

Exhibit No.
Issue: Energy Center 3 & 4
Construction Costs
Witness: Blake A. Mertens
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District
Case No.: ER-2006-0315

**Before the Public Service Commission
of the State of Missouri**

Rebuttal Testimony

Of

Blake A. Mertens

July 2006

**** Denotes Highly Confidential****

REBUTTAL TESTIMONY
OF
BLAKE A. MERTENS
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO ER-2006-0315.

1 **INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. Blake A. Mertens. My business address is 602 Joplin St., Joplin, Missouri.

4 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

5 A. The Empire District Electric Company (“Empire” or “Company”), I am
6 Construction Project Manager.

7 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

8 A. I graduated from Kansas State University in 2000 with a Bachelor of Science
9 Degree in Chemical Engineering with a minor in Business. I am currently pursuing
10 a Masters degree in Business Administration at Missouri State University.

11 **Q. PLEASE GIVE AN OVERVIEW OF YOUR PROFESSIONAL**
12 **EXPERIENCE.**

13 A. I was employed by Black & Veatch Corp. immediately following my graduation
14 from Kansas State University in May of 2000. From June of 2000 through
15 November of 2001, I held roles as a technical analyst and energy consultant for the
16 Strategic Planning Group of Black & Veatch’s Power Sector Advisory Services in
17 the Energy Services Division. Duties included assisting in power plant siting
18 studies, economic analysis of potential power plants using production cost
19 modeling, independent engineering evaluations of plant assets, and market analysis
20 of the California energy crisis of 2000 – 2001. I went to work for Empire in
21 November of 2001 as a Staff Engineer in Energy Supply where my duties included
22 tracking of plant capital and operating & maintenance (“O&M”) expenses,
23 involvement in energy supply regulatory issues, evaluation of new generating
24 resource options, assisting in the construction of new plant, and assisting in the
25 modeling and tracking of fuel and purchased power costs. In 2003, my title was

1 changed to Planning Engineer with similar duties but more responsibilities in the
2 area of generation planning. In the fall of 2004 I took my current position as
3 Combustion Turbine Construction Project Manager. In this position I am
4 responsible for the construction of a 155 MW combustion turbine at Empire's
5 Riverton Power Plant to be known as Riverton Unit 12.

6 **EXECUTIVE SUMMARY**

7 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

8 A. In this testimony, I will rebut the testimony of Staff witnesses David W. Elliott and
9 Paul R. Harrison concerning the proposed disallowance of a portion of Energy
10 Center Units 3 and 4 construction costs.

11 Staff proposes a disallowance of \$3,155,356 of construction costs related to Patch
12 Construction, LLC ("Patch"), a contractor hired to perform work on the project. A
13 contractual requirement for Patch was to provide a performance bond within 21
14 business days of contract signing but Patch was unable to do so. In an attempt to
15 complete the project in a cost and time effective manner, Empire entered into an
16 Amendment to the contract, which pledged the assets of Patch, and the personal
17 assets of Mr. and Mrs. Chester J. Patch as collateral to finish the scope of the
18 project at their contractual cost. Ultimately, Patch was unable to meet the
19 requirements. Patch was therefore terminated as a contractor for the project.
20 Empire personnel managed the final phases of construction and start-up for the
21 project. Because of this disruption, the cost to complete the activities associated
22 with Patch's contract was higher than the contract amount. Staff's opinion is that
23 the Company acted imprudently by exposing Empire to an unnecessary level of
24 financial risk. Empire disagrees with this assessment and believes rather that
25 Empire's management team did everything within its ability to effectively manage
26 the overall construction project costs when all of the circumstances are considered.
27 This project was budgeted at \$55 million and was completed with an unfavorable
28 variance of only \$220,000 from the original budget. As a result, Empire believes
29 the Commission should deny Staff adjustment of \$3,155,356.

