Crossroads

David Woodsmall
Midwest Energy Consumers' Group

Opening Statement

- 1) Give background on Crossroads; where it is located relative to MPS service area; and how it was acquired.
- 2) Explain MPS' historic need for capacity and Aquila's refusal to build regulated generation capacity.
- 3) Discuss what the Commission is being asked to decide in this case; the legal standards and cases involved.
- 4) Reference the Commission's decision on the last case where the established a two pronged approach: a) proxy sale valuation including recognition of <u>all</u> deferred taxes and b) exclusion of transmission costs.
- 5) <u>Valuation</u> including Great Plains Energy's SEC filing regarding Crossroads valuation; the proxy sale approach adopted by the Commission and GMO's inflated value.

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- 6) <u>Deferred taxes</u> including Commission's inclusion of all deferred taxes, why the Commission's approach is logical, and why GMO's approach is contrary to that decision.
- 7) <u>Transmission Expense</u> including the challenges of Crossroads transmission, the reason transmission costs are so high and why the Commission eliminated all transmission costs.

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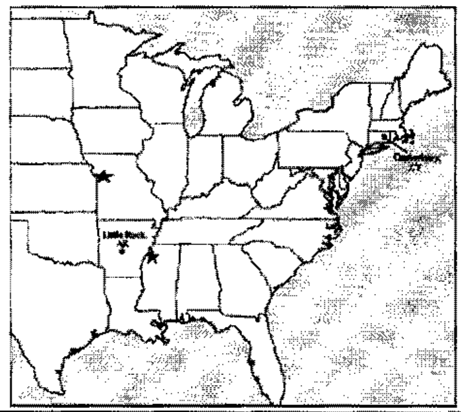
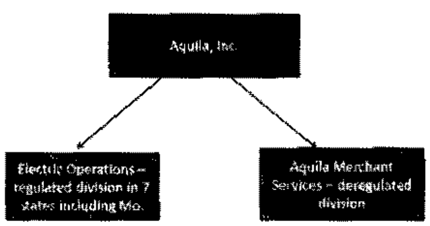
Date 10-29-12 Reporter KF
File No. ER-2012-0174
ER-2012-0175

Background

- Crossroads consists of 4 75 MW natural gas-fired combustion turbines.
- Combined capacity of 300 MWs.
- Constructed in 2002 by Aquila Merchant – a deregulated subsidiary of Aquila.
- Located in Clarksdale, Mississippi – 525 miles from MPS service area and approximately 200 miles from the nearest SPP service area.



Background – Aquila Structure



Background – Aquila Merchant

- Aquila Merchant purchased 18 Model 7 EA combustion turbines:
  - 6 constructed in 2003 at Goose Creek (Platt County, Illinois): 510 MWs;
  - 4 constructed in 2003 at Raccoon Creek (Clay County, Illinois): 340 MWs;
  - 4 constructed in 2002 at Crossroads (Clarksdale, Mississippi): 300 MWs; and
  - 4 never constructed.
- Merchant Power Market collapsed in 2002 after the Enron bankruptcy and Aquila Merchant began to close operations. Started marketing these generating units to third parties.

Background – Great Plains

- On February 6, 2007, Aquila announced the sale of the company. Acquisition closed in July 2008.
- At this point in time, Aquila only consisted of:
  - Colorado, Iowa, Kansas and Nebraska gas and electric regulated operations: sold to Black Hills Corporation – a South Dakota utility
  - Missouri electric operations – acquired by Great Plains
  - Crossroads Energy Center – acquired by Great Plains.
- By this time, Aquila Merchant had sold all other deregulated assets. Despite repeated efforts, Aquila Merchant could not set Crossroads.

