Exhibit No.: 704
Issue: *Merger Premium*
Merger Tracking,
Frozen Capital Structure
Witness: Cary G. Featherstone
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Rebuttal Testimony*
Case No.: *EM-2000-292*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

CARY G. FEATHERSTONE

UTILICORP UNITED INC.
AND
ST. JOSEPH LIGHT & POWER COMPANY

CASE NO. EM-2000-292

Exhibit No. 704
Date 7/12/00 Case No. EM-2000-292
Reporter KRM

Jefferson City, Missouri
May, 2000

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UTITICORP UNITED INC.

AND

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CASE NO. EM-2000-292

Q. Please state your name and business address.

A. Cary G. Featherstone, 3675 Noland Road, Independence, Missouri.

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

A. I am a Regulatory Auditor with the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. I graduated from the University of Missouri at Kansas City in December 1978 with a Bachelor of Arts degree in Economics. My course work included significant study in the field of Accounting.

Q. What has been the nature of your duties while in the employ of this Commission?

A. I have assisted, conducted and supervised audits and examinations of the books and records of public utility companies operating within the State of Missouri. I have participated in examinations of electric, industrial steam, natural gas, water and sewer and telecommunication companies. I have been involved in cases concerning proposed rate increases, earnings investigations and complaint cases as well as cases relating to mergers and acquisitions and certification cases.

Q. Have you previously filed testimony before this Commission?

A. Yes, I have. Schedule 1 to this testimony is a summary of rate cases in which I have submitted testimony. In addition, Schedule 1 identifies other cases I have directly supervised and assisted.

Q. With reference to Case No. EM–2000-292, have you made an examination and study of the books and records of UtiliCorp United, Inc. and St. Joseph Light & Power Company relating to the proposed merger application?

A. Yes, with the assistance other members of the Commission Staff (Staff).

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of UtiliCorp United, Inc. (UtiliCorp or UCU) and St. Joseph Light & Power Company (St. Joseph or SJLP), together referred to as the "Joint Applicants" or "Companies," regarding their proposal to merge. I will provide testimony setting out a general review of the regulation of utility merger and acquisition activity in the state of Missouri. I will present testimony relating to what is commonly referred to as the "acquisition adjustment" (or "merger premium") resulting from the proposed merger. I will also address the issue of rate recovery of this "merger premium" along with Staff Accounting witnesses Mark L. Oligschlaeger, Charles R. Hyneman and Janis E. Fischer. Staff witnesses David Broadwater of the Financial Analysis Department and Michael S. Proctor of the Electric Department also address the acquisition adjustment issue.

Q. How is your testimony organized?

A. The following represents the structure of the testimony by areas:

1. Mergers and Acquisition Background
2. Background of the St. Joseph Light & Power Merger with UtiliCorp United Inc.
3. Standard of Public Detriment
4. Acquisition Adjustment
5. UtiliCorp's Regulatory Plan
6. Historical Perspective Relating to Acquisition Adjustments
7. Gains on Sale of Utility Property
8. Disallowance of Merger Premiums in Rates does not Affect Mergers being completed in Missouri
9. Termination of the KCPL Merger with Western Resources
10. Merger Tracking
11. Customers are Entitled to Savings Generated by Utilities for either Merger or Nonmerger events
12. Commitments Made/Promises Kept
13. Capital Structure

MERGERS AND ACQUISITIONS BACKGROUND

Q. What has been your past experience relating to other mergers and acquisitions?

A. I have been involved in Staff's review of several merger and acquisition applications filed with the Commission.

Kansas City Power & Light Company Merger with Western Resources, Inc.— Case No. EM-97-515

I was project coordinator for Staff's review of Kansas City Power & Light Company's (KCPL) proposed merger with Western Resources, Inc. (Western Resources). On May 30, 1997, KCPL and Western Resources filed their initial application with the Commission requesting approval of a merger between KCPL and Western Resources. This application was designated as Case No. EM–97-515. A Stipulation and Agreement was filed with the Commission on July 20, 1999 and on September 2, 1999, the Commission issued an Order Approving Stipulation and Agreement.

Union Electric Company Merger with CIPSCO, Inc.—Case No. EM-96-149

Staff witnesses Oligschlaeger, Hyneman and I were involved in the Staff review of the proposed merger between Union Electric Company (Union Electric) and CIPSCO Inc. (CIPSCO). This merger was announced in August 1995 and was not completed until December 31, 1997. On November 7, 1995, Union Electric filed an application with the Commission requesting authority to merge designated as Case No. EM–96–149. The Commission conditionally approved this merger in a Report And Order issued on February 21, 1997.

Kansas City Power & Light Company Merger with Kansas Gas & Electric Company— Case No. EM-91-16

Along with other members of the Staff, I was involved in the review of the hostile tender offer to Kansas Gas & Electric Company (KGE) shareholders made by KCPL. On July 16, 1990, KCPL filed an application with this Commission to acquire and merge with KGE, which was docketed as Case No. EM–91–16. After KGE signed a merger agreement with Western Resources, known at the time as the Kansas Power & Light Company (KPL), KCPL withdrew its tender offer on December 13, 1990.

Kansas Power & Light Company Merger with Kansas Gas & Electric Company—Case No. EM-91-213

I was also involved in the review of KPL's merger with and acquisition of KGE. On November 21, 1990, KPL filed an application with this Commission docketed as Case No. EM–91–213, requesting authority to acquire all classes of capital stock of KGE, merge with KGE, and issue stock and incur debt obligations relating thereto. That application was a result of a definitive Agreement and Plan of Merger dated October 28, 1990, which was executed between the two companies. The Commission authorized the KPL merger with KGE in a Report And Order dated September 24, 1991. The State Corporation Commission of the State of Kansas (Kansas Commission or KCC), in Consolidated Docket Nos. 172,745-U and 174,155–U, approved that same merger on November 15, 1991. After receiving the necessary regulatory approvals, KPL completed the merger with KGE on March 31, 1992.

Southern Union Company Acquisition of Missouri Properties of Western Resources, Inc., d/b/a Gas Service—Case No. GM-94-40

I was also involved in the Staff's review of the Joint Application filed with the Commission on August 5, 1993 for the authorization to sell, transfer and assign certain assets relating to the provision of natural gas service in Missouri from Western Resources, d/b/a KPL Gas Service to Southern Union Company (Southern Union). This case was docketed as Case No. EM–94–40. The Joint Application was a result of an Agreement for Purchase of Assets dated July 9, 1993, which was executed between the two companies. The Commission approved this purchase transaction on December 29, 1993. Southern Union continues to operate this natural gas distribution system in the western part of Missouri as Missouri Gas Energy (MGE).

I was also one of the witnesses who addressed a proposal made by MGE in its 1996 rate case (Case No. GR-96-285) to share in purported savings relating to the acquisition.

Q. What other experience do you have regarding mergers and acquisitions?

A. I was involved in discussions with other Staff members reviewing the Union Electric acquisition of Arkansas Power & Light Company's (APL) Missouri properties, docketed as Case No. EM-91-29. This application was filed on August 2, 1990 and was approved in a Report And Order issued on September 19, 1991.

I have been involved in several other merger and acquisition applications filed with the Commission. Included among these applications was the application of United Cities Gas Company (United Cities) to acquire Monarch Gas Company, docketed as Case No. GM-96-180. This application was filed on November 29, 1995 and was approved by the Commission on March 22, 1996.

I presented testimony in Case No. GR-90-152 on the proper ratemaking treatment of the acquisition adjustment resulting from the acquisition of Associated Natural Gas Company by Arkansas Western Gas Company.

Also, I have been involved in examining the impacts of acquisition and merger activities of another utility operating within the State of Missouri. Specifically, I was involved in the supervision of an audit of UtiliCorp's Missouri Public Service (MPS) division in Case No. GR-88-194, wherein the Staff examined UtiliCorp's Corporate Office function, particularly the impacts on cost of service of that utility's acquisition and merger strategy, in the context of a natural gas rate increase case.

In addition, I was the principal Staff witness on the Corporate Office costs issue in UtiliCorp's 1990 electric rate increase case, Case No. ER–90–101, et al., respecting the MPS division's electric operations.

I have also reviewed several other applications filed with the Commission relating to acquisitions of utility property, primarily involving UtiliCorp.

BACKGROUND OF THE ST. JOSEPH LIGHT & POWER MERGER WITH UTILICORP UNITED, INC.

Q. Do UtiliCorp and St. Joseph currently provide utility services within the State of Missouri?

A. Yes. St. Joseph provides electric, natural gas and industrial steam to customers in the northwest part of the State of Missouri.

UtiliCorp operates regulated retail electric utility service in the States of Missouri, Kansas and Colorado serving approximately 349,000 customers. UtiliCorp also provides natural gas distribution service to 831,000 customers in the States of Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota.

Q. What is the history of St. Joseph Light & Power Company?

A. According to St. Joseph's 1998 Annual Report to Shareholders, St. Joseph "has been in the public utility business since 1883. It became an independent, investor-owned business in 1950." It was incorporated in the State of Missouri in 1895.

St. Joseph generates and distributes electricity to over 62,000 retail customers in 74 cities, towns and villages, and in a large rural area encompassing 3,200 square miles in northwest Missouri. In 1998 electric revenues represented about 70% of total revenues. St. Joseph also supplies natural gas to approximately 6,400 customers in Maryville and 14 other communities. St. Joseph provides industrial steam to six customers in St. Joseph, Missouri. In addition, in September 1996, SJLP Inc. was formed as a wholly–owned, non–regulated subsidiary of St. Joseph. Subsequently, SJLP, Inc. acquired a controlling interest in Percy Kent (manufacturer of paper bags).

Q. What caused the Staff's review in this case?

A. On October 19, 1999 UtiliCorp filed an application with the Commission requesting approval of a merger between UtiliCorp and St. Joseph as a result of the "Agreement and Plan of Merger" (Merger Agreement) dated March 4, 1999.

Under terms of this Merger Agreement, St. Joseph will merge with and into UtiliCorp.

Q. What regulatory approvals must UtiliCorp and St. Joseph receive to complete the merger?

A. The Proxy Statement/Prospectus of St. Joseph (Proxy Statement) dated May 6, 1999 (pages 28 and 29) identifies the regulatory approvals the Companies must receive to complete the merger. Besides this Commission, the Companies must receive approvals from the State commissions in Colorado, Iowa, Minnesota, and West Virginia (UtiliCorp disposed of its West Virginia properties as of December 31, 1999 and no longer requires regulatory approval from that State's commission). The Companies need approval from the Federal Energy Regulatory Commission (FERC) under the Federal Power Act. The Companies also need approval from the Securities and Exchange Commission (SEC). In addition, the Department of Justice and Federal Trade Commission have to review the merger.

Q. How did UtiliCorp approach St. Joseph to bring about this merger proposal?

A. UtiliCorp submitted a proposal to merge with St. Joseph in a bidding process to acquire all the common stock of St. Joseph. This bidding process was initiated by St. Joseph through its financial advisor, Morgan Stanley Dean Witter (Morgan Stanley) in late 1998.

Q. What is the purchase price being offered by UtiliCorp for St. Joseph?

A. UtiliCorp is paying a fixed value of $23.00 of its common stock for each share of St. Joseph's common stock. According to the direct testimony (page 6) of UtiliCorp witness Robert K. Green the total value of the merger transaction is $270 million, of which $190 million relates to the "purchase" of approximately 8.2 million shares of St. Joseph's common stock and the assumption of an expected $80 million in liabilities. This represents a $92 million or an approximately 36 percent merger premium to the book value of St. Joseph. The UtiliCorp common stock will be valued based on the average trading price for UtiliCorp's common stock during the 20 trading days ending on the fifth trading day prior to the closing date (Proxy Statement, page 31).

All the operations of St. Joseph will be merged with and into the operations of UtiliCorp, and St. Joseph will be operated as a division of UtiliCorp. UtiliCorp will maintain the St. Joseph Light & Power Company's name as a trade name within the existing service territory of St. Joseph.

Q. Why did St. Joseph seek a buyer for its utility property?

A. The Proxy Statement (pages 14 through 16) identifies in detail the process that the Board of Directors of St. Joseph engaged in to conduct a series of analyses relating to its future operations. Also, the direct testimony of Mr. Terry F. Steinbecker, Chairman of the Board, President and Chief Executive Officer of St. Joseph, (pages 2 through 6) there is similar detail about the merger process that St. Joseph used to determine its future corporate structure. Some of the more important events that occurred during the period of 1995 to the March 4, 1999, the date the merger agreement was executed, are as follows:

- Prior to 1995, St. Joseph's Board of Directors (Board) studied various strategies for maximizing shareholder value.

- In 1995, St. Joseph retained a consulting firm, Planmetrics, Inc., which presented to the Board an analysis in January 1996 relating to Strategic Planning of St. Joseph. This presentation was used by the Board to make decisions on St. Joseph's diversification program.

- The diversification program resulted in the acquisition of several companies by St. Joseph, including Percy Kent, who is a manufacturer of small paper bags for food, agricultural, chemical, pet food and other consumer packaging companies.

- In 1998, St. Joseph retained another consulting firm, Scott, Madden & Associates, Inc. (Scott, Madden), which issued a confidential report to the Board of Directors on St. Joseph's Strategic Planning. Scott, Madden recommended that St. Joseph should sell the Company.

- On July 15, 1998, the Board approved the retention of Morgan Stanley as financial advisor to St. Joseph. Morgan Stanley was instructed to develop potential strategic alternatives for maximizing shareholder value, including a potential merger or strategic alliance.

- On October 14, 1998, Morgan Stanley outlined the strategic challenges facing St. Joseph and recommended that St. Joseph explore a potential business combination with a larger utility company as the best means of maximizing long-term value for St. Joseph's shareholders.

- At the October 14 meeting, the Board instructed Morgan Stanley to contact seven companies for the purpose of obtaining expressions of interest in a potential business combination.

- Between November 27 and December 2, 1998, two of the seven potential bidders informed Morgan Stanley of their interest in receiving information about St. Joseph. During a December 4 meeting with the Board, Morgan Stanley informed the Board that a third party had indicated an expression of interest.

- Between December 16 and 18, 1998, Morgan Stanley received a preliminary expression of interest from each of three potential bidders. On December 21, Morgan Stanley discussed financial and non-financial aspects of the non-binding bids that contained preliminary proposed valuations of between $19.70 and $22.25 per share of St. Joseph common stock.

- Between January 12 and 21, 1999, the three parties that submitted non-binding bids performed due diligence reviews of St. Joseph.

- Between January 7 and February 17, 1999, St. Joseph's management conducted a due diligence review of the three interested parties.

- On February 16, 1999, St. Joseph received final binding proposals from two of the three interested parties. UtiliCorp's proposal was a fixed value of $22.50 per share of St. Joseph common stock. The second proposal was an all stock transaction at a value of $21.28 per share of St. Joseph common stock, with a downward price adjustment in the event of a reduction in the bidder's share price. The third interested party had informed Morgan Stanley it did not intend to submit a final binding proposal.

- On February 19, 1999 the Board met to review and compare the two binding bids. Because UtiliCorp had the higher and fixed nature of the bid, Morgan Stanley was requested to see if UtiliCorp would increase its offer. Morgan Stanley contacted UtiliCorp and encouraged it to increase its bid. UtiliCorp raised its bid to $23.00 per share of St. Joseph common stock.

- Based upon the increase in price to $23.00 per share and the more favorable structure of UtiliCorp's bid, on February 22, 1999 the Board of Directors authorized management and St. Joseph's legal advisors to negotiate a definitive merger agreement with UtiliCorp. This occurred over the next ten days.

- Sometime after February 22, 1999 and prior to March 4, Morgan Stanley contacted the financial advisor of the other bidder, which did not augment its proposal as a result of that conversation.

- On March 4, 1999 Morgan Stanley presented an opinion to St. Joseph's Board that the merger consideration is fair.

- On March 4, 1999 St. Joseph executed the merger agreement with UtiliCorp based on unanimous approval of the Board.

- On March 5, 1999 the merger was publicly announced.

The Board unanimously approved the merger with UtiliCorp, and Morgan Stanley presented its fairness opinion in accordance with their responsibilities to the shareholders of St. Joseph.

Q. Did the Board recommend approval of the merger to the shareholders of St. Joseph?

A. Yes.

Q. Did the shareholders approve the merger?

A. Yes. At a special meeting held on June 16, 1999, St. Joseph's shareholders approved the merger by the necessary two-thirds approval with a 68.6 percentage participation. This represented a 96.3 percent approval of those shares that voted.

Q. What were the reasons the Board recommended approval of the merger?

A. The Proxy Statement (pages 16 and 17) identified reasons the Board approved the merger. The overwhelming majority of reasons the Board approved and recommended shareholder approval dealt with St. Joseph's ownership issues. Very little mention is given to St. Joseph's customers or employees.

The reasons the Board believed the shareholders should approve the merger with UtiliCorp are identified in the Proxy Statement as follows:

- the merger **consideration offers St. Joseph's shareholders an attractive premium** over the recent historical trading prices of St. Joseph's common stock;

- the merger **offers St. Joseph's shareholders a more liquid market** for their shares;

- as a result of the merger, **St. Joseph's shareholders will most likely benefit from UtiliCorp's dividend rate,** which currently is, and in recent years has been, higher than St. Joseph's dividend rate;

- **St. Joseph's shareholders will benefit by participating in the combined economic growth of the service territories** of UtiliCorp and St. Joseph, and from the inherent increase in scale, the market diversification and the resulting increased financial stability and strength of the combined entity;

- the merger **will result in cost savings from decreased electric production and gas supply costs, a reduction in operating and maintenance expenses** and other factors;

- the combined enterprise **can more effectively participate in the increasingly competitive market** for the generation of power;

- UtiliCorp has significant non-utility operations and, as a larger and stronger financial entity following the merger, should be able to **manage and pursue further non-utility diversification activities** more efficiently and effectively than St. Joseph as a stand-alone entity; and

- the merger and various provisions of the merger agreement **offer St. Joseph's shareholders, customers and employees** and the St. Joseph community a unique **opportunity to realize the benefits** created by combining the two companies.

[emphasis added]

The reasons cited by the Board in its communication to the shareholders regarding the merger clearly illustrates that the merger is about increasing the overall wealth of St. Joseph's shareholders. As previously noted, in the Proxy Statement, and as stated in Mr. Steinbecker's direct testimony (pages 2 through 4), the Board made its decision to merge with UtiliCorp based solely on "maximizing shareholder value." The payment of the merger premium to St. Joseph's shareholders; more liquid market for trading St. Joseph's common stock; the increased dividend;

the opportunity to be part of a larger combined economic growth company; the opportunity to "keep" the vast majority of the merger savings; the ability to participate in the increasingly competitive market for power; the opportunity to manage and pursue further non-utility diversification; and the opportunity to realize the benefits of the combined company all relate directly to "maximizing shareholder value." To that end, the merger process engaged in by St. Joseph was a success. St. Joseph ensured that the interest of its shareholders was first and foremost in the merger analyses. The customers' interests were secondary in all respects.

Q. Will this proposed merger benefit employees?

A. It is uncertain if the merger will benefit employees the way it will benefit shareholders. Early in the merger process, UtiliCorp announced there would be reductions in excess of 100 employee as the result of the merger. This reduction represents a significant part (almost one third) of the 339 employees St. Joseph employed as of December 31, 1998. For those employees fortunate enough to retain their jobs, there may be some benefits to them that result from the merger of these two entities. One of the benefits may be more career opportunities that a larger organization can provide. Also, St. Joseph's employees may receive additional training opportunities because of the size of the merged company.

Q. Will the merger benefit customers?

A. Compared to the two stakeholders previously discussed, shareholders and employees, benefits to St. Joseph's customers are the least likely to receive benefits from this merger. Under the regulatory plan proposed by UtiliCorp, St. Joseph's customers will have to wait almost six full years before any merger savings are returned to them through rates. At the same time, St. Joseph's customers will not have the opportunity for any rate reductions that might have resulted from productivity gains, technological improvements and other non-merger matters that might take place. These non-merger matters typically result in cost reductions that are periodically passed on to customers in the form of rate reductions. UtiliCorp's and St. Joseph's proposed regulatory plan asks customers to give up their right to reductions in rates simply because UtiliCorp wants to merge with St. Joseph.

Q. Have there been any rate reductions in the recent past for St. Joseph customers?

A. Yes. There have been several rate reductions over the last 15 years. St. Joseph customers enjoy some of the lowest electric rates in the State. Staff Accounting witness Phillip K. Williams is addressing St. Joseph's electric rates over an historical time frame as well as the history of rate reductions since the mid-1980's in his rebuttal testimony.

Q. Will these rate reductions continue if the merger with UtiliCorp is completed?

A. It is unlikely. In fact, under the regulatory plan proposed by the Companies, St. Joseph's rates will be "frozen" for at least five years after the merger closes. At the close of the five-year moratorium period, UtiliCorp plans on a rate case to address the recovery of the acquisition adjustment and any other rate matters. The acquisition adjustment will be a significant cost that may very well contribute to the need to increase rates.

To the extent this merger results in the elimination of rate reductions for St. Joseph's customers, the merger is a detriment to the public interest. If that happens, the consequences of the merger can be summarized as follows:

- benefits to St. Joseph's shareholders who will receive the merger premium

- benefits to UtiliCorp shareholders for having a strategically larger company in which it will be better positioned to compete in the changing electric utility industry,

- detriments to St. Joseph's employees who lose their jobs because of the merger,

- potential detriments to the City of St. Joseph which will lose one of the community's larger employers and adverse impacts to the local economy with loss of the corporate offices of St. Joseph Light & Power and loss of in excess of 100 jobs, and

- detriments to St. Joseph's customers in (1) the loss of possible future rate reductions, and (2) potential for increased rates as result of rising costs, recovery of the merger premium and the shifting from lower administrative and general (A&G) costs of the stand-alone SJLP to the substantially higher A&G costs of UtiliCorp.

STANDARD OF PUBLIC DETRIMENT

Q. What standard did Staff utilize to develop its recommendation regarding the proposed merger between UtiliCorp and St. Joseph?

A. Staff utilized the standard of "detriment to the public interest," as it has in the other merger cases in which I have participated. If the Joint Applicants fail to show that the proposed merger of UtiliCorp and St. Joseph is not detrimental to the public interest in Missouri, i.e., if it is not demonstrated that the Missouri public will not be harmed by the proposed merger, then the Commission should reject this application and not approve the proposed merger. Staff counsel has advised that the "not detrimental to the public interest" standard is based on case law generally cited in Commission Orders as State ex rel. City of St. Louis v. Public Serv. Comm'n, 73 S.W.2d 393 (Mo.banc 1934); State ex rel. Fee Fee Trunk Sewer Co., Inc. v. Litz, 596 S.W.2d 466 (Mo.App. 1980). Staff counsel also advises that the Commission has incorporated the "not detrimental to the public interest" standard in its rules requesting applications for 4 CSR 240-2.060(8)(D).

Q. How is Staff defining the term "public?"

A. Consistent with Staff's position in other merger cases, Staff views the members of the "public" that are to be protected as those consumers taking and receiving utility service from St. Joseph's electric, natural gas and industrial steam operations in the State of Missouri.

In this case, Staff would define "public interest" as referring to the nature and level of the impact or effect that St. Joseph's merger action will have on its Missouri customers. This includes St. Joseph's electric, natural gas and industrial steam customers. There is a fundamental concern in the regulation of public utilities that the public being served must not be impacted adversely or harmed by those responsible for providing monopoly services. Public utilities in Missouri are charged with providing safe and adequate service at nondiscriminatory, just, fair and reasonable rates. If this merger results in adverse or negative impacts to St. Joseph's Missouri electric customers, natural gas customers and industrial steam customers, then the Commission should not approve the Joint Applicants' merger application or, in the alternative, should impose conditions sufficient to overcome the detriments of the merger.

In the merger case involving KPL and KGE in 1991, the Commission identified the "public" as Missouri ratepayers. At pages 12 to 13 of its Report and Order (Case No. EM–91–213), the Commission stated the following:

> The Commission has found no evidence in this record that KPL would be unable to render safe and adequate service to its Missouri ratepayers as a consequence of the proposed merger. However, the Commission has found that the savings sharing plan proposed by KPL as part of its merger application has the potential of exposing Missouri ratepayers to higher rates than would be the case without the merger which would be **detrimental to the public interest** . . . .
>
> The Commission has also found that there is potential for a **detrimental effect on Missouri ratepayers** from the merger through increased A & G and capital costs . . . .
>
> Based upon these findings and determinations, the Commission concludes that Missouri ratepayers will be shielded from any

> potential ill effects from the proposed merger and will suffer **no detriment** as a result. Therefore, the Commission concludes that, in the absence of a finding of **detriment to the public interest,** it may not withhold its approval of the proposed merger and will authorize KPL to acquire and merge with KGE.
>
> [emphasis added]

Clearly, the Commission was identifying the Missouri ratepayers as the relevant "public" in its Report and Order. This is the standard that is being applied by the Staff to the proposed merger between UtiliCorp and St. Joseph.

Q. Is Staff defining "detriment to the public interest" differently in this case than it has in previous merger cases?

A. No. Although this merger is being evaluated based on the **no detriment standard** for all of St. Joseph's Missouri customers in the three utility operations for which it supplies public service, another equally important group of customers must be considered. Unlike other mergers that have typically occurred in this State where only one of the two utilities has a Missouri service territory, this merger has additional Missouri customers that must be considered. UtiliCorp provides electric and natural gas service to Missouri customers through its Missouri Public Service division. Thus, the Commission should also evaluate this merger using the **no detriment standard** as it relates to UtiliCorp's Missouri customers.

ACQUISITION ADJUSTMENT

Q. Will this merger transaction result in an acquisition adjustment?

A. Yes. UtiliCorp will have to record on its books, for a period of 40 years, the acquisition adjustment which results from the merger premium being paid to St. Joseph shareholders.

Q. Are the Joint Applicants proposing to recover the acquisition adjustment in rates?

A. Yes. The Joint Applicants are, in effect, requesting to fully recover the acquisition adjustment through the proposed regulatory plan identified in the direct testimony of UtiliCorp witness John McKinney. The regulatory plan is a proposal that allows UtiliCorp to retain a substantial portion of the purported merger savings and future non-merger savings in order to recover the merger premium being paid to St. Joseph's shareholders. UtiliCorp assumed it would retain 100% of the merger savings in its financial evaluation of the merger with St. Joseph. Staff witness Oligschlaeger addresses the Joint Applicants' regulatory plan in his rebuttal testimony.

Q. What is the expected amount of the acquisition adjustment related to the proposed merger between UtiliCorp and St. Joseph?

A. UtiliCorp identifies the acquisition adjustment as approximately $93 million (UtiliCorp witness Streek's direct testimony, page 4). UtiliCorp will incur additional costs relating to closing or completing the merger, commonly known as transaction costs, i.e., legal, engineering, investment banking (including the separate financial advisors of St. Joseph) and other consultants' fees. Transaction costs are typically incurred prior to the completion of the merger since they are incurred in reaching the agreement to merge and in closing the merger.

UtiliCorp also will incur costs referred to as transition costs, commonly referred to as "costs to achieve" the merger, i.e., costs typically incurred after the merger is completed to integrate and implement systems and processes of the two combining companies. Transaction costs and "costs to achieve" the mergers are discussed in the rebuttal testimony of Staff witness James Russo. UtiliCorp has identified what it believes these costs are expected to be as follows:

Merger premium	$92.8 million
Transaction costs (Costs of the merger)	4.575 million
Total value of acquisition adjustment	$97.375 million
Transition Costs (Costs to achieve)	$ 8.673 million

[Source: UtiliCorp witnesses Streek, page 4 and Siemek—Schedule VJS-2]

Q. What is a "merger premium?"

A. The "merger premium" represents, in general, any portion of the purchase price for a company which reflects a valuation above the current book value of the acquired company's assets, or market value of the acquired company's stock.

For UtiliCorp specifically, the merger premium represents the transfer of shareholder wealth from UtiliCorp to St. Joseph to consummate the merger, measured by the gain in stock price and increase in the number of shares of UtiliCorp stock to be held by St. Joseph shareholders, compared to the market value and the number of shares of pre-merger St. Joseph stock.

Q. What is an acquisition adjustment?

A. An acquisition adjustment results when utility property is purchased or acquired for an amount either in excess of or below book value. Book value relates to the value placed on utility property and recorded on the Company's books and records at the time the utility property is first placed in public service, adjusted for depreciation and amortization. This assessment of value is commonly referred to as the property's "original cost." The acquisition adjustment is made up of two components, the merger premium and the transaction costs. The transaction costs are pre-merger costs to close or complete the merger.

Q. What is original cost?

A. The term "original cost," as defined by the Electric Plant Instruction Section of the FERC Uniform System of Accounts (USOA), relates to:

> All amounts included in the accounts for electric plant acquired as an operating unit or system, except as otherwise provided in the texts of the intangible plant accounts, shall be stated at the cost incurred by the person who first devoted the property to utility service. (Paragraph 15,052 of USOA).

Depreciation and amortization of the utility property from the previous owner must be deducted from the original cost, which results in a net original cost figure to be recorded on the purchaser's books and records. The acquired property is valued at the same value the seller placed on it, hence the "original cost when first devoted to public service," adjusted for depreciation and amortization, concept.

Q. Do utilities endorse the net "original cost" concept?

A. Yes. In a Joint Submission made by the then KPL and Gas Service Company (Joint Submission By KPL And Gas Service Pursuant To Order Of September 20, 1983; attached hereto as Schedule 2 to my testimony) to the KCC, in Docket No. 138,495–U respecting KPL's request for authority to acquire the Gas Service Company (Gas Service), KPL stated the following:

> The Commission has the "duty to ascertain the reasonable value of all property of any [regulated public utility] whenever it deems the ascertainment of such value necessary in order to enable the Commission to fix fair and reasonable rates . . . ." K.S.A. 66–128. The rate base of a public utility represents the reasonable value of all property which is in service and devoted to the public use. [citation and footnote omitted]
>
> **Because the value of the corporation's property remains unchanged as the corporation's stock is bought and sold, the transfer of a**

> **utility's stock, the indicia of ownership** in a corporate entity whose stockholders are separate and distinct from the entity itself, **does not affect the value of its property in service and devoted to the public use.** Thus, **no recalculation of the utility's property, or rate base, is appropriate.**
>
> The current rate base of Gas Service is derived from the **original cost of the property when first dedicated to public use**. The purchase of its stock does not affect original cost. A new stockholder does not purchase the assets of the corporation. Nor does a change in, or substitution of stockholders establish a new business entity. Transfer of ownership of common stock does not affect the ownership of the corporation's property, which still belongs to the corporation. [footnote omitted]
>
> In a stock transfer, no assets are removed from public service or transferred to another business entity. **The same assets will continue to be used to provide the same services to the same ratepayers and the assets will remain subject to the same ratemaking jurisdiction of the same regulators.** This continuity makes a recalculation of Gas Service's rate base incongruous.
>
> [Joint Submission, pp. 2–3; emphasis added]

The Joint Submission was requested by the KCC in Docket No. 138,495–U, wherein KPL and Gas Service were directed to provide a legal analysis of whether the Commission should consider adjusting Gas Service's rate base to reflect the purchase price of Gas Service common stock purchased by Gas Service. It is clear that KPL was arguing for Gas Service's rate base to be valued at net "original cost" even though the "transfer of common stock ownership was effected at approximately 89% of net book value." (Joint Submission, page 1). The Joint Submission was signed by David S. Black, at the time Senior Vice President, Law and subsequently Chairman of the Board, President and Chief Executive Officer of KPL.

Q. Is use of net original cost for valuing rate base still the predominant form of regulation?

A. Yes. In the State of Missouri, the use of original cost less depreciation and amortization, i.e., net original cost, to set rates is not only the predominant form of regulation, but to my knowledge, the only form that has been employed by this Commission.

Q. UtiliCorp witness McKinney discusses the use of the concept of Fair Value rate base at page 27 of his direct testimony. Has the Commission used Fair Value rate bases to determine rates for public utilities operating under its jurisdiction.

A. Not to my knowledge. During the 1970's and 1980's, Fair Value testimony was filed by both companies and Staff witnesses. However, the Commission determined rates based on net original costs concepts. The parties stopped presenting Fair Value testimony sometime in the last 1980's or early 1990's.

Q. How does an acquisition adjustment result?

A. Utility property is recorded on the company's books and records at net original cost. A utility must account for any difference between the acquisition cost or purchase price of property and the net original cost, i.e., the amount paid to the original owner (the seller) for utility property being first placed into service and the recorded net original cost amount. This difference in purchase price is recorded in USOA Account No. 114, Electric Plant Acquisition Adjustments. The amortization of the acquisition adjustment is made to Account 406, Amortization of Electric Plant Acquisition Adjustments, if authorization is granted to include the adjustment in cost of service for ratemaking purposes (above–the–line treatment). If no authorization is given to include an amortization for ratemaking purposes (i.e., below–the–line treatment occurs), then Account No. 425, Miscellaneous Amortization must be used.

Account 114 states:

> A. This account shall include the difference between (1) the cost to the accounting utility of electric plant acquired as an operating

> unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (2) the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated provisions for depreciation and amortization and contributions in aid of construction with respect to such property.
>
> . . . .
>
> C. Debit amounts recorded in this account related to plant and land acquisition may be amortized to account 425, Miscellaneous Amortization, over a period not longer than the estimated remaining life of the properties to which such amounts relate. Amounts related to the acquisition of land only may be amortized to account 425 over a period of not more than 15 years. Should a utility wish to account for debit amounts in this account in any other manner, it shall petition the Commission for authority to do so. Credit amounts recorded in this account shall be accounted for as directed by the Commission.

Account No. 406 states:

> This account shall be debited or credited, as the case may be, with amounts includible in operating expenses, pursuant to approval or order of the Commission, for the purpose of providing for the extinguishment of the amount in account 114, Electric Plant Acquisition Adjustments.

Account No. 425 states:

> This account shall include amortization charges not includible in other accounts which are properly deductible in determining the income of the utility before interest charges. Charges includible herein, if significant in amount, must be in accordance with an orderly and systematic amortization program.
>
> ITEMS
>
> 1. Amortization of utility plant acquisition adjustments, or of intangibles included in utility plant in service when not authorized to be included in utility operating expenses by the Commission.
>
> 2. Other miscellaneous amortization charges allowed to be included in this account by the Commission.

UTILICORP'S REGULATORY PLAN

Q. Is UtiliCorp seeking recovery of the acquisition adjustment created as result of this merger?

A. Yes. UtiliCorp is seeking direct, as well as indirect, recovery of the merger premium it is paying for St. Joseph as part of the regulatory plan being proposed in this case. UtiliCorp's regulatory plan would make it possible for it to recover in rates a substantial amount, if not the entire amount, of the acquisition adjustment. UtiliCorp is requesting that the Commission authorize St. Joseph a five-year rate moratorium that will result in the post-merger rates being frozen for a period of up to almost six years. At the end of the moratorium, UtiliCorp intends to file a rate case that will reflect one-half of the total revenue requirement relating to the acquisition adjustment. The total revenue requirement is the return "of" (the amortization) and the return "on" (the rate base component).

Q. How will UtiliCorp recover a substantial portion of the acquisition adjustment through its proposed regulatory plan?

A. All savings, both merger and non-merger related, will be retained by UtiliCorp during its proposed five-year moratorium. During this moratorium period, UtiliCorp will recover the merger premium indirectly. Subsequent to the five-year moratorium period, UtiliCorp will recover one-half of the return of and on the merger premium directly in rates and the other half indirectly through merger savings retained during the regulatory lag between rate cases. UtiliCorp will also recover the merger premium indirectly from growth opportunities in non-regulated activities that will be created by or benefit from the merger. UtiliCorp's regulatory plan includes unique regulatory proposals, such as using St. Joseph's pre-merger capital structure in future SJLP rate proceedings and excluding savings in the administrative and general (A&G) cost categories for the MPS division for rate purposes. These proposals will also allow for indirect recovery of the acquisition adjustment. Staff witness Broadwater and I will discuss the "frozen" capital structure issue in our rebuttal testimonies. Staff witnesses Traxler and Oligschlaeger will discuss the "frozen" A&G corporate allocations relating to MPS's and St. Joseph's future rate cases.

Q. Is it appropriate to allow utilities to retain non-merger related savings to pay for an acquisition adjustment?

A. No. The Commission made it clear that utilities must distinguish between merger and non-merger related savings. In several cases the Commission has required the separation of these two very different types of cost savings. I will address the importance of segregating merger and non-merger related savings in the section on Merger Tracking.

Q. Is UtiliCorp's regulatory plan seeking ratemaking approval in this case even though this is a merger application and not a rate application or general tariff filing?

A. Yes. UtiliCorp's proposal is seeking up-front ratemaking treatment in this case even though this is a merger application. Yet, despite the fact UtiliCorp is not seeking a change in its rates in the instant proceeding, it is necessary for the Staff to address the ratemaking ramifications of UtiliCorp's regulatory plan concurrent with UtiliCorp's request for approval of the merger. The regulatory plan presented by the Joint Applicants is an integral part of the merger application. The regulatory plan, as presented by UtiliCorp in the direct testimony of UtiliCorp witness John W. McKinney, seeks a dramatic departure from traditional ratemaking principles that this Commission has employed over its history. UtiliCorp wants assurances that it will receive favorable regulatory treatment from the Commission on an issue for which the Commission has never allowed rate recovery. Even though UtiliCorp cites two cases that it believes supports its view that the Commission is receptive to allowing recovery of the acquisition adjustments, the fact remains the Commission has never allowed direct recovery of this item. Staff believes the treatment afforded acquisition adjustments in the past is exactly the same treatment the Commission should afford the Joint Applicants' acquisition adjustment in this case.

Q. Does UtiliCorp's regulatory plan proposal take St. Joseph's rates off cost-of-service price determination?

A. Yes. UtiliCorp's proposal will take St. Joseph's rates off of cost-based ratemaking. The proposed regulatory plan freezes St. Joseph's pre-merger capital structure and attempts to freeze MPS's A&G allocations to a pre-merger basis which will in effect take MPS off of cost-based rates.

The frozen capital structure will push higher costs on post-merger St. Joseph customers who would otherwise benefit from UtiliCorp's lower-cost consolidated capital structure. Under the regulatory plan being proposed by UtiliCorp, the post-merger customers of St. Joseph will be deprived of this important and significant merger benefit even after the proposed moratorium period ends. The actual cost of capital for post-merger St. Joseph should be based on UtiliCorp's consolidated capital structure because that will be the traded stock after the merger closes. Thus, UtiliCorp's and St. Joseph's proposal to free St. Joseph's rates at St. Joseph's pre-merger capital structure level permits UtiliCorp and St. Joseph to keep the merger benefits in total and removes St. Joseph's rates off of a cost basis.

In addition, the frozen allocation to MPS of A&G costs relating to UtiliCorp's corporate overheads will also result in MPS going off of cost-based rates. In essence, MPS customers will be charged higher rates than actual costs would warrant if this part of the regulatory plan is adopted.

Q. Mr. McKinney states at page 17 of his direct testimony that he does not believe that if the Commission were to make a determination as to the reasonableness of a premium, that "it shift[s] the burden or risk of the premium to the regulators." Do you agree?

A. No. Causing regulators to get involved in the price determination of the so-called "investments" that mergers and acquisitions are asserted to be will most certainly shift the burden and place more of the risk on the regulators than they presently have. These risks will ultimately be shifted to the utility customers. If utilities are successful in placing merger premiums in rate base as an "investment" like any other rate base item, the regulator will either be required to perform an assessment of the "investment" or be forced to simply accept the utility's valuation and judgment respecting the merger or acquisition. Of course, the utility would much prefer the regulator accept the "we buy it, you put it in rate base at what we paid for it" approach. As it relates to mergers, this philosophy would be "we negotiate a price for a company and you put it in rates." It appears to be simple. Regulators would no more meet their responsibilities if this approach were adopted, than they would have if in the late 1970's and 1980's, regulators would have taken the approach sought by the utility industry of "we build it, you put it in rate base no matter what it cost us to build it." Fortunately, that regulatory philosophy was not employed during the nuclear construction projects of the mid-1980's or during the construction of the less costly coal fired base load units of the last 1970's and 1980's. Even the construction project UtiliCorp had in the early 1990's relating to the refurbishment of its base load Sibley Generating Station placed considerable pressure on the regulators to perform their regulatory oversight function.

Q. Mr. McKinney seems to imply in his direct testimony on page 19 that a merger premium is just like any other investment such as electric plant investments. Are the merger premiums that are being paid in mergers and acquisitions just like other "investments" that are typically placed in rate base?

A. No. An investment in a generating facility or transmission plant has direct, certain and known benefits. They are also required to provide essential utility service to customers in this state. A customer places a demand on the electric facilities. This demand has to be met in order for the customer to have electricity, natural gas or steam operations. The only way for a utility to meet its obligations to that customer is to generate or purchase the required energy, in this case electricity, and to have transmission and distribution facilities in place to transport the commodity to its destination. The only way the utility can meet its obligation to serve, is to have the necessary plant investment in place.

The key difference between the merger "investment" and the plant to serve investment is that the merger "investment" is unnecessary and not required to meet the utility's statutorily required provision of safe and adequate service. Mergers do not have to take place nor are they required. Mergers, generally are about shareholder wealth and management control issues. These have nothing to do with providing utility customers safe and adequate service at a nondiscriminatory just and reasonable price. Simply put, mergers and acquisitions are not necessary investments to provision of utility service and cannot and should not be considered like any other utility investment. Mergers cannot be compared to utility investments that are placed in rate base.

Q. Mr. McKinney states at page 19 of his direct testimony that "utility customers would be deprived of merger benefits because shareholders are not permitted to recover reasonable investments that include a premium and shareholders are not provided due process in the review of their investment." Do you have any comment?

A. If any entity is frustrating the Commission's fulfillment of its statutory obligations, it is the Joint Applicants. They are seeking Commission authorization of their proposed merger without providing the Commission and the parties adequate direct testimony and schedules. UtiliCorp and St. Joseph have chosen how to present their case and they will have every opportunity in which to be heard. The Commission's process to this point is the process that the Joint Applicants have advocated to the Commission. In fact, UtiliCorp made note of that in Mr. Robert Green's 1999 Year-end Conference Call which occurred on February 8, 2000. Mr. Green stated therein, in part, as follows:

> Okay, merger activity. We filed the St. Joe rate case in October. We filed Empire in December. The hearing on St. Joe is scheduled for July 10th, and we expect a hearing in the Empire transaction maybe in December of this year. We would hope to close St. Joe certainly this year, and Empire, it would be nice if we can get it closed this year. That might push into the first quarter of next year.
>
> And our Court filings were made in November, so that's all on track. The Commission has generally upheld all of our requests in terms of scheduling, even with the Staff opposed it. So we feel like we've built some good relationships there. Key to these deals is going to be the regulatory bargain we cut, and you're aware that both of these deals have regulatory out provisions. So in any transaction like this, synergies are key, and the regulatory deal is key in terms of creating value and growing earnings. And we will be focused on doing both.

[Transcript of February 8, 2000, Robert Green 1999 Year-end Conference Call, on UtiliCorp's Internet web site, www.utilicorp.com, at Investor Information, Presentations].

Q. UtiliCorp witness McKinney states at page 20 of his direct testimony that "when regulators do not allow recovery of a premium and yet pass all of the cost savings to the customer, it is the regulated utility that is disadvantaged." Have regulated utilities been disadvantaged by the Commission's prior treatment of the acquisition adjustment?

A. No. Regulated utilities are not disadvantaged because in all instances I am aware of utilities were allowed to retain whatever synergies existed from a merger or acquisition until such time as rates were adjusted, usually through some type of moratorium period. This is known as regulatory lag. Mergers are nothing more than the combining of corporate entities much like a reorganization of existing companies that result in downsizing, re-deployment of human resources and changes to system processes such as occurs in re-engineering. Utilities make these changes to meet objectives of providing utility service to its customers. Generally, utilities always retain the cost savings generated by the efficiencies gained from the re-organization and re-engineering that occur periodically at every utility.

To suggest, as Mr. McKinney does, that companies' shareholders are disadvantaged if merger savings are passed on to customers is clearly wrong. Utilities get first crack at savings up-front. Staff does not, and has not, advocated keeping all the merger savings for customers. To do so would be unreasonable. I agree with Mr. McKinney on this point. However, if anyone is disadvantaged in this process, it is generally the customers. They must wait for the savings, merger and non-merger alike, to occur and to have those savings reflected in rates. Savings are highly speculative; they may or may not occur. It has historically been much easier to increase rates than reduce them. A good example of this is the 1997 complaint case filed by Staff against UtiliCorp's Missouri Public Service division. Even once savings are discovered, generally as a result of an earnings review, it takes considerable time to fully reflect the savings in rates. During this interim period, the utility, and its shareholders, have enjoyed the full benefit of the savings.

HISTORICAL PERSPECTIVE RELATING TO ACQUISITION ADJUSTMENTS

Q. What is the historical background for the position that net original cost should be the basis for setting rates for utility property?

A. Abuses which occurred in the 1920's and 1930's created the need to adopt the original cost concept in setting rates. In the 1920's and 1930's, utilities were acquiring other utility properties for amounts in excess of net book value. This valuation and transfer in excess of book value (i.e., positive acquisition adjustments/merger premiums) created inflated rate bases, which, when included for ratemaking treatment, resulted in higher rates to the then existing customers. These customers were paying higher rates for the exact same property that had been providing them utility service prior to the merger and acquisition. It was believed that it was not reasonable to charge customers higher rates for the same utility property simply because the utility providing service was acquired by another company. Thus, the practice of using the "original cost" of the property when first devoted to public service became widely accepted. This principle has served to protect ratepayers from utilities selling properties at inflated prices, and then having the purchaser seek revaluation of the properties at higher levels in order to produce greater profits.

Q. Are the concerns that ratepayers will be paying inappropriate higher rates for utility service if the acquisition costs are included in rates just as valid now as they were in the past?

A. Yes.

Q. Is one of the standards that sometimes has been used to determine the ratemaking treatment of acquisition adjustments whether the purchase of the property was an "arm's length" transaction?

A. Yes.

Q. If the purchase of utility property is an arm's length transaction, would this guarantee that the lowest purchase price would result?

A. No. Simply because an acquisition of utility property would be considered an arms length transaction (i.e., no affiliation or tie between the negotiating parties), this criterion alone would not guarantee the lowest possible purchase price. This is particularly true if the purchasing utility management intended that the ratepayers should be required to pay for any premium above net book value. In that circumstance, there certainly would be no guarantee that the purchasing utility would have negotiated the best possible terms or an approximation thereto.

Q. If the Commission were to determine that acquisition adjustments should be included in the ratemaking process, would there be a need for the Commission to determine the appropriate price at which utilities should acquire other utilities?

A. Yes. Using the Commission's current precedent of not considering acquisition adjustments in the ratemaking process relieves the Commission and its Staff of the burden of determining the appropriate purchase price of acquired utilities. Alternatively, if the Commission were to adopt a position of including acquisition adjustments in rates, this would place the burden of determining the appropriate purchase price of acquired utilities on the Commission and its Staff. Certainly, it is difficult to determine what the "least cost," or otherwise appropriate price, should be for an acquired utility. In order to make that determination, the Commission and its Staff, in essence, would have to place itself in the negotiation process to ascertain if a utility property was being or had been acquired at the lowest possible price. If this were not done, then the Commission could in no way ensure that the public would not be harmed, i.e., that the transaction was not detrimental to the public interest.

By maintaining its current position of not authorizing direct or indirect recognition of either positive or negative acquisition adjustments in rates, the Commission can avoid making a determination that the utility property in question was acquired at the lowest possible, or otherwise appropriate, price. The practical effect of authorizing acquisition adjustments in the ratemaking process is in essence to shift the burden or risk from the company to the Commission and its Staff in making determinations regarding the purchase price of acquired utility properties.

Q. UtiliCorp witness John W. McKinney states at page 18 of his direct testimony that it "would be unreasonable" if regulators flow-through merger savings to customers but fail to allow rate recovery of the premium. Has this ever happened?

A. Not to my knowledge. I am not aware of any time at which the Commission approved a merger or acquisition and flowed all benefits to customers. While, it is true that this Commission has never allowed direct recovery of an acquisition adjustment in rates, it is equally true that this Commission has afforded utilities retention of related merger and acquisition benefits. In every instance I can think of, utilities were given opportunities up-front to capture these savings through regulatory lag.

Q. Why is the Staff opposed to the recovery of acquisition adjustments in rates?

A. Allowing recovery of positive acquisition adjustments in rates does not provide sufficient incentive for the acquiring utility to negotiate the best possible price for the acquired firm. If a utility were allowed recovery of acquisition adjustments, it need not be as concerned, or even concerned at all, that it was negotiating the most favorable terms possible in acquiring a property since the ratepayers would provide recovery through rates. Allowing acquisition adjustments in rates sends signals to buyers of utility property that recovery is guaranteed regardless of the purchase price, which may be an inflated amount above the value of the utility property. In fact, if the acquisition adjustment is allowed in rates, both the purchaser and the seller of said property can benefit from inflating the rate base.

The adoption of positive acquisition adjustments for ratemaking purposes removes from purchasing utilities (the buyer, which in this case is UtiliCorp) incentive to negotiate a lower price or terminate negotiations when a seller requests an unreasonable price for the property in question. A policy of giving ratemaking treatment to positive acquisition adjustments would place Missouri regulated utilities at a competitive advantage over unregulated entities, since Missouri jurisdictional utilities then would have in essence a "blank check" for recovery of their acquisition expenditures from ratepayers. This situation does not exist for unregulated entities. Thus, if utility executives knew that there would be recovery from ratepayers of an acquisition adjustment resulting from the purchase of utility property for an amount in excess of net book value, i.e., original cost less depreciation and amortization, this would pose the potential for tainting the negotiation process between the buyer and the seller.

Q. How do sellers of utility property benefit from selling above net book value?

A. The sale of utility property above net book value benefits the selling party because such a gain is treated below–the–line and therefore realized solely by the shareholders. The higher the price that the utility property is sold at, the larger the gain for the seller. Clearly, if the buyer believes there will be a recovery of the acquisition adjustment from ratepayers, there is a greater potential for an inflated rate base, which in turn results in higher utility rates as well as a larger gain to the seller.

Q. Do utilities benefit from consistent treatment of acquisition adjustments in the manner advocated by the Staff?

A. Yes. Utilities which purchase property below book value, resulting in negative acquisition adjustments, benefit because those utilities receive a return on property valued at its net original cost, not the purchase price. Since these utilities would be receiving a return on the net original cost rate base, their return component would be computed for a rate base greater than that which these utilities actually had invested.

The utility industry in Missouri may be in the position of arguing for net original cost ratemaking when negative acquisition adjustments occur, while at the same time advocating that positive acquisition adjustments be treated above net original cost. Under either scenario, the utility would benefit, to the potential detriment of the ratepayers. Western Resources, who once provided natural gas service to customers in western Missouri took such a position in the past when it purchased the former Gas Service Company in 1983 at below book value.

In Case No. GM–84–12, this Commission authorized Western Resources, then KPL, to acquire Gas Service. KPL acquired Gas Service for an amount valued at approximately 89% of net book value. KPL never advocated the use of a negative acquisition adjustment to value Gas Service's rate base in setting rates at any time that it owned the Missouri properties.

Q. Had Western Resources previously argued that negative acquisition adjustments should be ignored in the ratemaking process?

A. Yes. In a Joint Submission (attached as Schedule 2 hereto) filed in Kansas before the KCC in Docket No. 138,495–U, KPL took the position that a negative acquisition adjustment resulting from the Gas Service merger should not be reflected in the ratemaking process in Kansas. In its legal analysis filed before the KCC, KPL maintained that net original cost investment should be used. KPL stated as follows:

> Aside from the legal issues raised by the Commission's inquiry, revaluation of utility plant measured by the price paid for common stock would produce practical difficulties of potentially significant dimensions. Revaluation, whether on a stock acquisition or purchase of utility assets, would ultimately tend toward higher costs to consumers, since it would provide no incentive to make acquisitions at less than book value. If it is appropriate to write down rate base when stock is purchased below book value, it would be equally correct to write up rate base when the stock is acquired at a premium.

The Missouri Commission did not recognize the negative acquisition adjustment, but the KCC did. This Commission did not "write down" the assets. Thus, the customer paid higher rates to KPL under original cost theory than if the below book values were used to determine the rate base. Of course, KPL benefited from the use of original cost theory in Missouri for property that, in effect, was overstated because KPL collected higher rates from its Missouri customers.

The Joint Submission by KPL further stated:

> Even if the nature of this transaction could be disregarded and treated as a purchase of the assets of Gas Service, there should be no change in the rate base in recognition of the general rule that the rate base represents the original cost of utility property when dedicated to public use regardless of the price at which it is purchased by another utility. [citations omitted]
>
> In Kansas the rate base is not recalculated even when the assets are purchased at less than the original cost. [citation omitted] This Commission determined that the reasonable value of property purchased from other utilities was not its purchase price but rather the higher original cost to the first entity which devoted the property to public service. [citation omitted] The Commission accepted Staff's proposed adjustment to increase the utility's rate base from the purchase price of property already devoted to public service to its original cost when first devoted to public service. The Commission considered the increase to be "a traditional adjustment which recognizes for rate–making purposes

> that the rate base should be the original cost of plant when dedicated to public use regardless of price at a subsequent sale." [citation omitted; emphasis added]
>
> This carryover of book value is an appropriate valuation method because original cost is an appropriate determinant of reasonable value, and because the purchase price of Gas Service's stock does not accurately reflect the value of its assets. First, even assuming that the purchase price of Gas Service's stock accurately reflected the market value of its assets, there is no sound reason for deviating from the original cost or book value methodology adopted or given great weight in Kansas and most other jurisdictions. [citations omitted]
>
> Because the market value of assets seldom changes precisely in accordance with depreciation, depreciated original cost is often not an accurate proxy of current fair market value. Nonetheless, **original cost accounting is employed to avoid the difficulties of more subjective methods of property valuation. The use of the depreciated original cost valuation method provides an objective method of valuation without the need for independent assessments of the fair market value of acquisitions.**
>
> The unfortunate result of utilizing purchase price in this case would be to encourage the future transfer of properties at a premium above original cost regardless of fair market value. For example, had KPL paid above book value for Gas Service's stock, Gas Service's rate base would have increased, resulting in greater costs to consumers. **One reason for the applicability of original cost concept to acquisitions was to prevent utilities from artificially inflating their rate bases by acquiring properties at unrealistically high prices.** [citation omitted; emphasis added] . . . .
>
> ....
>
> **This inquiry has confirmed the propriety of Commission [KCC] use of original cost as the basis of the value of property devoted to utility service.** [emphasis added]

KPL's position at that time was clear. If the KCC were to consider the negative acquisition adjustment to value Gas Service's rate base, then that position would "logically dictate similar adjustments—up or down—for each utility regulated by the [Kansas] Commission in each rate case." (Joint Submission, Schedule 2).

Q. Did the KCC give consideration to the negative acquisition adjustment relating to the KPL/Gas Service merger?

A. Yes. In Docket No. 148,312–U, the KCC in its June 13, 1986 Order treated the Gas Service acquisition at below book value. In that Order, it was determined that the effective cost below book value was $8.4 million on a total company basis. The KCC adopted for ratemaking purposes an amortization of negative goodwill. This has the effect of increasing revenues and thus decreasing the revenue requirement.

Q. Are there any cases where this Commission has rejected reflection of a negative acquisition adjustment in rates?

A. Yes. In a U.S. Water/Lexington, Missouri, Inc. (U.S. Water) rate case, Case No. WR–88–255, the Commission rejected a negative acquisition adjustment which was proposed by the Office of the Public Counsel (OPC). The negative acquisition adjustment was not used by the Commission to reduce the U.S. Water rate base, or to reflect a negative amortization to the cost of service.

If it is inappropriate to use a negative acquisition adjustment to establish rates, then it would be equally inappropriate to use a positive acquisition adjustment. Fairness would dictate that consistent treatment be given for both positive and negative acquisition adjustments. Acceptance of a positive acquisition adjustment would be a reversal of Commission precedent in the U.S. Water rate case. Re U.S. Water/Lexington, Missouri, Inc., Report And Order, 29 Mo.P.S.C.(N.S.) 552, (March 10, 1989).

As stated in the rebuttal testimony of John C. Dunn, witness for U.S. Water in that proceeding and at one time Chief of Economic Research for the Commission, the Commission has traditionally rejected the use of positive acquisition adjustments in rates. Mr. Dunn stated at page 22 of his rebuttal testimony:

> Further, the Commission has historically adopted a policy of original cost ratemaking. Regardless of purchase prices, when properties are bought and sold, the Commission has, unless there were compelling circumstances otherwise, regulated on the basis of original cost. There are numerous properties within the state which have been acquired at prices above original costs. **The Commission has routinely rejected the use of the purchase price when it is greater than original cost.** It appears to me to be entirely unreasonable for the Commission to now take an asymmetrical position and adopt purchase price as the appropriate standard when the purchase price occurs below original cost. **Either Missouri is original cost ratemaking, or it is not.** [emphasis added]

Thus, the rebuttal testimony of U.S. Water's witness strongly argued that the appropriate and traditional ratemaking theory relating to acquisition adjustments in Missouri is the use of net original cost.

In its initial brief (attached as Schedule 3), the attorneys for U.S. Water argued the concept of "net original cost" rate base. At page 22 of U.S. Water's initial brief, it was stated:

> ...a negative acquisition adjustment would not be appropriate for general ratemaking principles either. Mr. Drees provided a brief review of the situations which gave rise to the "original cost when first devoted to public service" rules. (Exhibit 6, p. 6) This principle has served to protect ratepayers from utilities selling at inflated prices and then seeking to have the regulators revalue the properties at the higher level, just to produce greater profits. Although there are always exceptions, Mr. Drees **concludes that sales of utility property at higher than net book value should be borne by the shareholders. USW is under the impression that is the general principle utilized by this Commission,** although there may have been a few exceptions.
>
> [emphasis added]

Q. Does using net original cost valuation for ratemaking purposes give consistent treatment to utilities?

A. Yes. Using net original cost to determine rate base valuation for ratemaking purposes provides utilities consistency in establishing their rates. It also provides utilities with the incentive to acquire utility properties of what may be troubled utilities where it would be in the public interest for these troubled utilities to be acquired by another company. Mr. Dunn addressed this view in his rebuttal testimony in U.S. Water case. At page 23 of his rebuttal testimony, Mr. Dunn stated:

> . . . troubled properties would never be sold. Here, the Commission was confronted with a troubled property and a buyer willing to purchase that troubled property for less than original cost assuming original cost regulation. That difference was part of the incentive in the transaction. Without the incentive associated with this opportunity, the property would have never changed hands and improvements wouldn't even have been contemplated.
>
> If the Commission adopts an asymmetrical policy in this proceeding where it uses the lower of purchase price or original cost to make rates, no potential buyer would even consider purchasing a troubled property in Missouri.

Indeed, Mr. Dunn's rebuttal testimony implies that utilities in the State of Missouri have considered and negotiated the acquisition of utility properties with the full knowledge and understanding that Missouri is a net original cost jurisdiction. Utility management in this State has made decisions to acquire utility properties with this belief.

Q. Has Mr. Dunn ever represented UtiliCorp?

A. Yes. Mr. Dunn has appeared as a witness on numerous occasions in Missouri and other states on behalf of UtiliCorp and Missouri Public Service over the past two decades, most recently in the last rate case filed by UtiliCorp in Case No. ER-97-394 as its rate of return witness.

GAINS ON SALE OF UTILITY PROPERTY

Q. How have gains on sale of utility property been treated for ratemaking purposes?

A. Recently, the Commission has not flowed back to ratepayers any of the benefits of the gains on sales. The selling party's shareholders have realized the entire benefit of the gains.

The Commission in its Report And Order in KCPL's 1977 general rate increase case, Case No. ER-77–118, found that none of the gains relating to four transactions should be included "above–the–line" and the Staff's adjustment on this issue was disallowed. At Re: Kansas City Power & Light Company, Case No. ER–77–118, Report And Order, 21 Mo.P.S.C. 543, 576, (October 20, 1977), the Commission stated:

> It is the Commission's position that ratepayers do not acquire any right, title and interest to Company's property simply be paying their electric bills. It should be pointed out that Company investors finance Company while Company's ratepayers pay the cost of financing and do not thereby acquire an ownership position. Therefore, the Commission finds that the disposal of Company property at a gain does not entitle its ratepayers to benefit from that gain nor does the disposal of Company property at a loss require that Company's ratepayers absorb that loss.

Further, in decisions reached by the Commission in rate cases involving Missouri Cities Water Company, Re: Missouri Cities Water Company, Case Nos. WR–83–14, et. al., Report and Order, 26 Mo.P.S.C.(N.S.)1, 5–6,10–19 (May 2, 1983) and again respecting KCPL, Re: Kansas City Power & Light Company, Case Nos. EO–85–185, et al., Report and Order, 28 MoP.S.C.(.S.) 228, 253–56 (April 23, 1986), the Commission found that gains on sale of utility property sold by those utilities would be treated "below–the–line." The Commission has consistently followed this practice of not flowing any gains resulting from sales of utility property to ratepayers. It would be inequitable for the shareholders of a seller of utility property to receive the benefit of any gain therein, while at the same time, the buyer of utility property to be permitted to recover from its ratepayers any "premium" or excess costs above net book value. It would be an unfair approach and disadvantage the ratepayers, if the seller's gain would be taken below–the–line, while the buyer's premium would be treated above–the–line.

Q. Do utilities sell properties to other utilities and later reacquire the very same properties?

A. Yes, this has happened in the past. In some cases, utilities sell property to another utility and reacquire the sold property back through a merger or acquisition later. This is an instance where the seller's owners reap the profits from any gain and the buying company may request ratemaking treatment for any of the acquisition premium paid for the property. This is a situation where the seller keeps gains and the buyers' customers are requested to pay for the premiums relating to the acquisition.

Q. Has this Commission seen examples of one the companies under its jurisdiction entering into a transaction to sell property and then reacquiring the very same property later through a merger?

A. Yes. On March 12, 1992, Union Electric filed an application with the Commission, docketed as Case No. EM-92-225, to sell its Iowa properties to Iowa Electric Light & Power Company (Iowa Electric). On March 31, 1992, Union Electric also filed an application in Case No. EM-92-253 to sell its northern Illinois properties to CIPSCO. The Commission authorized the sale of these properties in its Report and Order dated December 22, 1992. Re: Union Electric Company, Case Nos. EM-92-225 and EM-92-253, Report and Order, 1 Mo.P.S.C. 3d 501 (1992).

Q. Please identify the properties sold to Iowa Electric and CIPSCO.

A. Union Electric's Iowa properties were located in the southeastern part of the state having a service area of 566 square miles and serving approximately 17,000 customers. The northern Illinois service area was located just east of the Iowa service area and had approximately 4,200 customers. (Source: Gary L. Rainwater, Direct Testimony, pp. 6 and 7, Case Nos. EM-92-225 and EM-92-253.)

Q. When were these properties sold?

A. These properties were sold on December 31, 1992.

Q. Did Union Electric sell these properties for a gain?

A. Yes. The gain for both the Iowa and northern Illinois properties totaled $34 million. Case Nos. EM-92-225 and EM-92-253, 1 MoPSC 3d 501, 503 Report and Order (1992).

The gain associated with the northern Illinois property was approximately $4.8 million. The remaining portion of the gain of $29.2 million relates to the Iowa service area ($34 million - $4.8 million).

Q. How was the sale of these properties recorded on the books and records of Union Electric?

A. Union Electric recorded these transactions by removing the properties from plant in service and accumulated provisions for depreciation. It also recorded the cash received from Iowa Electric and CIPSCO and reflected the gains from the sale.

Q. How did CIPSCO record the purchase transaction?

A. CIPSCO recorded the purchase of the northern Illinois service area and facilities as an increase to Plant in Service on the "original cost" basis. It recorded the same amount on its books for plant as Union Electric had on its books.

CIPSCO debited the plant account for $8,882,092 and credited accumulated depreciation for $5,168,022. Union Electric credited the plant account and debited the accumulated depreciation account for the exact same amounts. Iowa Electric would have recorded amounts on its books in a similar fashion.

Q. Did CIPSCO identify an amount for an acquisition adjustment?

A. Yes. CIPSCO established an acquisition adjustment of approximately $4.9 million for the property sold to it by Union Electric. Union Electric recorded a gain to Account 421.1, Gain on Disposition of Property, of approximately the same value (the amounts differ slightly for the recording of salaries and other sales expenses recorded by Union Electric).

Q. How did Union Electric treat the gain?

A. The gains from the disposition of the Iowa and northern Illinois properties were treated below-the-line for ratemaking purposes, i.e., the profit from the sale of these properties was flowed back exclusively to the shareholders.

Q. Does CIPSCO still own the property it purchased from Union Electric?

A. Yes.

Q. How did the merger between Union Electric and CIPSCO affect this property?

A. The merger had the effect of bringing the property back to Union Electric shareholders, who became AmerenUE shareholders after the merger. The acquisition created from the sale of the northern Illinois property formerly owned by Union Electric was reflected through an adjustment in the accounts of Ameren CIPS as an operating company of Ameren.

The property Union Electric sold in 1992 for a gain is reflected on Ameren's consolidated financial statements as an acquisition adjustment. Union Electric shareholders received the full benefit to earnings for this gain, and with the merger, these shareholders received the property back.

Q. How do gains on sale of property relate to the booking of acquisition adjustments?

A. The amount a selling utility books as a gain on sale will equal the amount a buying utility will book as an acquisition adjustment.

Q. How did the Application of Union Electric merger with CIPSCO relate to the Union Electric sale dockets, Case Nos. EM-92-225 and EM-92-253?

A. In the sale dockets, Union Electric sold certain property to CIPSCO at a gain. This gain was booked below-the-line by Union Electric and was provided to its shareholders. In the Union Electric and CIPSCO merger Application, Union Electric, through Ameren, reacquired the property it earlier sold to CIPSCO that was at issue in Case Nos. EM-92-225 and EM-92-253. However, as a result of Union Electric's initial proposal, it sought to charge the additional cost of the merger premium related, in part, to that specific property to its customers. This would have been clearly inconsistent with the treatment afforded the earlier gain on sale.

DISALLOWANCE OF MERGER PREMIUMS IN RATES DOES NOT AFFECT MERGERS BEING COMPLETED IN MISSOURI

Q. UtiliCorp witness John W. McKinney suggests in his direct testimony at page 18, that "by arbitrarily choosing not to include a premium in rates, the regulators create disincentives for mergers that may establish net benefits for customers." Will disallowances of recovery of acquisition adjustments in rates create disincentives for utilities to acquire other utilities?

A. No, that does not appear to be the case at all in Missouri. The experience in Missouri appears to be that if the utility considering an acquisition believes that it is in its economic as well as its business interest, it will acquire the other company regardless of any recovery of an acquisition adjustment from ratepayers. There have been numerous mergers and acquisitions that have occurred over the years that were negotiated with merger premiums. No utility to date has received recovery in rates in Missouri for an acquisition adjustment, but that has not stopped any of the mergers from being completed.

Utilities have combined with other utilities independent of receiving recovery of the merger premium directly from their customers. There have been numerous mergers announced and completed in the past, all with the knowledge that this Commission has not ever included a merger premium in rates.

Q. Was there an acquisition adjustment relating to the KPL merger with KGE in Case No. EM–91–213?

A. Yes. Western Resources paid an amount for KGE in 1992 which exceeded its net book value, resulting in an acquisition adjustment identified at the time of the filing in that case of approximately $388.7 million.

Q. Did the Commission ever include any amount of the KGE acquisition adjustment in rates?

A. No. No amount of the KGE acquisition adjustment was ever recovered in rates from Missouri ratepayers.

Q. