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**Missouri Public
Service Commission**

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Issues: Corporate Governance
Principles - Electric Energy,
Inc.
Witness: Prof. Robert C. Downs
Sponsoring Party: Union Electric Company
Type of Exhibit: Direct Testimony
Case No.: ER-2007-0002
Date Testimony Prepared: July 5, 2006

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2007-0002

DIRECT TESTIMONY

OF

PROFESSOR ROBERT C. DOWNS

ON

BEHALF OF

**UNION ELECTRIC COMPANY
d/b/a AmerenUE**

**St. Louis, Missouri
July, 2006**

AmerenUE 44
Date 3/20/07 Case No. ER-2007-0002
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1 **Q. Please describe your education.**

2 A. I attended Kansas State University where I received my B.A. degree in 1963.
3 I received my J.D. degree from the University of Nebraska College of Law, in 1966. I also
4 completed an LLM. degree at the UMKC School of Law in 1976.

5 **Q. Please describe your professional work experience.**

6 A. I practiced law with the Kansas City law firm of Linde, Thomson, Van Dyke,
7 Fairchild & Kohn, from 1968 to 1978. I was an Associate for three years and a partner for
8 seven years. I began my teaching career as an adjunct professor, teaching Business
9 Organizations in the 1977-78 academic year. I became a regular, tenure-track faculty
10 member, as an Associate Professor of Law, in the fall of 1978. My subject areas include
11 Business Organizations, 1978-present, Contracts I & II, 1993-present, Mergers &
12 Acquisitions, 1978-present, Securities Regulation, 1978-1993, and Jurisprudence which I
13 occasionally teach. My research interests and publications have been focused in the
14 corporate and securities area, but I have a special interest in economic analysis of law and the
15 history of the UMKC School of Law. I am currently a full Professor of Law, a Law
16 Foundation Scholar, and Chair of the UMKC School of Law Policy and Planning Committee,
17 which also serves as the Executive Committee. I have continued to practice law since 1978
18 in the corporate area, including representing corporations and doing merger and acquisition
19 work. I advise boards of directors regarding their duties and responsibilities involving state
20 and federal law, as well as other substantive law pertaining to corporate governance. I have
21 also testified in a number of cases in state and federal courts, and in arbitration matters in
22 various states.

1 **II. PURPOSE AND SUMMARY OF TESTIMONY**

2 **Q. What is the purpose of your direct testimony?**

3 A. The purpose of my testimony is to discuss the controlling principles of lawful
4 and sound corporate governance that dictate the obligations of the Board of Directors (the
5 “Board”) of Electric Energy, Inc. (“EEInc.”) with respect to the Board’s operation of EEInc.,
6 including the sale of power from EEInc.’s Joppa, Illinois power plant.

7 **Q. Please summarize your conclusions.**

8 A. As I understand the direct testimony of Union Electric Company d/b/a
9 AmerenUE (“Company” or “AmerenUE”) witness Michael L. Moehn, AmerenUE’s capital
10 stock in EEInc. was purchased with shareholder funds which, as Mr. Moehn explains, are
11 funds that are excluded from the calculations used by the Missouri Public Service
12 Commission (“Commission”) to set electric rates. Because AmerenUE is a wholly-owned
13 subsidiary of Ameren Corporation and given that AmerenUE shareholders bought
14 AmerenUE’s EEInc. stock, the EEInc. stock owned by AmerenUE is held for the ultimate
15 benefit of the shareholders of Ameren Corporation. EEInc.’s Board has an obligation as a
16 matter of law to maximize the value of those shares as well as all other shares of capital stock
17 of the corporation.

18 As Mr. Moehn explains, the Missouri Office of the Public Counsel (“OPC”) has
19 previously taken the position that EEInc. should forego profits (or be forced to forego
20 profits) on the sale of power by continuing to sell power to AmerenUE at cost. OPC’s
21 position flies directly in the face of the binding legal obligation of EEInc.’s Board to
22 maximize the value of the stock held by EEInc. shareholders. Consequently, it would be

1 improper for EEInc. to sell power at cost to one of its shareholders or anyone else when it
2 can sell power at higher market prices.

