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Witness: Kevin C. Higgins
Sponsoring Party: The Commercial Group
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Case No.: ER-2007-0002
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BEFORE
THE MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2007-0002

Surrebuttal Testimony of Kevin C. Higgins

on behalf of

The Commercial Group

February 27, 2007

SURREBUTTAL TESTIMONY OF KEVIN C. HIGGINS

Introduction

Q. Please state your name and business address.

A. Kevin C. Higgins, 215 South State Street, Suite 200, Salt Lake City, Utah, 84111.

Q. By whom are you employed and in what capacity?

A. I am a Principal in the firm of Energy Strategies, LLC. Energy Strategies is a private consulting firm specializing in economic and policy analysis applicable to energy production, transportation, and consumption.

Q. On whose behalf are you testifying in this proceeding?

A. My testimony is being sponsored by The Commercial Group. The Commercial Group is comprised of the Missouri locations of Lowe's Home Centers, Inc.; Wal-Mart Stores East, LP; and J.C. Penney Corporation, Inc. Collectively, the members of The Commercial Group purchase more than 236 million kWh annually from AmerenUE in Missouri, primarily on rate schedules LGS and SPS.

Q. Are you the same Kevin C. Higgins who has pre-filed direct testimony in the Revenue Requirement, Cost-of-Service, and FAC phases of this proceeding, and has also pre-filed rebuttal testimony?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony responds to arguments made in the rebuttal testimony of AmerenUE witnesses Robert C. Downs and Michael L. Moehn regarding the treatment of power sales from the AmerenUE generation affiliate, Electric Energy, Inc. ("EEInc.").

Response to Robert C. Downs

Q. On page 4 of his rebuttal testimony, Professor Downs states that sales from EEInc. below fair market value would violate the duty of care because it would not be a rational business decision of the board of directors. As an economist, do you agree that a sale below market price is, by definition, not a rational business decision?

A. No, I do not agree with this simple blanket statement. EEInc. is an affiliate of AmerenUE. Economic theory has demonstrated that affiliated companies may enter into rational transactions at below-market prices. There is a well-established literature addressing this topic, which is known as "transfer pricing." A seminal article by Hirschleifer demonstrates that setting transfer prices between affiliates at market prices will not always result in profit maximization for the firm as a whole.[1] This result means that the pricing of transactions between affiliated companies may rationally occur at prices that are below market.

With respect to actual corporate practices, a 1992 study by Tang found that 46.2 percent of the Fortune 500 firms responding to his survey used cost-based transfer pricing for domestic transactions, whereas 36.7 percent used

market-based transfer prices. For transactions between foreign affiliates, 41.4 percent used cost-based transfer prices, and 45.9 percent used market-based prices.[2]

In recent years, transfer pricing has gained considerable attention in the area of corporate taxation. National taxing authorities have long recognized that multinational corporations have an economic incentive to establish transfer prices between affiliates that are designed to minimize corporate income tax.[3] This tendency is so pervasive that taxing authorities (including the IRS) have adopted extensive regulations to govern transfer pricing.

The upshot here is that, with respect to transactions between affiliated companies, it is not correct to rely on a simple rule of thumb that portrays any transaction below market price as necessarily representing an irrational business decision. Both the theory and practice of transfer pricing indicates that affiliated companies routinely – and rationally – transact at prices below market. In doing so, these affiliates are rationally subordinating their individual balance sheet results to those of their corporate families as a whole.

Q. In what manner could a transfer price between EEInc. and AmerenUE be established at a price below market and still be a rational business decision?

A. Assume for the moment (for simplicity) that EEInc. is wholly owned by AmerenUE. Both EEInc. and AmerenUE are in the electric power business. All other things being equal, the energy from a cost-based power sale from EEInc. to

[1] Jack Hirschleifer, "The Economics of Transfer Pricing," *The Journal of Business*, July 1956.
[2] Roger Y.W. Tang, "Transfer Pricing in the 1990s", *Management Accounting*, Feb. 1992.