1 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS**
2 **CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION**
3 **(“COMMISSION”)?**

4 A. In this testimony, I will rebut the testimony of Staff witnesses David W. Elliott and
5 Paul R. Harrison concerning the proposed disallowance of a portion of Energy
6 Center Units 3 and 4 construction costs.

7 **Q. WHAT WAS YOUR INVOLVEMENT WITH THE CONSTRUCTION OF**
8 **ENERGY CENTER UNITS 3 AND 4?**

9 A. At the time of construction of Energy Center Units 3 & 4, my position at Empire
10 was Staff Engineer – Energy Supply. With regards to the Energy Center Units 3 &
11 4 construction project, I was responsible for tracking costs related to the overall
12 project, assisting in the evaluation of contractors and contract negotiations, and
13 working with Patch Cost Engineers to audit Patch Cost Reports and invoices. Once
14 Patch was terminated, I spent the final few months of the project on-site assisting
15 with construction and start-up management.

16 **Q. PLEASE SUMMARIZE THE ISSUE REGARDING ENERGY CENTER**
17 **UNITS 3 AND 4 AND STAFF’S PROPOSED DISALLOWANCE OF**
18 **CONSTRUCTION COSTS, AS YOU UNDERSTAND IT.**

19 A. By way of background, the Energy Center Units 3 & 4 construction project started
20 in the fall of 2001 and was completed in the spring of 2003, a period of a little more
21 than 1 ½ years from date of equipment contract signing to commercial operation
22 date. This project was budgeted at \$55 million and was completed with an
23 unfavorable variance of approximately \$220,000 from the original budget. Staff
24 proposes a disallowance of \$3,155,356 of these construction costs which focuses on
25 a single line item cost out of numerous categories of project costs that Empire
26 effectively managed to meet its overall project budget of \$55 million.

27 **Q. PLEASE EXPLAIN.**

28 A. Empire utilized a multi-contract approach to construct Energy Center Units 3 & 4.
29 One of the contractors, Patch Construction, LLC (“Patch”), was retained to perform
30 engineering, installation, and procurement of balance of plant (“BOP”) equipment
31 activities for the Energy Center Unit 3 & 4 construction project. One of the

1 contractual requirements for Patch was to provide a performance bond within 21
2 business days of contract signing for the work that was to be performed under the
3 contract.

4 **Q. WAS PATCH ABLE TO MEET THIS REQUIREMENT?**

5 A. No.

6 **Q. WHAT DID EMPIRE DO AS A RESULT?**

7 A. In an attempt to complete the project in a cost and time effective manner, Empire
8 entered into Amendment 01 to the contract with Patch. This amendment, among
9 other things, pledged the assets of Patch Construction, LLC, Patch, Inc., and the
10 personal assets of Mr. and Mrs. Chester J. Patch as collateral to finish their scope of
11 the project at their contractual cost.

12 **Q. WHAT HAPPENED?**

13 A. Ultimately, Patch was unable to meet the requirements of the original contract and
14 Amendment 01. Patch was therefore terminated as a contractor for the project.
15 Empire personnel managed the final phases of construction and start-up for the
16 project. Because of this disruption, the cost to complete the activities associated
17 with Patch's contract was higher than the contract amount.

18 **Q. WHAT IS THE STAFF'S POSITION?**

19 A. Staff contends that a portion of the costs above the original contract amount should
20 be disallowed as plant-in-service. It is "Staff's opinion that the Company acted
21 imprudently by exposing Empire to an unnecessary level of financial risk" (page 5,
22 lines 20-21 of Paul R. Harrison's Direct Testimony).

23 **Q. HOW DO YOU RESPOND?**

24 A. Empire disagrees with this assessment and believes rather that Empire's
25 management team did everything within its ability to effectively manage the overall
26 construction project costs when all of the circumstances are considered.

27 **Q. IF THESE COSTS ARE DISSALLOWED, WHAT WILL BE THE IMPACT?**

28 A. Empire will have to expense the Missouri jurisdictional portion of these
29 construction costs, meaning that Empire and its shareholders will have to bear these
30 costs, which were incurred to provide service and reliable energy to Empire's
31 electric customers.