3 A summary of my testimony is included in Attachment A.

4 **III. EEINC.'S DECISION TO SELL POWER AT MARKET RATES IS**
5 **DEICTATED BY CONTROLLING PRINCIPLES OF**
6 **CORPORATE GOVERNANCE**

7 **Q. Why are you testifying on these subjects in connection with AmerenUE's**
8 **filing of this rate case?**

9 A. AmerenUE asked me to provide expert testimony with respect to principles of
10 corporate governance applicable to the EEInc. Board, in particular respecting decisions the
11 EEInc. Board has made regarding the sale of power from EEInc.'s power plant. As Mr.
12 Moehn explains in his direct testimony, OPC has previously contended that EEInc. must sell
13 power at cost to AmerenUE after the expiration of what I understand to have been a cost-plus
14 power contract that AmerenUE formerly had with EEInc.

15 **Q. On what do you base your understanding of OPC's position?**

16 A. I base my understanding of OPC's position upon the facts outlined in Mr.
17 Moehn's direct testimony, which I have supplemented by my own review of materials from
18 prior regulatory proceedings where OPC has taken this position.

19 **Q. Although Mr. Moehn addresses this as well, to provide context for your**
20 **remaining testimony, can you please provide some background on EEInc. and**
21 **AmerenUE's connection with EEInc.?**

22 A. Yes. As Mr. Moehn outlines as well, it is my understanding that EEInc. is an
23 Illinois corporation formed in 1950 by AmerenUE and four other utilities for the purpose of
24 building a power plant to supply the energy requirements of a United States government
25 agency owned uranium re-enrichment plant near Paducah, Kentucky. Initially, AmerenUE

1 owned 40% of the issued and outstanding shares of EEInc., Central Illinois Public Service
2 Company owned 20%, Illinois Power Company owned 20%, Kentucky Utilities Company
3 (“KU”) owned 10%, and Middle South Utilities, Inc. owned 10%. Through a series of
4 corporate transactions occurring over the past six decades, AmerenUE continues to own 40%
5 of the shares, Ameren Energy Resources Company (“AER”), an unregulated subsidiary of
6 Ameren Corporation, owns 40% and Kentucky Utilities owns 20%.

7 EEInc.’s Board consists of seven members, five of whom are employees of
8 Ameren Corporation or its affiliates and two of whom are employees of Kentucky Utilities or
9 its affiliates. It is my understanding that originally, the federal government purchased
10 substantial quantities of power from EEInc., with available power not purchased by the
11 government being sold by EEInc. to its shareholders under long-term cost-based or cost-plus
12 power contracts. Under those long-term cost-based or cost-plus contracts, each shareholder
13 paid the same price for power and had the opportunity to buy a proportionate share of the
14 available power (not taken by the government) equal to its proportionate ownership of shares
15 in EEInc.

16 **Q. How was AmerenUE’s capital stock in EEInc. purchased?**

17 A. According to Mr. Moehn’s testimony, AmerenUE’s shareholders, using
18 shareholder, not ratepayer funds, purchased 24,800 shares of capital stock in EEInc. at two
19 separate times in the 1950s, and continue to hold those shares today.

20 **Q. Do you know what Mr. Moehn means when he says “using shareholder,
21 not ratepayer funds” ?**

22 A. I am not an expert in public utility regulatory law. However, my
23 understanding of Mr. Moehn’s testimony is that shareholders of regulated utilities like

1 AmerenUE provide equity that the utility then uses to buy assets, such as power plants,
2 power lines, equipment, and the like. Mr. Moehn's testimony indicates that those assets are
3 placed into the utility's regulated "rate base." Mr. Moehn goes on to explain that through the
4 ratemaking process, retail ratepayers pay rates that provide both a return *of* the shareholders'
5 investment which was used by the utility to invest in rate base assets (through cash flows
6 provided by depreciation expense) and a return *on* the shareholders' investment used to
7 invest in those rate base assets. Mr. Moehn refers to these rate base assets as "above-the-
8 line" investments. As I understand Mr. Moehn's testimony, funds provided by shareholders
9 not used to invest in rate base are "below-the-line" funds that do not figure into rate
10 calculations made by the Commission. This appears to me to be analogous to investments
11 utilities make in operations that as I understand it are not regulated by state utility
12 commissions.

13 **Q. Why is this distinction important from a corporate governance**
14 **standpoint?**

15 A. Because it dictates the duties that directors of any corporation, including
16 EEInc., owe and to whom those duties are owed. Where, as here, shareholders have made an
17 investment – AmerenUE's investment in EEInc. stock – EEInc.'s Board as a matter of law
18 owes shareholders, including AmerenUE, a fiduciary duty to maximize the value of that
19 stock. This is a very fundamental and basic tenet of corporate law in virtually all
20 jurisdictions, including in Illinois where EEInc. is incorporated. *See, e.g., Graham v.*
21 *Mimms*, 111 Ill.App. 3d 759, 444 N.E.2d 599 (Ill. App. 1982). Directors do not owe that
22 duty to third parties, including Missouri retail ratepayers, which seems to be the premise of
23 OPC's position.

1 **Q. What rights, obligations or other incidents of ownership does the**
2 **ownership of shares of capital stock of AmerenUE entail?**

3 A. When a person or, as here, a corporate entity, buys shares of capital stock of a
4 for-profit corporate business entity the shareholder obtains three basic things. First, the
5 shareholder has an opportunity to earn a return on the shareholder's investment through
6 appreciation of the value of the stock or through the receipt of dividends, or both. This is
7 what the shareholder hopes will be the "upside" of the investment. To gain that upside
8 potential, the shareholder takes on a second aspect of stock ownership -- risk. Thus, stock
9 ownership also potentially has a downside. This downside or risk can take various forms. A
10 shareholder's investment could depreciate, it could under-perform relative to alternative
11 investments, or it could be lost entirely. Because it is the shareholders' money that is "on the
12 line," shareholders possess a third key incident of ownership – the right to elect the
13 corporation's board of directors who, in turn, run the corporation and do so based upon a key
14 controlling legal principle and duty: to maximize shareholder value.

15 **Q. How are corporations governed?**

16 A. As I briefly mentioned earlier, except for limited actions reserved to
17 shareholders by statute or in the corporation's articles or bylaws, a corporation's board of
18 directors acts as the decision maker for the corporation. The power of the board of directors
19 to act is a power inherent in the position, sometimes referred to as *sui generis*, and
20 shareholders are not entitled to usurp that power or make decisions for the corporation that
21 fall within the responsibility of the directors. For example, shareholders are not entitled to
22 contract on behalf of the corporation, or to declare dividends, or to select officers of the

1 corporation, or to issue stock of the corporation. Directors have the exclusive responsibility
2 to manage the corporation.

3 **Q. Is EEInc. governed in the same way?**

4 A. Yes. EEInc.'s seven-member board of directors is vested with authority to
5 make most decisions relating to the operation of the corporation. In this regard, EEInc.'s
6 Bylaws provide that the board of directors has the power to "manage the property, business
7 and affairs" of the corporation.

8 **Q. As you understand it, what, specifically, is OPC's position regarding the**
9 **sale of power from EEInc.?**

10 A. OPC's position apparently reflects OPC's belief that Ameren Corporation and
11 its affiliates should improperly and unlawfully manipulate the operations of EEInc. by
12 exerting its influence as an employer of some of EEInc.'s Board members to require EEInc.'s
13 Board to in turn force EEInc. to sell 40% of the power from EEInc. to AmerenUE at cost.

14 **Q. Why is such an action, as you put it, improper and unlawful?**

15 A. Because such an action would fly directly in the face of the most basic
16 principles of corporate governance embodied in the law. Indeed, any such action by the
17 Board would be a direct and unlawful violation of the fiduciary duty I spoke of earlier. As I
18 previously noted, EEInc.'s directors owe that fiduciary duty *to EEInc. and EEInc.'s*
19 *shareholders*, including AmerenUE, AER and KU. In the corporate governance context, to
20 owe a fiduciary duty means to act in accordance with two key principles, as follows: to act
21 in the best interest of the corporation and its shareholders and, similarly, to be loyal to the
22 corporation and to those shareholders and their interests. OPC wants Ameren Corporation or

1 AmerenUE, as shareholders, to usurp the lawful authority and duties of the directors of
2 EEInc.

3 **Q. What about the fact that these EEInc. board members also hold positions**
4 **with AmerenUE, which is a regulated public utility in Missouri?**

5 A. That does not change the nature or extent of their duties to EEInc.'s
6 shareholders in their capacities as EEInc. directors, or their duties to the corporation and to
7 the shareholders of AmerenUE with respect to AmerenUE shareholder investments that are
8 not in AmerenUE's regulated rate base. On these facts, the AmerenUE representatives on
9 EEInc.'s Board must faithfully advance the interests of EEInc., which in turn advances the
10 interest of AmerenUE shareholders.

11 **Q. Please explain why selling EEInc.'s power at market-based rates**
12 **advances both the interests of EEInc. and AmerenUE shareholders.**

13 A. Mr. Moehn's testimony suggests to me that today EEInc. – the corporate
14 entity – the business – essentially does one income-producing thing and one thing alone: it
15 produces power. In order to make the most profit it can, which after all is what for-profit
16 entities are bound to do for shareholders, it needs to sell as much of that power as it can at as
17 high a price as it can on the open market while producing that power at as low a cost as it
18 can. That is how this business makes money. If EEInc. does those things, it will maximize
19 shareholder value. It is the duty of EEInc.'s Board to do just that. Therefore, when
20 presented with the opportunity to sell power at higher market prices versus at lower cost-
21 based rates, the Board has only one course available to it consistent with its fiduciary duties
22 to shareholders – to sell at market. That decision is also in the best interest of AmerenUE's
23 shareholders because if EEInc. maximizes its profits the value of AmerenUE's investment in

1 EEInc. is also maximized. This, in turn, contributes the maximum value to the investment
2 made by AmerenUE's shareholders' in AmerenUE itself, which is exactly what the
3 AmerenUE's representatives on EEInc.'s Board are bound to do in their capacities as
4 representatives of AmerenUE.

5 **Q. Would accepting OPC's position violate duties to shareholders?**

6 A. Absolutely. If AmerenUE representatives on EEInc.'s Board force EEInc. to
7 sell power to AmerenUE at cost, the Board is no longer maximizing the value of its
8 shareholders' investment. Instead, EEInc.'s Board would be making decisions to favor the
9 interests of *non-shareholders*; in this case, Missouri customers of AmerenUE. Consequently,
10 a decision by the EEInc. Board to continue to sell power at cost when it now can sell power
11 at market at a greater profit shifts value that belongs to EEInc. shareholders away *from* those
12 shareholders *to* retail ratepayers. This will lower the value of AmerenUE's investment in
13 EEInc., which in turn, makes AmerenUE's stock less valuable. As I noted above, this
14 effectively harms the Ameren Corporation shares held by millions of members of the public,
15 including nearly 30,000 Missourians.

16 **Q. Are you saying that EEInc. directors have acted contrary to their duties**
17 **in the past when EEInc. allowed AmerenUE to buy power under cost-based or cost-plus**
18 **contracts?**

19 A. No, not at all. As I understand Mr. Moehn's testimony, cost-plus power
20 contracts were the norm in the electric industry for decades prior to the advent of competitive
21 wholesale energy markets in recent years. It was not until the expiration of long-term power
22 contracts at the end of 2005 (which had been in place since 1987 and, before that, since the
23 1950s) that EEInc. had the opportunity to sell power at market. It appears to me that what

1 the EEInc. Board did starting in the 1950s through 1987, when it last approved the power
2 supply agreements that expired at the end of 2005, was to act consistent with the interests of
3 EEInc. shareholders based upon conditions existing at the time the Board made those
4 decisions. This is because as I understand it, for decades a cost-based or cost-plus price was
5 a "market price," as the market was defined at that time. This means that when EEInc.'s
6 Board approved past cost-based or cost-plus contracts it was achieving a fair market price
7 that maximized shareholder value, just as it is doing today, in the market as it exists today, by
8 selling power at market-based rates in the recently developed competitive wholesale energy
9 market. In summary, the EEInc. Board's recent decision to sell power at market-based rates
10 is simply a continuation of the decisions it has always made to maximize shareholder value.

11 **Q. But why should shareholders obtain these benefits versus, for example,**
12 **AmerenUE's customers?**

13 A. The simple, economic and common sense answer is: Because one who puts up
14 the investment and takes the investment risk ought to receive the benefits of that investment.
15 From a corporate governance standpoint, which not surprisingly comports with common
16 sense and fairness, one gets the same answer: it would be a violation of the fiduciary duties
17 of the directors of EEInc. to improperly shift shareholder benefits to which shareholders are
18 legally entitled to customers.

19 **Q. Does this conclude your Direct Testimony?**

20 A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of Union Electric Company)
d/b/a AmerenUE for Authority to File)
Tariffs Increasing Rates for Electric)
Service Provided to Customers in the)
Company's Missouri Service Area.)

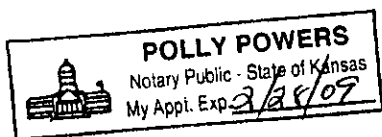
Case No. ER-2007-0002

AFFIDAVIT OF PROFESSOR ROBERT C. DOWNS

STATE OF KANSAS)
)
) ss
CITY OF JOHNSON)

Robert C. Downs, being first duly sworn on his oath, states:

1. My name is Robert C. Downs. I work in Kansas City Missouri as a Professor of Law and the University of Missouri-Kansas City School of Law.
2. Attached hereto and made a part hereof for all purposes is my Direct Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 12 pages and Attachment A, all of which have been prepared in written form for introduction into evidence in the above-referenced docket.
3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.



Robert C Downs
Robert C. Downs

Subscribed and sworn to before me this 5th day of July, 2006.

My commission expires: 2/28/09

Sally Powers Bank of America
Notary Public Sally Powers

EXECUTIVE SUMMARY

Professor Robert C. Downs

Professor of Law, University of Missouri-Kansas City

AmerenUE's capital stock in EEInc. was purchased with shareholder funds which, as AmerenUE witness Michael L. Moehn explains, are funds that are excluded from the calculations used by the Missouri Public Service Commission ("Commission") to set electric rates. Because AmerenUE is a wholly-owned subsidiary of Ameren Corporation and given that AmerenUE shareholders bought AmerenUE's EEInc. stock, the EEInc. stock owned by AmerenUE is held for the ultimate benefit of the shareholders of Ameren Corporation. EEInc.'s Board has an obligation as a matter of law to maximize the value of those shares as well as all other shares of capital stock of the corporation. This is a very fundamental and basic tenet of corporate law in all jurisdictions, including in Illinois where EEInc. is incorporated. Directors do not owe that duty to third parties, including Missouri retail ratepayers.

As Mr. Moehn explains, the Missouri Office of the Public Counsel ("OPC") has previously taken the position that EEInc. should forego profits (or be forced to forego profits) on the sale of power by continuing to sell power to AmerenUE at cost. OPC's position flies directly in the face of the binding legal obligation of EEInc.'s Board to maximize the value of the stock held by EEInc. shareholders. Consequently, it would be improper for EEInc to sell power at cost to one of its shareholders or anyone else when it can sell power at higher market prices. Doing so would improperly shift benefits to which shareholders are legally entitled to customers, in violation of the EEInc.'s Board's fiduciary duties as a matter of law.