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MPS' Historic Need for Capacity

- Beginning in the late 90s, Aquila had "a corporate policy not to build generation assets for its regulated utility operations." Therefore, all construction was done by deregulated subsidiary with desire to sell power to regulated operations.
- Constructed Aries (Dogwood) in 2002 as deregulated plant and had purchased power agreement with MPS. Aries PPA was an affiliate transaction and Staff made adjustments to reduce to market price.
- Aries PPA expired in May 2005. Prior to that, GMO conducted an integrated resource plan which showed that the least cost plan was the construction of 5 combustion turbines with a capacity of 525 MWs. Still GMO did not build to its plan!

MPS Historic Need for Capacity

- Instead of building 5 combustion turbines (525 MWs), GMO only built 3 combustion turbines (315 MWs). So, GMO still needed capacity!
- "The tragedy of Aquila's decision not to add the necessary capacity to replace the Aries power agreement is that Aquila could have added significant capacity at significantly discounted turbine prices. Aquila simply missed a tremendous opportunity to add low cost generation to its fleet."

MPS Historic Need for Capacity

- Chairman Davis dissent:
- "There are ample grounds for questioning the prudence of Aquila's management, past and present. These include: management decision to pursue unregulated business ventures that eventually caused Aquila to hemorrhage money, lose its investment grade status and some would say neglect its customers for years." "There is no question Aquila's decisions have been detrimental to its ratepayers." "These issues will continue to haunt Aquila management for years to come regardless of who's in charge."
  - *Concurring Opinion of Chairman Davis*, Case No. ER-2007-0004, pages 11 and 12 (issued July 9, 2007).

Perfect Marriage?? Not Quite

- So, you have two situations colliding:
  - First, Great Plains had a deregulated facility that it couldn't sell with capacity of 300 MWs.
  - Second, MPS had a 10 year need for capacity.
- Since it couldn't sell Crossroads to anyone else, Great Plains moved this deregulated unit to MPS's regulated books in August 2008.
- Two problems
  - First, GMO did not want to reflect the true market value of Crossroads. GMO repeatedly had to write-off value for other deregulated CTs that it sold. Nevertheless, it wants book value for Crossroads.
  - Second, there were significant problems and expense associated with transmitting energy from Crossroads (Mississippi) to customers (Missouri).

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Scope of Crossroads Issues – Legal Standards

- <u>Issue III.1</u>: What should be the value of Crossroads included in rate base?
- Legal Standard: "The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. . . . We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation . . . must be the ***<u>fair value of the property being used by it for the convenience of the public</u>***. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be extracted from it than the services rendered by it are reasonably worth."
  - *Smyth v. Ames*, 169 U.S. 466, 546-547 (1898) (emphasis added).

Scope of Crossroads Issues – Statutes and Rules

- Section 393.230.1: "The commission shall have the power to ascertain the value of the property of every electrical corporation in this state and every fact which in its judgment may or does have any bearing on such value."
- Affiliate Transaction Rule (4 CSR 240-20.015): "This rule is intended to prevent regulated utilities from subsidizing their non-regulated operations. . . . The rule and its effective enforcement will provide the public the assurance that their rates are not adversely impacted by the utilities' non-regulated activities."
  - When a utility purchases goods from a non-regulated subsidiary, compensation is limited to the lesser of: (1) fair market price or (2) fully distributed cost.

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Prior Commission Decision – Value to Include in Rate Base Exact Same Issue as Last Case!

2010 Case

- If the decision to add Crossroads was prudent, what is the appropriate valuation of Crossroads?
- If Crossroads is included in rate base, should the accumulated deferred taxes associated with Crossroads be used as an offset to rate base?

2012 Case

- What should be the value of Crossroads included in rate base?
- What amount of accumulated deferred taxes associated with Crossroads should offset the value of Crossroads in rate base?

Prior Commission Decision – Value to Include in Rate Base

- After considering the depressed market for combustion turbines (see the sale of Raccoon Creek / Goose Creek), the Commission found:
- "It is incomprehensible that GPE would pay book value for generating facilities in Mississippi to serve retail customers in and about Kansas City, Missouri. And, it is a virtual certainty that GPE management was able to negotiate a price for Aquila that considered the distressed nature of Crossroads as a merchant plant which Aquila Merchant was unable to sell despite trying for several years. Further, it is equally likely that GPE was in as good a position to negotiate a price for Crossroads as AmerenUE was when it negotiated the purchases of Raccoon Creek and Goose Creek, both located in Illinois, from Aquila Merchant in 2006."