1 **Q. DID EMPIRE ADDRESS THIS ISSUE IN ITS DIRECT TESTIMONY?**

2 A. No.

3 **Q. WHY NOT?**

4 A. Empire was able to complete the construction project within .04 percent of the total
5 original project budget and therefore believes, based on prior regulatory treatment
6 utilized by Commission and Staff concerning new plant-in-service, that no
7 legitimate issue exists relating to Energy Center Unit 3 & 4 construction costs.

8 **Q. WHAT PRIOR REGULATORY TREATMENT ARE YOU REFERRING**
9 **TO?**

10 A. In the rate case that audited construction costs associated with Empire's State Line
11 Combined Cycle (Case No. ER-2001-299), Staff utilized a "definitive estimate"
12 standard to audit costs. To quote the Direct Testimony of Staff Witness Mark L.
13 Oligschlaeger, page 4, lines 9-16: "As a starting point of its construction review,
14 the Staff obtains the budget document that is used by the utility for cost control
15 purposes. In most instances, this budget document is known as the "definitive
16 estimate".

17 **Q. HAVE OTHER STAFF MEMBERS USED SIMILAR TERMS IN PRIOR**
18 **TESTIMONY WHEN DISCUSSING WHERE TO BEGIN CONSTRUCTION**
19 **AUDITS?**

20 A. Yes. In Case No. ER-2001-299, Staff Witness Cary G. Featherstone used the
21 phrase "original estimate" at least nine (9) times when referring to the basis of
22 proposed construction project cost disallowance.

23 **Q. HOW MANY TIMES DOES STAFF REFERENCE "DEFINITIVE**
24 **ESTIMATE" OR "ORIGINAL ESTIMATE" IN ITS DIRECT TESTIMONY**
25 **IN THIS CASE?**

26 A. None.

27 **Q. OTHER THAN EMPIRE RATE CASES, HAS STAFF UTILIZED THE**
28 **"DEFINITIVE ESTIMATE" OR "ORIGINAL ESTIMATE" STANDARD IN**
29 **RATE CASES.**

30 A. Yes. In Empire's Case No. ER-2001-299, which Mr. Oligschlaeger cites on page 5,
31 lines 2-4 of his rebuttal testimony, and in a Union Electric case (Case No. EO-85-

1 160 and EO-85-17) the Commission stated “[t]he definitive estimate is the proper
2 starting point for an investigation of cost overruns and a determination as to
3 whether costs incurred on the project are reasonable.” (Report and Order, pp. 39-
4 40). From this same testimony Mr. Oligschlaeger quotes:

5 In Case No. ER-77-118, Re: Kansas City Power & Light
6 Company, the Commission was of “the opinion that the
7 appropriate starting point for the calculation of any cost overrun
8 would be the target used by the Company in controlling cost. The
9 Commission is of the opinion, as in Case No. ER-77-118, that the
10 Company’s definitive estimate is the appropriate starting point for
11 determining cost overruns. Kansas City Power & Light Company,
12 24 MO.P.S.C (N.S.), (1981). (Ibid, p. 40).

13 **Q. YOU KEEP REFERRING TO EMPIRE’S CASE NO. ER-2001-299. WERE**
14 **COST OVERRUNS AN ISSUE IN THAT CASE?**

15 A. Yes. During the construction of State Line Combined Cycle (“SLCC”), Empire
16 encountered several obstacles that caused construction costs to exceed the “original
17 estimate.” When Empire filed its 2001 rate case to recover plant-in-service costs
18 related to this project, the Staff argued that costs above the “original estimate”
19 should be disallowed as plant-in-service. To quote Mr. Oligschlaeger’s direct
20 testimony in Case No. ER-2001-299, page 7, lines 6-7, “the original cost estimate
21 for the SLCC unit project was approximately **_____**.” Later, on the
22 same page, lines 10-12, he stated “the current construction cost estimate for
23 completing the SLCC unit is approximately **_____**, meaning total cost
24 overruns for the project are expected to be approximately **_____**.”