AmerenUE could be resold by AmerenUE into the market with same net profit to AmerenUE's shareholders as would have occurred had EEInc. sold the power itself at market prices. In such a situation, it would not be irrational for the two affiliates to arrange a transfer price between them based on cost. Consequently, one cannot conclude, as a blanket statement, that sales between these affiliates at prices other than market value would constitute an irrational business decision.

Q. In providing this explanation you assumed that EEInc. was a wholly-owned subsidiary of AmerenUE. Does your answer change if you recognize that EEInc. has other owners besides AmerenUE?

A. No. The principle here does not change, although the discussion becomes slightly more complicated. In the case of a sale from a partially-owned affiliate to a parent, care would have to be taken not to damage the economic interests of the other owners of the affiliate. However, in the particular case at hand, all of the owners of EEInc. are in the electric power business. Consequently, it is possible for the output from EEInc. to be sold on similar terms to each owner in proportion to each owner's respective ownership share, and re-marketed as each sees fit, without violating the principle of rationality.

Q. You also stated above that the energy from a cost-based power sale from EEInc. to AmerenUE could be resold by AmerenUE into the market with same net profit to AmerenUE's shareholders as would have occurred had EEInc. sold the power itself at market prices, *all other things being equal.* But *are* all other things equal?

[3] Corporations have a rational incentive to set relatively low transfer prices when the selling affiliate is domiciled within a taxing jurisdiction in which the corporate tax rate is higher than that of the purchasing

A. It depends. In the period between rate cases, under traditional treatment of off-system sales margins, the description of the situation as stated in the question is reasonably accurate. That is, between rate cases, AmerenUE should be relatively indifferent as to whether the power produced by EEInc. is sold at market prices directly by EEInc., or purchased on a cost-plus basis by AmerenUE, and then resold by AmerenUE at market prices. However, as soon as AmerenUE files a general rate case, the situation changes. If a rate case is filed, the off-system sales margins the Company would be earning from such sales are likely to be credited to retail customers.

Thus, once a general rate case is filed, all other things are no longer equal. This, of course, is where the real issue for AmerenUE lies. The issue is not that a transaction between affiliates at a below-market price is irrational by definition – affiliates can rationally transact at transfer prices other than market prices. The issue is that such an arrangement is less profitable for AmerenUE in the context of a rate case. Put another way, a power sales agreement between EEInc. and AmerenUE priced below market is not irrational as a threshold matter, as Professor Downs presumes, as the two companies are affiliates. Instead, there is a business decision to be made. That decision involves the profitability of AmerenUE, and that Company's clear intent to preclude its share of margins earned from the Joppa plant from being credited to retail customers.

Q. Professor Downs depicts your testimony as asserting that AmerenUE should have "forced" EEInc. to sell power at below market prices. Did you use the term "force" in your direct testimony?

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affiliate.

A. No. My testimony focuses on AmerenUE's own decision to forego the opportunity to purchase cost-based power from its share of the EEInc. Joppa generating plant. Based on my review of the Company's filing and deposition transcripts there is no evidence that AmerenUE ever *requested* that its contract with EEInc. be extended or renewed. This failure stands in sharp contrast to the requests for such an arrangement made by one of EEInc.'s co-owners, Kentucky Utilities.

Q. On page 5 of his rebuttal testimony, Professor Downs states that in advocating for a balancing of interests between shareholders and ratepayers, you have drawn this balance to exclude shareholder interests entirely. Do you agree?

A. No. The expired power sales agreement between EEInc. and AmerenUE established prices that assured a 15 percent return on shareholder equity. In calculating my proposed imprudence disallowance I have used the average price paid by AmerenUE under that prior contract in 2005, plus an escalator of 5 percent. Building in a 15 percent return on equity cannot reasonably be characterized as excluding shareholder interests.

Q. In his rebuttal testimony at page 4, lines 17-23, Professor Downs asserts that "AmerenUE is purchasing its power for fair market value" and, further, that you believe "that the acquisition by AmerenUE of power at market rates is somehow unjust or unreasonable." What is your response to these statements?

