MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. EM-99-369

FROM: Michael S. Proctor
Chief Regulatory Economist

Director-Utility Operations Division/Date — General Counsel's Office/Date

SUBJECT: Staff's Recommendation For Approval Of The Application Of UtiliCorp United, Inc. Under §32(k) Of The Public Utilities Holding Company Act Of 1935 Concerning A Proposed Power Sales Agreement Between MEP Pleasant Hill, L.L.C. And UtiliCorp United, Inc., d/b/a Missouri Public Service

DATE: April 5, 1999

Missouri Public Service Commission Determinations under §32(k) of PUHCA

In order for Missouri Public Service (MPS), a division of UtiliCorp United, Inc. (UtiliCorp) to enter into a Power Sales Agreement (PSA) with Merchant Energy Partners Pleasant Hill, L.L.C. (MEPPH), a subsidiary of UtiliCorp, subsection 32(k) of the Public Utility Holding Company Act (PUHCA) of 1935 requires the Missouri Public Service Commission (Commission) to make the following determinations regarding the PSA:

1. it will benefit consumers;
2. it does not violate any state law;
3. it would not provide MEPPH any unfair competitive advantage by virtue of its affiliation or association with UtiliCorp; and
4. it is in the public interest.

The Commission must also make a determination that it has sufficient regulatory, resources and access to books and records of UtiliCorp and any relevant associate, affiliate or subsidiary company to exercise its duties under subparagraph 32(k)(2) of PUHCA. UtiliCorp in its Application at page 5, paragraph 11 states that:

> . . . The Commission's existing rules and regulations permit it to examine the books and records of UtiliCorp. Furthermore, the Commission, its Staff and the Office of the Public Counsel may examine the books, accounts, contracts and records of MEPPH as required for the effective discharge of the Commission's regulatory responsibilities affecting the provision of electric service by MPS."

In this memorandum and the accompanying memorandum of Staff members Mark Oligschlaeger and Steve Dottheim, it will be shown that the PSA, subject to the review and ratemaking conditions proposed by the Staff, meets all four of the subsection 32(k) PUHCA standards.

1. The PSA will benefit consumers

The capacity from PSA between MPS and MEPPH is required to meet the capacity reliability needs of MPS customers and is therefore of benefit to consumers. What follows is a description of the process by which the Staff has determined that there is a capacity need which the PSA will meet to the benefit of consumers.

The Staff has met with MPS on a regular basis following UtiliCorp's initial resource plan filing[1] required by 4 CSR 240-Chapter 22. In these meetings, MPS has provided Staff with updates on load forecasts as well as other changes that have occurred in its resource acquisition plans. In its resource plan filing, MPS stated its intention to implement a competitive bidding process to acquire the capacity needed to meet the requirements of its customers for capacity and energy. This need comes from two sources: (1) load growth in the MPS service territory; and (2) expiration of existing purchased power contracts. Most of the changes in UtiliCorp's resource acquisition strategy have come in the timing of resource additions.

[1] In its 1995 Missouri Energy Plan filed in May 1995 in Case No. EO-95-187, UtiliCorp included supply-side options for 206 megawatts (MW) in combined cycle capacity for the summers of 2000 and 2001. The supply-side implementation plan strategy included a competitive-bidding process that was to be completed in 1997.

For the summer of 1999, MPS has accredited generation capacity of 1,047 MW with 280 MW of purchased power from existing purchased power contracts to meet a total capacity requirement[2] of 1,366 MW. Not directly related to this pleading, MPS is evaluating bids for purchased power of 50 MW to meet its capacity requirement for this summer. The contracts making up the 280 MW of purchase power will expire and not be available to meet load for the summer of 2000. Thus, there is clearly a need for either purchased power or MPS owned capacity starting with the summer of 2000.

It is important to note that the MPS purchase power acquisition strategy was split between meeting a short-term need and a long-term need. For the short-term (prior to the summer of 2001), MPS planned to enter into one- or two-year contracts for purchased power. Starting for the year 2001, MPS would seek longer-term contracts. In part, the rationale behind this strategy is that the short-term contracts would have to come from generating units that were already built, while the longer-term contracts would allow bids from new generating units that would not be available to supply power in the short-run.[3] The PSA between MPS and MEPPH is for a longer-term contract.

In the year 2001, MPS plans to improve the accredited capacity of its existing generating units from 1,047 MW to 1,085 MW. MPS plans to have a short-term purchase of 25 MW and begin the first year of its long-term contract with MEPPH with 320 MW of combustion turbine capacity. This provides a total capacity of 1,430 MW to meet a capacity requirement of 1,430. In the year 2002, the short-term purchased power contracts are terminated and the long-term

[2] The capacity requirement is the peak demand forecast, minus demand-side reductions such as interruptible load, plus a capacity reserve margin of 12 percent.

[3] How this strategy evolved is described in the third section of this memorandum.

contract with MEPPH goes up to 500 MW as MEPPH adds 180 MW of combined cycle capacity to the 320 MW of combustion turbines.