25 **Q. WHAT WAS EMPIRE’S ORIGINAL ESTIMATE FOR CONSTRUCTION**
26 **OF ENERGY CENTER UNITS 3 AND 4.**

27 A. \$55,000,000. Attached as Schedule BAM-1 is the Board Resolution approving this
28 budget as well as an excerpt from Empire’s December 2002 10-k.

29 **Q. BASED ON STAFF’S POSITIONS IN PREVIOUS RATE PROCEEDINGS,**
30 **WOULD EMPIRE EXPECT STAFF TO CONSIDER THIS THE**
31 **“ORIGINAL ESTIMATE” OR “DEFINITIVE ESTIMATE”?**

1 A. Yes.

2 **Q. TO WHAT LEVEL OF COSTS WAS EMPIRE MANAGEMENT**
3 **EXPECTED TO MANAGE COSTS?**

4 A. Empire's project management team was expected to manage costs to \$55,000,000,
5 which was considered to be the "definitive estimate" or "original estimate" based
6 on prior rate proceedings.

7 **Q. DOES STAFF AGREE THAT EMPIRE'S DEFINITIVE ESTIMATE WAS A**
8 **PRUDENT PROJECTION OF COSTS FOR ENERGY CENTER UNITS 3**
9 **AND 4.**

10 A. In response to DR-0332, which is an update to DR-0471 from Empire's previous
11 rate proceeding Case No. ER-2004-0570, Staff states, "Staff believes that the
12 Company's determination of \$55 million was an acceptable amount to use for the
13 purpose of gaining approval from Empire's Board of Directors for the construction
14 of Energy Center 3 and 4." However, Staff goes on to state "Staff believes this
15 amount was not appropriate for the purpose of project control". This statement
16 seems contradictory in itself and to prior rate proceeding testimony and begs the
17 question "To what level of costs was Empire to manage?"

18 **Q. WHAT WAS THE FINAL COST TO COMPLETE THE CONSTRUCTION**
19 **OF ENERGY CENTER UNITS 3 AND 4?**

20 A. During Empire's previous rate proceeding, it was determined during the
21 construction audit the final cost of the project was \$55,220,301, not including
22 AFUDC. (Please refer to schedule BAM-2). When compared to the original cost
23 estimate, this represents a \$220,301 or 0.4% cost overrun.

24 **Q. WHAT IS STAFF'S PROPOSED LEVEL OF DISALLOWANCE?**

25 A. Staff recommends a disallowance of \$3,155,356.

26 **Q. IS THIS DISALLOWANCE RELATED TO THE OVERRUN OF THE**
27 **ORIGINAL COST ESTIMATE?**

28 A. No.

29 **Q. WHAT IS THE DISSALLOWANCE BASED UPON?**

30 A. It appears that Staff is utilizing a different standard than in previous rate
31 proceedings to audit the construction costs of Energy Center Units 3 & 4. Instead

1 of utilizing the “original estimate” as a basis for the construction audit, Staff is
2 scrutinizing the budget line item by line item. The line item Staff is using to
3 calculate its proposed disallowance was the estimate to install, engineer, and
4 procure BOP material. The actual cost to complete this line item was higher than
5 the original cost estimate. Schedule BAM-3 presents the original cost estimate
6 breakdown. Comparing Schedule BAM-3, the original cost estimate, to Schedule
7 BAM-2, actual project costs, shows that no credit is given to line items that Empire
8 was able to “outperform”, for example Start-up Fuel and the BOP Fire System
9 outside the BOP Contract. As stated earlier, Staff agrees with Empire’s “original
10 estimate” or “definitive estimate” but does not seem to be using it when auditing the
11 actual costs of the project.

