIA") projected compound annual Consumer Price Index ("CPI") growth rate. AIC Ex. 3.0E, pp. 32-33; AIC Ex. 3.0G, pp. 33-34. Mr. Thomas analyzed the consensus forecast published in the Blue Chip Economic Indicators and found that it varied significantly over time. For example, on February 10th, 2011, the real GDP forecast was 3.2% in 2011 (up from the 2.5% forecast made in December 2010) and 3.3% in 2012.[5] Adding real GDP growth to inflation, as measured by the CPI, implies growth of 5.1% and 5.3% being forecasted in February, 2011 - a significant increase from the 4% being forecast in December 2010.

[4] Eugene F. Fama and Kenneth R. French, The Equity Premium, 57 J. Finance 651 (April 2002).

[5] http://tippie.uiowa.edu/economics/institute/forecasts.cfm (accessed June 23, 2011).



[6]

Growth returns should reflect unbiased growth estimates as indicated by market prices since utility companies cannot reasonably be expected to grow faster than the overall economy. AG/CUB Ex. 3.0, p. 13. This means, as Mr. Thomas concluded, the Commission should continue to use the long-term growth in GDP as the upper boundary of sustainable growth for utility companies.[7] Using the Commission's traditionally accepted methodologies, Mr. Thomas calculated a long-term sustainable growth rate of approximately 4.825%, well within the range of all other experts in this proceeding except Ameren's:

Witness	Long-term Sustainable Growth
Gorman	4.90%
Freetly	4.80%
Thomas	4.825%
Hevert	5.66%

c. CAPM Model Estimates

AG/CUB/AARP stated the key assumptions of the CAPM are (1) that in the market, investors are compensated only for non-diversifiable risk, quantifiable as a uniform Expected Market Risk Premium ("EMRP"), and (2) that beta is an accurate measure of the relative risk of an individual security when compared with the overall market. AG/CUB/AARP explained that

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[6] http://blogs.wsj.com/marketbeat/2011/05/31/34980/ (accessed June 23, 2011).

[7] In AIU's last rate case, the Commission relied on both Staff's estimate of the implied 20 year forward US Treasury rate in 10 years and the Illinois Industrial Energy Consumers' ("IIEC") use of Blue Chip economic growth forecasts.

for a utility, the investors' required rate of return is the risk-free rate, or the return investors expect from government securities (typically 30 years) plus the value of the "non-diversifiable risk", that is, the risk inherent in the marketplace. The inherent risk is represented by what is known as the "beta coefficient." The beta coefficient measures the amount of that non-diversifiable, or market, risk that investors are exposed to through their investment in a particular firm's shares.

Mr. Thomas pointed out that even though the CAPM is widely used and relatively simple, there are several well-known problems with both the theory and the practical application of the model. He noted that economists have studied the relationship between actual market behavior and the CAPM model for a number of years, in particular, how to evaluate the risk of a company as compared to that of the marketplace overall.[8] As a result, Mr. Thomas said, the CAPM should be used with its limitations understood: it is best employed as a check on the results of a DCF model.

(i) The Beta Coefficient

AG/CUB/AARP explained the beta coefficient ("B") represents the degree to which the price of a stock moves with the overall market, or the volatility of an individual stock compared to the volatility of the market. A beta of 1.0 represents a stock that moves in complete unison with the overall market – a stock that has exactly the same risk as the overall market. If the beta is less than 1.0, then the stock is less volatile than the overall market, indicating that returns are more stable and less risky. If the beta is greater than 1.0, then the stock is more volatile than the overall market, which indicates the stock is riskier than the market.

AG/CUB/AARP averred the Commission has traditionally accepted beta coefficients that are adjusted for mean reversion, or a supposed tendency to revert to the market mean (1.0), as valid CAPM inputs. This is the method commonly relied on by Value Line, one source used by Mr. Hevert in his analysis, but this method also means that the Value Line beta (and Mr. Hevert's CAPM analysis) is upwardly biased in comparison to a broader sample of the published estimates of that critical input. Mr. Hevert averages this Value Line beta with one from Bloomberg for the proxy group companies, and calculates short-term betas, resulting in a range from .74 to .829 for the electric sample and from .703 to .862 for the gas sample.