Prior Commission Decision – Value to Include in Rate Base

- The Goose Creek / Raccoon Creek turbines were exactly the same as the Crossroads combustion turbines.
- Crossroads, built in 2002, acquired by Great Plains in 2007.
- Raccoon Creek / Goose Creek, built in 2003, acquired by AmerenUE (third party transaction) in 2006.
- Perfect proxy transaction, excluding location, to determine fair market value of Crossroads.
  - Raccoon Creek: 340,000 kW sold for $71 million
  - Goose Creek: 510,000 kW sold for $104 million
    - TOTAL: 850,000 kW for $175 million ($205.88 / kW)
- Therefore, Crossroads (300,000 kW) ($205.88 / kW) =
  - **$61,764,000 - fair market value**

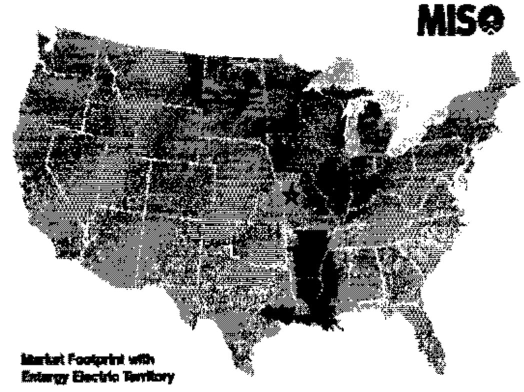
Prior Commission Decision – Value to Include in Rate Base

- The $61.8 million fair market value must be reduced by accumulated deferred taxes. "The accumulated deferred taxes associated with Crossroads should be applied as an offset to MPS's rate base."
- On rehearing, GMO asked the Commission to adjust deferred taxes. In its May 27, 2011 Order, the Commission stated that deferred taxes was part of its valuation and not a mathematical calculation from its valuation.
  - "The Commission set the value of Crossroads considering all relevant factors presented [including deferred taxes] and found that GPE had conducted due diligence in the purchase of Aquila, Inc. Therefore, the Commission need not clarify this point in the Report and Order."

Prior Commission Decision – Transmission Costs

- Crossroads is located in Clarksdale, Mississippi surrounded by Entergy service area. Entergy has applied for membership in Midwest Independent System Operator (MISO)
- MPS service area is located in Missouri and located in Southwest Power Pool (SPP).
- Given that the service area is in a different Regional Transmission Operator (RTO) service area, there are significant transmission costs associated with transmitting energy from Mississippi to Missouri.
- Given the fact that Entergy is joining MISO, there is considerable uncertainty associated with GMO's transmission agreement with Entergy. MISO transmission costs are twice as high as Entergy transmission costs.

MISO



Prior Commission Decision – Transmission Costs

- "Paying the additional transmission costs required to bring energy all the way from Crossroads and including Crossroads at net book value with no disallowances, is not just and reasonable."
- "It is not just and reasonable to require ratepayers to pay for the added transmission costs of electricity generated so far away in a transmission constricted location. Thus, the Commission will exclude the excessive transmission costs from recovery in rates."
- "In addition to the valuation, the Commission concludes that but for the location of Crossroads, customers would not have to pay the excessive cost of transmission. Therefore, transmission costs from the Crossroads facility . . . shall be disallowed from expenses in rates and therefore also not recoverable through GMO's fuel adjustment clause (FAC)."

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Proper Valuation

- <u>GMO</u>: Just like last case, GMO proposes net book value ($82.7 million). GMO position is faulty because it fails: (1) to recognize that Crossroads is in a different RTO; (2) to recognize, at the time of transfer, the market for combustion turbines was depressed; (3) to recognize that GMO could not find any other purchasers; and (4) to comply with the directive in the affiliate transaction rule to price at the lesser of cost of fair market value.
- <u>Staff</u>: consistent with Commission order from last case ($61.7 million) – value Crossroads using the value of the proxy sales from Aquila Merchant to AmerenUE of Raccoon Creek / Goose Creek.