12 **Q. DO YOU HAVE ANY COMMENTS ON AN AUDITING STANDARD THAT**
13 **COMPARES ACTUAL COSTS TO ORIGINAL COST ESTIMATES ON AN**
14 **ITEMIZED BASIS?**

15 A. Yes. As stated in Mr. Elliott’s Direct Testimony in Case No. ER-2004-0570, page
16 14, lines 19-20, “most construction projects have cost overruns. The larger the
17 project, the more complex the project. The more complex the project is, the more
18 likely it is that unforeseen situations will occur as construction progresses.” Due to
19 this complexity to which Mr. Elliott alludes, at the beginning of a project it is
20 difficult to pinpoint all categories of costs. For those categories of costs that are
21 identified, it is often difficult to estimate the costs that will be associated with
22 activities in that category. Often, at the time the original cost estimate is prepared,
23 bids from contractors are not available and the original cost estimate is based on
24 available industry information and previous construction project experience. Such
25 was the case when the original cost estimate for Energy Center Units 3 and 4 was
26 prepared. Since it is impossible to predict all costs accurately, an audit standard
27 that compares the original cost estimate to actual costs line item by line item does
28 not seem fair or reasonable, especially when only the line items with unfavorable
29 variances are considered.

30 **Q. WHAT METHODS ARE UTILIZED BY PREPARERS OF ORIGINAL**
31 **COST ESTIMATES TO ACCOUNT FOR UNKNOWN COSTS?**

1 A. Preparers of original cost estimates do their best to categorize costs and estimate the
2 costs of construction activities. To account for inaccuracies, unpredictable costs,
3 and “unforeseen situations”, as characterized by Mr. Elliott, that will be
4 encountered during large construction projects, budgeters apply a contingency
5 factor to the overall cost estimate.

6 **Q. DID EMPIRE’S ORIGINAL COST ESTIMATE FOR ENERGY CENTER**
7 **UNITS 3 AND 4 CONTAIN CONTINGENCY?**

8 A. Yes.

9 **Q. WHAT AMOUNT OF CONTINGENCY WAS INCLUDED IN THE**
10 **ORIGINAL COST ESTIMATE?**

11 A. As shown on Schedule BAM-3, Empire included a contingency of \$1,997,560, or
12 approximately 3.6% of the total cost estimate.

13 **Q. WOULD YOU CONSIDER THIS A “NORMAL” AMOUNT OF**
14 **CONTINGENCY?**

15 A. It is my experience that construction projects of this magnitude usually contain 5 –
16 10% contingency. The amount of contingency Empire included is obviously below
17 the lower end of this scale. But considering that the cost of the turbines was already
18 under contract at the time the detailed cost estimate was derived, Empire’s estimate
19 appears to be an acceptable level of contingency.

20 **Q. WAS THE CONTINGENCY ESTIMATE USED DURING THE PROJECT?**

21 A. Yes. As it turned out, the contingency was used to cover the additional costs that
22 were incurred related to the work that was to be completed under Patch’s contract
23 and for other construction issues that arose. Additionally, Empire was able to
24 manage costs in other cost categories, such as Start-up Fuel and the BOP Fire
25 System outside the BOP Contract, to offset some of the higher than estimated costs
26 related to the Patch contract. It is Empire’s opinion that this is a prime example of
27 why contingency is included in the original cost estimate.

28 **Q. WHAT WERE THE CIRCUMSTANCES THAT LED TO THE EXECUTION**
29 **OF AMENDMENT 01 BETWEEN EMPIRE AND PATCH?**

30 A. There were several issues Empire was dealing with around the time it was deemed
31 that Patch could not obtain a performance bond.

1 1. Empire needed at least one of the new units on line to meet the 12% minimum
2 Southwest Power Pool (“SPP”) capacity margin requirement before June 1,
3 2003.

4 2. Given that Patch could not obtain a performance bond, Empire had to
5 determine the most cost effective way to complete the project for our
6 customers.