2. **The PSA does not violate any applicable state law**

Staff counsel has advised that state law does not prohibit any utility from purchasing power rather than building generation. In addition, Staff counsel has indicated that there is no state law that prohibits any electric utility from purchasing power from an affiliate.

3. **The PSA did not provide MEPPH any unfair competitive advantage by virtue of its affiliation with UtiliCorp**

As described below, the competitive bidding strategy employed by MPS involves a complex process that would more properly be described as a competitive negotiation. In addition, this process was flexible; allowing MPS to change its strategy as information became available. The Staff's limited observation/review of that process found no evidence to indicate that an unfair competitive advantage was afforded MEPPH.

As MPS developed its resource acquisition strategy for purchased power, the Staff made it clear that if an affiliate of UtiliCorp were to bid, that affiliate would need to be on a level playing field with all other potential bidders. This means no communications regarding the competitive bid between people representing the interests of MPS and those representing the interests of the affiliate, except through the formal competitive bidding/negotiation process. It also means that the affiliate would have to bid at the same time as others and that a transparent evaluation of the bids would need to take place.

The history of the competitive bidding/negotiation process for the long-term purchased power contract is as follows:

(1) Initial Request for Proposals was issued by MPS on May 22, 1998. At this time, MPS wanted capacity to be supplied beginning June 1, 2000 and go through May 31, 2004; i.e., a four-year contract, with capacity initially available for the summer of 2000.

(2) Eight proposals were received on July 3, 1998. The eight proposals were opened on July 6, 1998. One of the eight proposals was from Aquila Power Corporation (Aquila), a power-marketing subsidiary of UtiliCorp. Both Aquila and UtiliCorp/MPS have their principal offices and places of business at 10750 East 350 Highway, Kansas City, Missouri 64138. An outside consultant, Burns & McDonnell, a Kansas City engineering and consulting firm, reviewed all proposals. Initial evaluation of the proposals was completed on August 21, 1998 by Burns & McDonnell. On August 25, 1998, all bidders were requested to confirm their interest and update their proposals. All but three of the bidders (New Century Energies, Aquila and Basin Electric Cooperative) stated that they would not be able to provide capacity in time for the summer of 2000. From the three that could meet the summer 2000 requirement, the Basin Electric Cooperative bid was determined to not be cost effective because of its high capacity charge. In addition, UtiliCorp was in the process of negotiating purchased power for its West Plain's service territory in Kansas, for which it had received a bid from Sunflower Electric Cooperative (Sunflower) that included capacity that would be available for the June 2000 to May 2001 period. MPS made the decision to split its purchases between short-term capacity and long-term capacity, with the three bidders that could meet the short-term need (Aquila, New Century Energies and Sunflower) being included in the evaluation process for the short-term purchase power contracts.

(a) At this time, UtiliCorp concluded that it could build a generation plant at a lower cost than what it had received in bids from those who were proposing to supply from newly built generation. UtiliCorp was seriously considering building its own generation to meet the MPS long-term capacity need and in September 1998 formed MEPPH as a subsidiary to develop, own and manage UtiliCorp's portfolio of exempt wholesale generators (EWG), independent power producers (IPP) and cogeneration facilities and to possibly build and own generation for Missouri retail jurisdictional needs as an EWG. However, this capacity would not be available for the summer of 2000 and perhaps not even for the summer of 2001. The EWG option under consideration by MPS and the Aquila proposal for June 2001 through May 2004 were assigned to MEPPH.

(b) By November 3, 1998, the evaluation of the three short-term bids was completed with MPS determining that a combination of Sunflower and Aquila resources was the most cost effective.

(3) On November 6, 1998, MPS requested that bidders again confirm their interest and update their proposals that would begin supply in the summer of 2001. On November 30, 1998, only two of the eight companies submitted revised bids: Aquila Power/MEPPH and Houston Industries for the June 2001 through May 2006 period. These bids were evaluated by MPS as well as by its outside consultant, Burns & McDonnell. It was determined that the Houston Industries bid was not competitive. MPS contacted Houston Industries on December 21, 1998 to advise it that its bid was not cost effective and requested that it consider revising its

proposal. Houston Industries revised its proposal on January 6, 1999, and MPS received confirmation that MEPPH would replace Aquila as the owner of the proposed EWG and would be the entity contracting with MPS. MEPPH revised its proposal on January 12, 1999. It appears that in the evaluation/negotiation process, Houston Industries was given the first opportunity to revise its bid, and then MEPPH was given an opportunity to respond. The rational for this sequence is that the bidder with the non-competitive bid is allowed the first opportunity to make its bid competitive. After receiving the January 12, 1999 revision from MEPPH, MPS informed Houston Industries on January 13, 1999 that its revised bid was not competitive. On January 14, 1999, Houston Industries responded that it was not able to improve its offer. On January 15, 1999, Houston Industries was advised that it was not the successful bidder, and MPS awarded the contract to MEPPH, subject to further negotiations on final terms and conditions.