A. Professor Downs opens this section of his rebuttal testimony with a dubious premise, and concludes by drawing conclusions about my beliefs with respect to that premise. Professor Downs' statement that "AmerenUE is purchasing its power for fair market value" is a broad declaration of questionable factual merit. On its face, this statement can be taken to mean that Professor Downs believes AmerenUE is procuring all of its power from the market. This is untrue. Alternatively, Professor Downs may be assuming that AmerenUE is now purchasing EEInc.'s output at market prices. Yet, this too, is a hazardous presumption, as the Company's filing states that EEInc.'s output is being purchased by Ameren Energy Marketing Company, not by AmerenUE.

Whatever Professor Downs intends by his statement about market purchases, I make no assertions in my testimony regarding the appropriateness or inappropriateness of AmerenUE acquiring power from the market. Rather, my testimony addresses AmerenUE's failure to pursue a specific opportunity to procure cost-based power from the Joppa plant. Consequently, Professor Downs' assertions about my "beliefs" concerning the acquisition of power at market prices are misplaced.

Response to Michael L. Moehn

Q. In his rebuttal testimony, on pages 10-11, Mr. Moehn addresses the dual role of AmerenUE as owner and customer of EEInc. Do you have any response to Mr. Moehn's rebuttal?

A. Yes. Mr. Moehn acknowledges that AmerenUE had been a customer of EEInc. for over fifty years and, in that role, the Company assumed the obligation to pay for Joppa power while receiving the benefit of reliable, low-cost generation. Mr. Moehn goes on to state that with the expiration of the most recent PSA on December 31, 2005, these obligations and benefits ended. What Mr. Moehn does not explain is AmerenUE's failure to seek an extension of its contract with EEInc. under terms similar to those of the PSA that expired in 2005.

In defending the Company's position in the EEInc. matter, Mr. Moehn points to EEInc. as the decision maker with respect to the development of a post-2005 Power Supply Agreement.[4] That being the case (*arguendo*) one may reasonably ask why AmerenUE did not request a cost-based contract extension from this decision maker, as Kentucky Utilities did. This failure by AmerenUE to seek a contract extension under terms similar to the previous PSA is the glaring omission in the "EEInc. as Decision Maker" theory.

Either Ameren Corporation "called the shots," and AmerenUE used its representation on the EEInc. Board to carry out the Ameren corporate agenda with respect to the disposition of EEInc. generation; or EEInc. called the shots, as Mr. Moehn and Professor Downs maintain, in which case AmerenUE failed to act prudently to seek a cost-based contract extension. In either case, AmerenUE – as a regulated utility – should be held accountable for the cost consequences of its actions, or its failure to act, as the case may be.

[4] Rebuttal testimony of Michael L. Moehn, p. 7, lines 3-6. "AmerenUE did not choose to forego any such opportunity [to purchase cost-based power] because such opportunity did not exist after the expiration of the then current PSA on December 31, 2005. The Board of Directors of EEInc. made the decision to sell power from the Joppa Plant at market-based prices."

Q. Does this conclude your surrebuttal testimony?

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 KEVIN C. HIGGINS

STATE OF UTAH)
)
COUNTY OF SALT LAKE)

Kevin C. Higgins, being first duly sworn, deposes and states that:

1. He is a Principal with Energy Strategies, L.L.C., in Salt Lake City, Utah;

2. He is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Kevin C. Higgins;"

3. Said testimony was prepared by him and under his direction and supervision;

4. If inquiries were made as to the facts and schedules in said testimony he would respond as therein set forth; and

5. The aforesaid testimony and schedules are true and correct to the best of his knowledge, information and belief.

Kevin C. Higgins

Subscribed and sworn to or affirmed before me this 23rd day of February, 2007, by Kevin C. Higgins.

Margaret A. Petersen
Notary Public

My Commission No.: _____
My Commission Expires: 02-28-08
(SEAL)

NOTARY PUBLIC
MARGARET A PETERSEN
505 EAST 200 SOUTH
SALT LAKE CITY, UT 84102
My Commission Expires 2/28/2008
STATE OF UTAH