7 3. Given the Staff position in Case No. ER-2001-299, Empire also had to
8 determine the most effective way to minimize risk to our shareholders.

9 To further expand on item 1, SPP requires every load-serving entity to maintain
10 installed capacity equal to 12% in excess of its seasonal peak. Although it is each
11 member of the SPP’s responsibility to maintain electric reliability for its customers,
12 mismanagement by any one member of SPP can jeopardize the entire system,
13 resulting in unfortunate events like the blackout in August of 2003. Empire
14 reasonably concluded that a change in contractors late in the project was sure to
15 delay the schedule and probably not allow the Company to meet SPP’s
16 requirements.

17 Item 2 required Empire to assess the potential costs to complete the project
18 without Patch. Empire knew that if it replaced Patch the next bidder was a higher
19 cost. Empire also knew that if it replaced Patch there would be additional expense
20 for re-work and transition. On the other hand, Empire believed that if it managed
21 Patch’s financial involvement in the job, there was an opportunity to complete
22 Patch’s scope at the contract value and finish the project on schedule.

23 As for item 3, Staff’s recent position on rate treatment of State Line Combined
24 Cycle in 2001 (Case No. ER-2001-299) weighed on our decision process. In the
25 SLCC case, Empire had deemed a contractor, Fru-Con, was in default of the
26 contract and replaced them with another contractor at a higher cost. The
27 replacement of Fru-Con with another contractor at a higher cost was the major basis
28 cited by the Staff in its plant disallowance position in the previous case. If Empire
29 replaced Patch with another bidder, Empire would have not only jeopardized
30 meeting its SPP requirement, but it would have been repeating conduct that Staff
31 judged as imprudent in the previous case. By this point in the project, Empire also

1 knew that the Patch entities were not financially strong. If Empire continued with
2 Patch, Empire had to limit Patch's financial involvement. Based on what Empire
3 knew at the time and balancing all relevant concerns that I have outlined above,
4 Empire concluded that executing Amendment 01 with Patch provided for the best
5 balance of all concerned.

6 **Q. WHAT DOES STAFF SUGGEST AS ALTERNATIVES TO ENTERING**
7 **INTO AMENDMENT 01 WITH PATCH?**

8 A. In Staff witness Paul R. Harrison's Direct Testimony, page 11, lines 12-13, he states
9 "elimination of Patch from consideration would have resulted in Sega being
10 awarded the contract to install EC3&4."

11 **Q. WHO IS SEGA AND HOW DO YOU RESPOND TO STAFF'S PROPOSED**
12 **ALTERNATIVE?**

13 A. Sega is a Kansas City area engineering company that was the runner-up bidder on
14 the Energy Center Unit 3 & 4 construction project. While this may have been a
15 possible alternative, if Empire had terminated Patch and hired Sega to perform the
16 work, it is likely that Staff would have contended that any termination charges
17 related to the Patch contract should be disallowed. Additionally, conversations with
18 Sega management after the completion of the Energy Center 3 & 4 project show
19 that it is likely Sega would not have been able to obtain a performance bond for the
20 project either. This would have pushed us to the third bidder, Bibb-Kiewit, and
21 further delayed the project.

22 **Q. WHY DO YOU CONTEND THAT IT IS LIKELY SEGA WOULD NOT**
23 **HAVE BEEN ABLE TO OBTAIN A PERFORMANCE BOND FOR THE**
24 **PROJECT EITHER?**

25 A. Sega was the runner-up bidder on Empire's Energy Center Units 3 and 4 project.
26 Sega was also the original winning bidder on a similar project for KCPL at the West
27 Gardner site in February 2002. Like Patch, Sega could not obtain a performance
28 bond for the KCPL project. An e-mail Mr. Brown sent to Empire in April 2004
29 confirming this fact is attached as Schedule BAM-4. Staff's own investigation has
30 not led to a contrary conclusion. In his response to Company DR-0330, an update to
31 DR-0468 in Case No. ER-2004-0570, Staff states, "the Staff has not researched or

1 performed any analysis of the performance bond market during the late 2001 to
2 early 2002 timeframe, or Sega's bonding capabilities in the 2002 timeframe."