Proper Valuation

- <u>MECG</u>: In the event that the Commission reconsiders any component of its prior valuation, MECG maintains that the Commission should reduce the value of Crossroads to $51.6 million. In several SEC filings made between May and August, 2007, Great Plains indicated that the fair market value for Crossroads is $51.6 million.
- "The adjustment was determined based on Great Plains Energy's estimates of fair market value based on estimates of proceeds from sale of units to an unrelated party of similar capacity in the current market place. The preliminary internal analysis indicates a fair value estimate of Aquila's non-regulated Crossroads power generating facility of approximately $51.6 million."
  - Great Plains Energy Joint Proxy Statement, filed May 8, 2007, at page 175

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Deferred Taxes

- Regardless of the valuation used, the Commission should continue to recognize the full balance of accumulated deferred taxes.
- First, Aquila Merchant, like the rest of the deregulated electric industry following the collapse of Enron, operated at a loss. Except for their affiliation to the profitable regulated operations, Aquila would never have been allowed to take the accelerated depreciation that created these deferred taxes.
- Second, Great Plains undertook due diligence and would undoubtedly have been aware of the accumulated deferred taxes when it valued Crossroads.
- As the Commission said, accumulated deferred taxes is part of the "relevant factors" previously considered by the Commission.

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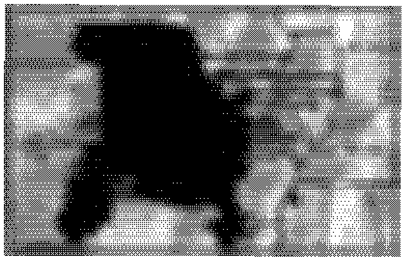
Transmission Costs

- GMO incurs additional expenses because it must transmit energy across Entergy into the Southwest Power Pool. If Crossroads was located in SPP, they would not incur the Entergy transmission costs.

Southwest Power Pool (SPP)



Transmission Costs

- The Commission's proxy sale involved the sale of combustion turbines that were in the same RTO as the UE service area.

	CT Location	Service Area	Transmission Costs	Fair Market Value
Proxy Sale	[illegible]	[illegible]	[illegible]	[illegible]
Crossroads Acquisition	Inside Entergy	SPP	Different RTO – Therefore costs to transmit across Entergy to SPP	[illegible] / kW

- Therefore, in order to make an apples to apples comparison, the Commission should eliminate all transmission costs.
- If the Commission allows any transmission costs, the fair market value for Crossroads would have to be reduced.

Transmission Costs

- Current transmission costs are likely to escalate quickly. Currently, Entergy is a stand-alone transmission operator. Current Entergy transmission charge is $1.55 / kW – month.
- Entergy as applied for membership to MISO. Therefore, any transmission will likely be at MISO rates. The current MISO transmission charge is $3.10 / kW – month.
- When Entergy joins MISO, GMO's transmission costs could immediately double.
- It is becoming rapidly apparent why Aquila could not sell Crossroads. The cost of transmitting energy out of Clarksdale is cost prohibitive. Crossroads needs to be moved and GMO will never move it so long as the Commission allows any recovery of transmission costs.

Conclusion

- The Commission must consider these issues under the doctrine provided in *Smyth v. Ames*. That requires the Commission to give a return on the "***fair value of the property being used by it for the convenience of the public***."
- The affiliate transaction rule also provides that compensation for goods from an affiliate must be at lesser of cost or fair market value.
- In this case, fair market value was admitted to be $51.6 million less than a year before it was transferred to regulated operations.
- This fair value also mandates inclusion of all deferred taxes.
- Finally, fair market value assumes that Crossroads is in the GMO service area. In order to be consistent, the Commission should continue to disallow all transmission costs associated with Crossroads.