AG/CUB/AARP argued that comparing Mr. Hevert's results to the published betas clearly demonstrates his upwards bias, and highlights the problem with relying on few sources. Betas from different sources exhibit wide variability. To be complete, AG/CUB/AARP said, the Commission should consider a range of betas reported by the various reputable financial data reporting sites so the Commission can avoid unintended bias in various estimates used in a cost of equity determination. Mr. Thomas performed such an analysis:

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[8] One such study concluded that "the CAPM as a model has been seriously challenged in the academic literature," noting that business schools across the country may in fact be teaching a tool that "may not be of much value when it comes to estimating the cost of capital for a project." Ravi Jagannathan and Iwan Meier, Do We Need CAPM For Capital Budgeting?, Financial Management, 5, 7, 10 (Winter 2002).

Published Beta Estimates						
Electric Group		**Value Line**	**Bloomberg**	**Yahoo**	**Google**	**Zacks**
American Electric Power	AEP	0.700	0.772	0.54	0.58	0.58
Cleco Corp.	CNL	0.650	0.655	0.44	0.5	0.5
DPL, Inc.	DPL	0.600	0.742	0.6	0.6	0.6
Great Plains Energy Inc.	GXP	0.750	0.935	0.76	0.75	0.75
Hawaiian Electric	HE	0.700	0.977	0.6	0.55	0.55
IDACORP, Inc.	IDA	0.700	0.798	0.43	0.44	0.44
NextEra Energy, Inc.	NEE	0.750	0.766	0.57	0.6	0.6
Pinnacle West Capital	PNW	0.700	0.886	0.56	0.57	0.57
Portland General	POR	0.750	0.729	0.65	0.69	0.69
Southern Co.	SO	0.550	0.594	0.32	0.35	0.35
Westar Energy	WR	0.750	0.825	0.62	0.66	0.66
Average Beta		*0.691*	*0.789*	*0.554*	*0.572*	*0.572*
Combined Average			***0.635***			
Gas Group		**Value Line**	**Bloomberg**	**Yahoo**	**Google**	**Zacks**
Atmos Energy	ATO	0.65	0.80	0.51	0.53	0.53
Laclede Group	LG	0.60	0.69	na	0.08	0.08
New Jersey Resources	NJR	0.65	0.70	0.13	0.19	0.19
Northwest Nat. Gas	NWN	0.60	0.76	0.22	0.31	0.31
Piedmont Natural Gas	PNY	0.65	0.76	0.22	0.26	0.26
South Jersey Industries	SJI	0.65	0.69	0.22	0.3	0.3
Southwest Gas	SWX	0.75	0.94	0.73	0.74	0.75
WGL Holdings Inc.	WGL	0.65	0.70	0.17	0.25	0.25
Average Beta		*0.650*	*0.756*	*0.314*	*0.333*	*0.334*
Combined Average			**0.477**			

(ii) Expected Market Risk Premium ("EMRP")

AG/CUB/AARP explained the EMRP represents the premium, above the risk-free rate, that investors expect when they take on the risk of an investment in the market portfolio, or the universe of potential investment opportunities available to investors. Mr. Hevert uses EMRP values ranging from 8.09% to 9.36% in his analysis, which are estimates derived from academic studies of market performance or using EMRP estimates calculated for particular situations.

Mr. Thomas noted, the EMRP is "the premier question relating to the cost of capital, for theorists and practitioners alike."[9] The overwhelming conclusion from current research on the

[9] Seth Armitage, The Cost of Capital: Intermediate Theory, 87 (2005).

EMRP, Mr. Thomas said, is that the return expected by investors and appropriate for use in the CAPM is far lower than returns calculated from selective samples of historical information. Historical estimates found in most textbooks (and locked in the minds of many), which often report numbers near 8%, are too high for valuation purposes because they compare the market risk premium versus short-term bonds, use only 75 years of data, and are biased by the historical strength of the U.S. market.[10] Mr. Thomas further averred the general consensus is that the aggregate stock market exhibits negative autocorrelation, resulting in an arithmetic mean that is upwardly biased.[11] For example, Enrique Arzac presents data from Sigel (2002) that the nominal arithmetic risk premium was 5.9% from 1926-2002 while it was only .2% from 1982-2002.[12]

AG/CUB/AARP argued the Commission should consider an EMRP analysis that relies on a reasonable range of EMRPs, which the academic research indicates is within the range of 3.0 to 5.0%, with some research indicating that the actual EMRP is much lower. Mr. Thomas calculated two different CAPMs using the end points of a spectrum of EMRP estimates. At one end of the spectrum, AG/CUB/AARP maintained, is the historic EMRP of 6.70%, as reported in Mr. Hevert's work papers but not used in his testimony, and at the other end is the 9.36% estimate calculated by Mr. Hevert, which is clearly outside the estimates found in the academic research.

(iv) CAPM Results

AG/CUB/AARP stated the CAPM model is very sensitive to changes in the selected beta – that is, small changes in the beta coefficient produce large changes in the overall CAPM result. Mr. Thomas adjusted Mr. Hevert's CAPM analyses with a variety of reported betas and expanded the EMRP using inputs identified in Mr. Hevert's testimony. If the Commission believes that the CAPM is a valuable tool, AG/CUB/AARP maintained it should use these results to find that the cost of equity for Ameren should be at the lower end of any range of valid estimates.

Corrected Hevert CAPM Results

			Market Risk Premium			Return on Equity		
	Risk Free Rate	**Avg. Publish. Beta**	**Historic**	**Sharpe Ratio Derived**	**Market DCF Derived**	**Historic**	**Sharpe Ratio Derived**	**Market DCF Derived**
Electric	4.21%	0.635	6.70%	8.09%	9.36%	8.47%	9.35%	10.16%
Gas	4.21%	0.477	6.70%	8.09%	9.36%	7.41%	8.07%	8.68%

[10] Tim Koller et al., Valuation: Measuring and Managing the Value of Companies, 306 (2005).

[11] Tim Koller et al., Valuation: Measuring and Managing the Value of Companies, 303 (2005).

[12] Enrique Arzac, Valuation for Mergers, Buyouts, and Restructuring, 38-9 (2005).

Therefore AG/CUB/AARP argued the Commission should look to the lower end of any range of reasonable CAPM estimates this record defines when it determines the appropriate equity return for Ameren.

d. Proposed Adjustments to Cost of Equity

(i) Financial Risk Adjustment

AG/CUB/AARP noted the risk premium method that Mr. Hevert uses is another measure of capital costs based on the same principle of evaluating the relative riskiness of a security to the market. The analysis he presents, they said, is similar to other risk premium analyses presented to the Commission in past cases. AG/CUB/AARP argued the Commission previously rejected this type of analysis. In a recent rate case for Peoples Gas Light and Coke Co. and the North Shore Gas Company, ICC Docket Nos. 07-0241/07-0242 (Cons), the Commission found:

> The Commission understands that the CAPM is similar to a risk premium model. However, the risk premium model that the Utilities used in addition to their CAPM is unhelpful. The primary reason that the Commission has repeatedly rejected that type of risk premium analysis is the difficulty in establishing the "correct" risk premium. The risk premium for common equity relative to debt changes over time and, in the Commission's view, there is no objective mechanism for establishing that risk premium. While all cost of equity analyses require the application of judgment, this particular approach is primarily a matter of judgment and we are unwilling to rely on such a subjective analysis.
>
> The Utilities acknowledge that this Commission "has in the past rejected the [Risk Premium] model as a valid basis on which to set [ROE]." NS-PGL BOE at 29 (citing CILCO, Docket No. 02-0837, Order (Oct. 17, 2003)). Despite that, the Utilities contend that the risk premium should still be utilized, in conjunction with the Utilities' other models, to determine ROE in the instant dockets. The Utilities assert that the Commission ratified that viewpoint in Commonwealth Edison, Docket No. 05-0597, Order (June 26, 2006), when we relied, in part, on an intervenor witness whose ROE recommendation was derived from three models, including the risk premium. Staff responds that the witness did not give risk premium equal weight with his other models, that the Commission also used Staff's recommendations (without risk premium) to set ROE, and that the issue was not analyzed as it has been here. Staff RBOE at 23-24. The Commission again rejects the risk premium model. Insofar as it crept into decision-making in Docket No. 05-0597, that was an anomaly we will not repeat.

ICC Dockets 07-0241/07-0242 (cons.) Final Order of Feb. 5, 2008 at 93-94.

AG/CUB/AARP argued when Ameren and IIEC last presented this adjustment to the Commission it was rejected, with the Commission concluding those analyses were no reason to "deviate from past practice wherein it has relied on the DCF and CAPM models to estimate cost of common equity." Order, ICC Docket 09-0306, p. 216. Because of the similarities between

Mr. Hevert's analysis and the past analyses rejected by the Commission, AG/CUB/AARP maintained the Commission should reject the proposed "financial risk adjustment" once again.

(ii) Flotation Cost Adjustment

AG/CUB/AARP rejected Mr. Hevert's proposal to include adjustments to recover flotation costs is based upon estimates of other utilities' flotation costs, not in relation to any specific costs incurred by Ameren. This is an inappropriate and unnecessary adjustment, they said, and yet another one previously rejected by the Commission:

> [T]here is no flotation in the test year, and no specific flotation planned, nor do the Utilities address how the cost of stock issuance by their parent corporation is allocated to their regulated activities.
>
> As for the Companies' allegedly unrecovered prior flotation costs, the record does not support recovery now..... Even if this request would not violate the prohibition on retroactive ratemaking, there is no adequate evidence connecting old stock issuances to these Utilities or negating prior recovery.

ICC Dockets 07-0241/07-0242 (cons.) Final Order of Feb. 5, 2008 at 102.

AG/CUB/AARP argued the Commission should reach the same conclusion here, both because Ameren has not proven that the costs are actually unrecovered, and because it is fundamentally inappropriate to recover "costs" that the Company has not actually incurred.

B. Recommended Overall Rate of Return

AG/CUB/AARP proposed the following recommended overall rate of return:

Range of Reasonable ROEs (DCF is the Upper Boundary)			
	Low	**High**	**Average**
Electric Group	8.47%	9.65%	**9.06%**
Gas Group	7.41%	9.02%	**8.22%**

V. COST OF SERVICE
C. Contested Issues
2. Electric
a. Allocation of Public Utilities Revenue Act (PURA)/Electric Distribution Tax Expense

AG/CUB witness Mr. Scott Rubin recommended that the Commission implement the General Assembly's policy and impose the same tax rate on all kilowatt-hours sold by Ameren. To do otherwise, they said, would elevate a general regulatory policy or philosophy over a specific statute enacted by the legislature." AG/CUB Ex.5.0 at 2. Moreover, within one utility, AG/CUB/AARP argued there is no reason why any tax should be imposed on a discriminatory basis to a particular rate class, and.

Mr. Rubin recommended an alternative plan in the event the Commission does not adopt his proposed elimination of the tax subsidy across rate classes. Mr. Rubin stated that, at the present time, all DS-1 customers pay an improper and excessive IEDT rate per KWH. AG/CUB Ex.2.0 at 8. However, he found that the DS-1 rate is not the same in all rate zones. Specifically, he noted, customers are paying $0.00196 per KWH, $0.00136[13] per KWH, and $0.00197 per KWH in rate Zones I, II, and III respectively. *Id*. at 9. Ameren's three year plan proposes to put most customers in a rate zone on the same IEDT rate. AG/CUB/AARP averred this has the effect of greatly increasing the rate paid by Rate Zone II DS-1 customers in year 1 of the phase in, than reducing that rate in years 2 and 3 to eventually arrive at a rate that is less than the current rate. AG/CUB Ex. 2.0 at 9. AG/CUB/AARP finds this plan illogical as there is no reason to greatly increase a rate that is already above costs, only to reduce it in the following two years. *Id.*

Mr. Rubin recommended a phase-in plan that AG/CUB/AARP argued resolves the problem of raising rates to customers that already exceed the proper tax rate:

- In year 1 there is neither an increase nor decrease in the rate paid by DS-1 and DS-2 customers with the result being those classes would continue to subsidize the DS-4 class. The rates paid by DS-3 and DS-5 classes would increase to the average tax rate, which is a much smaller increase than Ameren recommended. The resulting rate to DS-4 customers in Year 1 would be significantly higher than the current rate, but still would be below the actual tax rate Ameren is required to pay.

- In Year 2, as shown on AG/CUB Ex.5.1, one-half of the subsidies from the DS-1 and DS-2 classes to the DS-4 Class are eliminated. In year 3 all customers would pay the same tax rate per KWH. AG/CUB Ex. 5.0 at 3-4[14]

AG/CUB/AARP disagreed with IIEC witness Mr. Stephens's testimony that the IEDT is somehow not strictly related to the number of kilowatt-hours sold. IIEC Ex. 1.0 at 19-36. AG/CUB/AARP said that while Mr. Stephens is generally correct about the history of the tax and

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[13] For example, in rate Zone II, DS-1 customers currently pay an IEDT charge of $0.00136. Ameren Ex. 13.3E at 1. Ameren proposes to increase that rate by 34% to $0.0018249 in year 1. *Id*. Then in years 2 and 3, Ameren would reduce the rate. *Id.* at 22. In year 2, though, the rate still would be higher than the existing rate in Zone II-even though that existing rate already exceeds the appropriate charge. AG/CUB Ex.at 9.

[14] Company witness Mr. Jones disagrees with Mr. Rubin's alternative proposal. Ameren Ex. 31.0 at 41. AG/CUB/AARP stated that this disagreement may be due to a misunderstanding of Mr. Rubin's proposal as he never said that the DS-1 rate should be capped at no more than the average tax rate during the phase-in. Instead Mr. Rubin said that the DS-1 rate should not increase above its current rate, which already exceeds the average tax rate, during the phase in period. AG/CUB Ex. 5.0 at 3.

how it was modified as part of the electricity industry in Illinois, this is irrelevant to the current imposition of the tax. AG/CUB Ex. 5.0 at 13. AG/CUB/AARP pointed out that in his direct testimony, Mr. Stephens has a table that shows that the tax is levied solely based on the number of KWH used by the utility's customers. IIEC Ex. 1.0 at 22. AG/CUB/AARP maintained that while the rates charged are a sliding scale that varies with consumption, the only basis for imposing the tax is KWH consumption. *Id.*

AG/CUB/AARP contended that using Mr. Stephen's table, the rates Ameren's largest customers, the DS-4 class, have been paying are substantially lower than even the lowest tax rate that would apply to Ameren. In fact, AG/CUB witness Scott Rubin calculated from Ameren's schedule E-5 that DS-4 customers are estimated to use 15,772,537,910 KWH in the test year. If those were Ameren's only customers, Ameren would have a tax liability of 21.7 million. AG/CUB Ex.5.0 at 13. This illustration would give DS-4 customers the exclusive benefit of low tax rates imposed on the first 4 billion KWH per year, as shown in Mr. Stephan's table. Yet DS-4 customers currently are paying less than $5 million in revenues for the tax, a shortfall of more than $16 million. *Id.* AG/CUB/AARP argued there is no question that the DS-4 class is being heavily subsidized -to the sum of at least $15million- by the DS-1 and DS-2 customer classes. *Id.* at 13-14.

AG/CUB/AARP maintained Ameren's proposal to phase in this tax rate allocation over three years should be rejected. Small customers have been subsidizing this tax for large users for several years and it is time to end that subsidy, they said. AG/CUB/AARP stated that customers whose rates already exceed the proper tax rate should not receive any rate increase as part of a phase-in plan.

VI. REVENUE ALLOCATION

C. Contested Issues

1. Electric

a. Allocation of Revenue Requirement Across Rate Zones

AG/CUB/AARP argued that Ameren's proposed DS-1 customer charge of $15.55 per month is not based on the customer-related cost of providing service. AG/CUB witness Scott Rubin describes, of Ameren's total customer-related cost of $230,514,000, $72,878,000 is the revenue requirement associated with metering which is recovered through the separate meter charge. AG/CUB Ex. 2.2, line 10. This leaves $157,636,000 in customer-related cost to be recovered through the customer charge. *Id.* Ameren's COSS also shows that it has an average of 1,231,674 customers. Ameren Ex. 13.2 at 1. Thus, dividing the customer-related cost by the number of customers, and then dividing by 12 months, leads to average customer-related cost of only $10.67 per customer per month. AG/CUB Ex.2.0 at 10-11.

AG/CUB/AARP argued that even $10.67 per month is too much to collect through a customer charge. They maintained that this amount includes 100% of Ameren's uncollectibles expense, or $9,296,000. AG/CUB Ex. 2.2. AG/CUB/AARP argued uncollectibles expense should be recovered in proportion to a customer's total bill, not in an equal amount per customer. AG/CUB Ex. 2.0 at 12. If uncollectibles were removed, Mr. Rubin found the proper, cost-based customer charge would be approximately $10.05 per month, an amount which would be at most increase by approximately 10 cents to recover a portion of uncollectibles expense. *Id.* A reasonable, cost-based customer charge, therefore, would be approximately $10.15 per month, but certainly no more than $10.67 per month. *Id.* AG/CUB/AARP stated that Ameren's proposal to dramatically raise its minimum charges would also move its rate design further out of line with the $8.00 minimum customer charge that its neighboring Missouri affiliate is allowed to charge residential electric customers. Report and Order, issued by the Missouri Public Service Commission on July 13, 2011, Re: Union Electric Company, d/b/a Ameren Missouri, pp. 120-121.

Therefore, AG/CUB/AARP recommended that there should be no increase in Ameren's existing customer charge of $12.28 per month. *Id.* AG/CUB/AARP maintained that charge already exceeds by a substantial amount the customer-related cost under Ameren's proposed revenue requirement, and there is no reason to further increase a charge that already greatly exceeds the cost of service. *Id.* Any increase allocable to the DS-1 class should be recovered solely through increases in the per-KWH distribution charges, following the basic approach outlined by Mr. Jones. Ameren Ex. 13.0E at 31-32. AG/CUB/AARP showed their recommended residential rates, under Ameren's proposed revenue requirement, as described as described in AG/CUB Ex. 2.3.[15]

AG/CUB/AARP recommended that the Commission should reject Ameren's proposal to increase the DS-1 customer charge. They argued that xisting rates already exceed Ameren's proposed customer related cost of service. AG/CUB/AARP contended that any rate recoverable from residential customers should be recovered through increase in distribution charges.

b. Allocation of Revenue Requirement Across Customer Classes

AG/CUB/AARP argued that while Ameren appropriately proposes to limit any class's base rate increase to no more than 1.5 times the system average percentage increase, Ameren did not properly apply this limitation in its filing. AG/CUB Ex. 2.0 at 4. Instead, AG/CUB/AARP said, the base rate increase to the DS-4 class should be approximately 11.0 percent and not 4.9% as proposed by Ameren. Ameren Ex. 13.0 E at 8; AG/CUB Ex.2.0 at 3-4. For example, Mr. Rubin found that with regard to the DS-4 class, Ameren's cost-of-service studies ("COSS") shows that the cost to serve the DS-4 class, excluding the IEDT is $65,246,000. AG/CUB Ex. 2.0 at 5. Present base rates for the DS-4 class recover $54,512,000. To bring the class's base rates up to the cost of service would require an increase of 20.0%, which exceeds the 1.5 times average limit, which equates to an increase of 11.0%. *Id.* Mr. Rubin argued the DS-4 class should see increases in base rates of approximately 11%, which would bring revenues for the

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[15] AG/CUB witness Scott Rubin performed calculations in AG/CUB Ex. 2.3, using the Company's proposed revenue requirements, so that his recommendations can be compared directly with Ameren's recommendations. This does not constitute an endorsement Mr. Rubin or the AG or CUB of Ameren's proposed revenue requirement. That exhibit also shows a proof of revenues demonstrating that the rates would recover the revenue requirement properly allocable to the DS-1 class, as shown on AG/CUB Ex. 2.1.

class to approximately $60,481,000, still almost $5 million below cost. *Id.* Ameren has proposed to increase DS-4's base rate revenues to only $57,169,000; an increase of just 4.9%, which is less than the system average increase, and more than $8 million below cost. AG/CUB Ex.2.0 at 5; AG/CUB Ex. 2.1.

AG/CUB supported the use of a constraint that limits the increase to any customer class to no more than 1.5 times the system average because it is a reasonable way to move toward rates that recover each class's cost of service while remaining sensitive to the impacts that dramatic rate changes can have on customers. AG/CUB Ex.2.0 at 4-5. The discrepancy to Ameren's application of the limit of 1.5 times the system average increase appears to come from their using this limit on the combined effect of base rates and the IEDT. Mr. Rubin stated the IEDT is a completely separate issue and should have no effect on the base rate revenues that are allocated to each class. AG/CUB Ex. 2.0 at 5. Ameren's COSS also excluded the IEDT total revenues from the COSS are $875,981,00, which matches Ameren's proposed base rate revenues from sales to the DS-1 through DS-5 classes AG/CUB Ex.2.0 at 5 and 6; AG/CUB Ex.2.2.

AG/CUB/AARP argued that Ameren also erred in allocating revenue responsibility to the other service classes. Ameren's COSS shows that the existing revenues received from DS-3 and DS-5 are in excess of Ameren's proposed cost of serving those classes. AG/CUB Ex. 2.0 at 6. AG/CUB/AARP stated that Ameren's proposal reduces the rates for those classes while at the same time increasing DS-1 and DS-2 rates to more than the cost to serve those classes, and reduces DS-3 rates to below the cost of serving that class., as shown on AG/CUB Ex. 2.1; AG/CUB Ex.2.0 at 6. Thus, AG/CUB/AARP stated DS-1 and DS-2 are being asked to subsidize the rate reductions for DS-3 and DS-5. *Id.*

AG/CUB/AARP recommended the Commission direct Ameren to calculate the base rate increase for DS-4 customers to be limited to 1.5 times the system average increase. Additionally, they argued the revenues for the DS-1 and DS-2 classes should be brought to the cost of serving each class and still provide rate reductions for the DS-3 and DS-5 classes.

VII. Rate Design

C. Contested Issues

1. Electric

c. DS-1 Customer Charge

Please refer to Section VI, Revenue Allocation, subsection C(1).

2. Gas

Mr. Rubin stated demand-related costs account for approximately 45% of Ameren's total cost of serving residential customers ($107 million out of $235 million). AG/CUB Ex. 2.0 at 21. AG/CUB/AARP argued Ameren has proposed rates that do not recover these residential demand costs from the customers who cause them to be incurred (those customers who use more gas). Instead, Ameren has proposed rates that would require low-use residential customers to provide substantial subsidies to high-use residential customers – charging higher-use customers less than one-half the demand cost that they impose on the system. *Id.*

AG/CUB/AARP argued that over the past few rate Ameren rate cases, the Company has had a steady, non-cost-justified increase in the customer charge portion of the monthly bill based on Ameren's skewed definition of "fixed" costs and the supposition that its delivery service costs are not affected by gas consumption. AG/CUB Ex. 2.0 at 20. Mr. Rubin detailed that the Company's own COSS shows that there are substantial demand-related costs that are incurred because of the amount of gas consumed by customers. *Id.*

AG/CUB/AARP maintained that Ameren's proposed per-therm distribution rates that are significantly less than the per-therm demand costs incurred to serve residential customers. Specifically, they said, the demand cost is approximately 19 cents per therm, but Ameren is proposing distribution charges of between 7 and 9 cents per therm – or well less than one-half of the actual demand-related cost of service. AG/CUB Ex. 2.0 at 20. In effect, the Company proposes to recover most of its demand-related costs on a per-customer basis – something that AG/CUB/AARP argued is inconsistent with the setting of cost-based rates for utility service. AG/CUB Ex. 2.0 at 21. AG/CUB/AARP averred Ameren has tremendous diversity within its residential classes – ranging from customers who do not use natural gas for space heating (and thus place very low demands on the system) to those who use hundreds, or even thousands, of therms per month during the winter for space heating. *Id.* This diversity means that these customers in fact place different demands – and impose different costs – on the Company's natural gas distribution system.

AG/CUB/AARP further argued Ameren's proposal is contrary to established notions of fairness and non-discrimination in rate-setting. They maintained utility rates should be "just and reasonable" and should not improperly discriminate among customers; that is, that people should not be asked to pay different rates for the same service. AG/CUB Ex. 2.0 at 21. In order to determine whether rates are just, reasonable, and not improperly discriminatory, AG/CUB/AARP averred the Commission must rely on information about the cost to serve different types of customers. Differences in rates among different types of customers should be related to differences in the cost of providing service so that regulators can have confidence that the rates are not improperly discriminatory. *Id.*

AG/CUB/AARP argued Ameren's proposed rates are highly discriminatory against low-use residential customers because they would require those customers to pay substantially more than the cost that is incurred to serve them. AG/CUB Ex. 2.0 at 22. For example, they said, the evidence shows that heating customers place dramatically larger demands on the system than do non-heating customers, and larger heating customers place greater demands on the system than smaller heating customers. AG/CUB Ex. 2.0 at 23. AG/CUB/AARP maintained it is grossly unreasonable to recover most demand-related costs on a per-customer basis.

Instead, AG/CUB/AARP recommended a transition to cost-based residential rates by recommending any rate increase allocable to residential customers be recovered solely from the per-therm distribution charge. AG/CUB Ex. 2.0 at 23. AG/CUB Ex. 2.4 shows the residential rates AG/CUB recommends under Ameren's proposed revenue requirement, and for example, that there would not be any increase in the GDS-1 customer charges in this case.

AG/CUB/AARP urged the Commission to seriously consider the fairness and reasonableness of how a disproportionate increase in the minimum charge in this case would impact low usage customers. Additionally, they said, Ameren's proposed rate design would send a confusing message to low usage consumers who could experience a significant increase in the overall rate that they pay, even if they are conserving in an aggressive way.

(i) Ameren inappropriately Applies "Fixed" Costs

AG/CUB/AARP notes that the Company apparently refers to "fixed" costs to mean costs that do not vary in the short-term as the throughput of gas changes, a definition that would render essentially all of the Company's costs as "fixed." AG/CUB Ex. 2.0 at 13. In fact, said AG/CUB/AARP, a standard economic definition of a "fixed" cost is one "whose quantity cannot be changed during the period under consideration,"[16] and the relevant period – short or long – for determining whether a utility cost is fixed or variable should be the long run. *Id.*

AG/CUB/AARP explained that Ameren's COSS shows its total proposed revenue requirement is $343,728,700. Ameren Ex. 13.2G, line 31. Ameren then divides this amount by the average number of customers and then by the 12 monthly bills per customer to determine that the allegedly fixed cost per customer is $34.89 on a total-company basis ($26.07 for residential customers). *Id.*, line 37. On the following line in its study, it then calculates what it calls "Total fixed 80% recovery," that is, the recovery of 80% of so-called "fixed" costs through the customer charge, which is $27.91 on a total-company basis and $20.85 for residential (GDS-1) customers. In other words, said AG/CUB/AARP, Ameren has treated all of its costs as being fixed. The Company's own data show that it incurs substantial demand-related costs related costs, which are are apparent in the sizing of distribution mains, storage facilities, and other types of distribution facilities and related operations and maintenance costs. AG/CUB/AARP stated the Company incurs millions of dollars in costs each year that are directly related to demand. AG/CUB/AARP maintained these costs should be recovered from customers in proportion to the amount of natural gas that they use, particularly when that gas is used during the winter.

AG/CUB/AARP demonstrated Ameren's focus on the short run to determine whether costs are fixed or variable is not appropriate for setting utility rates or evaluating a utility's cost of service. They maintained there is no support among reputable public utility economists or among public utility commissions for setting utility rates based on short-run marginal costs., explaining that economists considered and rejected Ameren's type of pricing proposal more than 50 years ago. AG/CUB/AARP maintained that such a method of utility pricing is simply a method of transferring wealth (or consumer surplus) from one group of customers to another. AG/CUB Ex. 2.0 at 18. AG/CUB/AARP averred there is no discernible increase in overall societal welfare and no improvement in the efficiency of use of the utility's service, and such a pricing proposal could lead consumers and utilities to make decisions that are not in their long-run best interests. *Id.*

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[16] Edwin Mansfield, *Microeconomics: Theory and Application* (New York, 2nd Ed., 1975), p. 121.

AG/CUB/AARP found the essential flaw in pricing utility distribution service based on short-run marginal cost is that the industry exhibits economies of scale (as one would expect from a natural monopoly) – which in turn means that the marginal cost declines as more of the product is supplied (at least up to some point). AG/CUB Ex. 2.0 at 15. This is apparent in nearly every component of the distribution system: for example, it does not cost twice as much to install a two-inch pipe as it does to install a one-inch pipe. *Id.* AG/CUB/AARP stated that in an industry that exhibits economies of scale (that is, declining marginal costs for at least a portion of the supply curve), setting prices equal to short-run marginal cost results in the firm being unable to recover its costs. *Id.* Gas distribution service by its very nature is a long-term service, and one that provides an essential public. Therefore, AG/CUB/AARP maintained it is unreasonable and improper to treat most of Ameren's costs as "fixed" and to recover them on a per-customer basis when Ameren's own COSS shows that more than 45% of its cost of serving residential customers is related to those customers' demand for natural gas. AG/CUB Ex. 2.0 at 16, 19.

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Respectfully submitted,

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