3 **Q. WHAT DOES THIS LIKELY INABILITY TO OBTAIN A PERFORMANCE**
4 **BOND BY SEGA MEAN?**

5 A. If one were to utilize the standard of "definitive estimate" or "original cost
6 estimate," it may mean nothing. However, if it is decided to use Staff's new
7 proposed methodology of scrutinizing the original cost estimate line item by line
8 item, it means the Sega bid should not be considered as a valid qualifier and instead
9 the third bid should be utilized.

10 **Q. WHO IS THE THIRD BIDDER AND HOW MUCH HIGHER WAS ITS BID**
11 **THAN SEGA'S.**

12 A. Bibb-Kiewit was the third highest bid. Bibb-Kiewit's bid was \$1,297,000 higher
13 than Sega's.

14 **Q. WAS EMPIRE REQUIRED TO MAKE CONTRACTORS PROCURE**
15 **PERFORMANCE BONDS FOR THE ENERGY CENTER UNIT 3 & 4**
16 **PROJECT?**

17 A. No. To Empire's knowledge, neither the Staff nor the Commission itself has a
18 policy, statute, or regulation in place that would require Empire, to make its
19 contractors procure a performance bond for construction projects. Staff agrees with
20 this conclusion in response to DR-0333 and DR-0334. Empire took it upon itself to
21 have the performance bond provision in Patch's contract. When Patch was
22 ultimately unable to procure the performance bond, Empire management considered
23 all of its alternatives and signed Amendment 1 with Patch as the best means to
24 minimize risk and complete the project on schedule.

25 **Q. ARE THERE ANY OTHER FACTORS THAT SHOULD BE CONSIDERED**
26 **IF STAFF'S LINE ITEM BY LINE ITEM METHODOLOGY IS UTILIZED**
27 **BY THE COMMISSION?**

28 A. Yes. Upon contract signing with Patch, Empire paid to Patch a "down payment" of
29 \$1,136,000, representing 10% of the total contract value. Had Empire terminated
30 Patch after the 21 business days it had after contract signing to obtain the
31 performance bond, this is money that would have already been expended to Patch.

1 With 20/20 hindsight, Empire believes this money would not have been recoverable
2 from Patch.

3 **Q. IS THE PRACTICE OF PAYING A CONTRACTOR A “DOWN**
4 **PAYMENT” NORMAL IN THE CONSTRUCTION INDUSTRY?**

5 A. It has been my experience that it is. In fact, the contract Empire signed with Pratt &
6 Whitney for the purchase of the turbines that were installed as part of the Energy
7 Center 3 & 4 construction project required a 10% down payment. As part of the
8 Riverton Unit 12 project currently ongoing at Empire’s Riverton Power Plant, down
9 payments with almost all major contractors and equipments suppliers is the norm.
10 Contractors require this provision so they have a neutral cash flow and are not using
11 short term debt to finance the customers’ projects.

12 **Q. CONSIDERING SEGA’S LIKELY INABILITY TO OBTAIN A**
13 **PERFORMANCE BOND AND THE DOWN PAYMENT THAT WAS**
14 **EXPENDED TO PATCH PRIOR TO KNOWLEDGE OF ITS INABILITY**
15 **TO OBTAIN A PERFORMANCE BOND, WHAT IS EMPIRE’S POSITION**
16 **AS IT RELATES TO STAFF’S PROPOSED DISALLOWANCE?**

17 A. Again, Empire believes that the “definitive estimate” or “original estimate” standard
18 established in prior rate proceedings should be utilized as the basis for the audit.
19 However, if the Commission decides to use Staff’s proposed line item by line item
20 methodology, Empire contends that the Staff’s proposed disallowance of
21 \$3,155,356 should be decreased by two amounts: 1) the amount that the third
22 bidder’s bid (Bibb/Kiewitt) was higher than Sega’s bid (\$1,297,000), and 2) the
23 amount of the down payment that was expended to Patch prior to knowledge of
24 their inability to procure a performance bond (\$1,136,000). This would decrease
25 Staff’s proposed disallowance to \$722,356. In addition, it could also be argued that
26 the first invoice from Patch, dated March 29, 2002 (30 business days after Patch
27 contract signing) and totaling \$892,309, would have been paid to Patch and
28 unrecoverable since it was not completely evident at the 21 business day milestone
29 (March 18th, 2002) that Patch would be unable to procure a performance bond for
30 the project.

1 **Q. WAS EMPIRE EVER ABLE TO RECOVER MONIES FROM PATCH**
2 **RELATED TO THE CONTRACT FOR ENERGY CENTER UNITS 3 AND**
3 **4?**

4 A. No. Empire filed suit against the Patch corporate entities and the personal owners
5 of those entitites, Mr. and Mrs. Chester Joe Patch, in the Jasper County Circuit
6 Court. Empire ultimately received a favorable judgment from the court. Upon
7 award of this judgment, the Patch corporate entities and the personal owners of the
8 companies filed for bankruptcy protection and all assets were distributed to
9 creditors. Empire received nothing as a result of these bankruptcy proceedings.
10 Please refer to Company witness Gary Lentz's Rebuttal Testimony for further
11 information regarding Empire's attempt to recover money for the Patch entities.

12 **Q. YOU HAVE ALLUDED TO TESTIMONY AND DATA REQUESTS IN**
13 **PRIOR RATE PROCEEDINGS CONCERNING THIS ISSUE. WAS**
14 **ENERGY CENTER 3 AND 4 CONSTRUCTION COSTS AN ISSUE IN**
15 **PRIOR RATE PROCEEDINGS?**

16 A. Yes. In Empire's 2004 rate case, Case No. ER-2004-0570, Energy Center Unit 3
17 and 4 construction cost disallowance was an issue.

18 **Q. WERE THERE ANY DISALLOWANCES TO PLANT-IN-SERVICE**
19 **RELATING TO ENERGY CENTER 3 AND 4 AS A RESULT OF THOSE**
20 **PROCEEDINGS.**

21 A. No. A "Stipulation and Agreement As To Certain Issues" was signed as part of
22 those rate proceedings. This stipulation and agreement is silent on the issue of
23 Energy Center 3 & 4 plant-in-service disallowance. Empire never settled on an
24 "amount of construction overrun costs that would be included in rate base" (Direct
25 Testimony, Paul R. Harrison, page 6, line 6) as Mr. Harrison asserts in his Direct
26 Testimony as part of this "black box" stipulation and agreement.

27 **SUMMARY**

28 **Q. PLEASE SUMMARIZE YOUR POSITION ON THE ENERGY CENTER**
29 **UNITS 3 AND 4 PROPOSED DISALLOWANCE TO PLANT-IN-SERVICE**
30 **ISSUE.**

BLAKE A. MERTENS
REBUTTAL TESTIMONY

1 A. In prior rate proceedings the Commission and Staff have utilized a “definite
2 estimate” or “original estimate” standard as a baseline to audit construction project
3 costs. Based on this standard and the circumstances that were prevalent at the time
4 of the Energy Center Unit 3 and 4 construction project, the Commission should find
5 that Empire effectively managed the construction project to meet the “definitive
6 estimate” and completed the project in a timely manner. Contrary to Staff’s
7 assertion that Empire’s decisions caused “additional unnecessary costs to complete
8 the construction of EC3&4” (Direct Testimony, Paul R. Harrison, page 6, lines 2-3),
9 Empire contends that all the costs related to the construction of Energy Center 3 and
10 4 were prudently incurred in order to meet Empire’s customer needs and its SPP
11 requirements.

12 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

13 A. Yes, it does.