4. The PSA is in the public interest

The public interest is met when electricity is provided to end-use consumers at the lowest expected cost consistent with reasonable levels of risk associated with cost varying from its expected level. In today's environment of competitive wholesale power, properly implemented competitive bidding and/or negotiation for purchased power is a process by which least-cost acquisition of resources can be obtained. Based on the information presently available, the competitive bidding/negotiation process used by MPS appears to be consistent with obtaining the needed purchased power at least cost. Therefore, the Staff is willing to state that the PSA between MPS and MEPPH is in the public interest, subject to the conditions and ratemaking

standards discussed below and in the accompanying recommendation, which will permit a detailed review of the transaction in the context of a rate increase or earnings complaint case.

It is important to note that the Staff has not evaluated the two proposals to determine which is least cost or whether accepting either of the two proposals would be a prudent management decision. Moreover, this Commission does not pre-approve the acquisition of resources by electric utilities. Instead, in its 1993 rulemaking on electric resource acquisition (4 CSR 240-Chapter 22), this Commission enacted rules that focused on the process, not the outcome. At the time these rules were adopted by the Commission, the Federal Energy Regulatory Commission (FERC) had not issued Order No. 888, which is premised on open transmission access on a non-discriminatory basis as being a means of fostering a competitive wholesale market for electricity. Thus, the Chapter 22 rules do not include any specific guidelines for competitive bidding or negotiations.

Since the Commission's adoption of 4 CSR 240-Chapter 22, there has been only one case in which the Commission was asked to evaluate whether or not the resource chosen by an electric utility was least cost prior to introducing the costs associated with the resource into rates.[4] This request that the Commission evaluate whether a resource chosen is least cost occurred because one of the options that was rejected by the utility was a cogenerator, and under the Public Utility Regulatory Policies Act of 1978 (PURPA), utilities are required to purchase from cogenerators that are competitive under an avoided cost criteria. Neither Houston Industries nor MEPPH are claiming to be a cogeneration facility. It is important to note that a review of the testimony submitted in that case indicates that a significant amount of analysis is required to determine which alternative is least cost.

[4] Alstrom Development Corporation vs. Empire District Electric Company, Case No. EC-95-28, Report And Order, 4 Mo.P.S.C.3d 187 (1995).

At this time, the Staff has not performed a detailed analysis of which of the two alternatives is least cost. Such an analysis should be done prior to the Commission approving the costs of the PSA in rates for Missouri Public Service customers. Subject to this condition, it is not necessary that this analysis be conducted at this time in order to determine whether or not the PSA is in the public interest. Moreover, to make such a determination at this time would put the Commission in the position of pre-approval of the prudency of MPS entering into the PSA, which is an approach that the Commission uniformly has rejected over many years. UtiliCorp in its Application recognizes and accepts the Commission's historical approach, wherein at paragraph 15, UtiliCorp states as follows:

> UtiliCorp understands that an order containing the findings required by the PUHCA with respect to the PSA shall in no way be binding on the Commission or any party to a future rate case to contest the ratemaking treatment to be afforded the PSA.

UtiliCorp also notes in its Application that:

(1) a copy of the RFP was forwarded to the Staff and the Office of the Public Counsel (Public Counsel) on August 24, 1998 for comment under the integrated resource plan format (page 3, paragraph 5 of Application);

(2) the eight (8) proposals received in response to the RFP were forwarded to the Staff and Public Counsel on August 24, 1998 under the integrated resource plan format (page 3, paragraph 6 of Application); and

(3) the reviews and evaluations of the proposals were provided to the Staff and Public Counsel on February 8, 1998 (page 3, paragraph 6 of Application).

As previously commented upon above, the 4 CSR 240-Chapter 22 rules focus on process, not outcome, and the review under these rules is not intended to have the Commission and its Staff engage in a contemporaneous evaluation with the utility of the proposals solicited to determine which is least cost or whether accepting any one of them would be a prudent management decision. Although the Commission generally has or can acquire sufficient regulatory resources

to exercise its ratemaking duties when a utility seeks to reflect a resource decision in rates, the Staff does not want its position to be misinterpreted as indicating or implying that the Commission also has sufficient regulatory resources to exercise its ratemaking duties if utilities were to also seek pre-approval of their resource decisions.

The timing of the instant project to meet the June 1, 2001 on-line date is crucial. A determination of which of the options is least cost would involve a Staff analysis that at best could take several weeks, but more likely would take several months, to complete. If the results of the analysis were not in favor of approval of the PSA with MEPPH, written testimony and hearings would need to take place. All of this would put off the time at which MEPPH would initiate the building of the generating units required to meet the June 1, 2001 deadline for capacity.

The Staff believes that what is needed to determine that the PSA is in the public interest is a review of the process followed by MPS in acquiring the needed capacity. In the context of its ongoing efforts in reviewing the resource plans of MPS, the Staff believes that the process followed by MPS is adequate to meet the public interest standard, subject to the review and ratemaking conditions set out above and the accompanying Staff recommendation of Staff members Mark Oligschlaeger and Steve Dottheim.

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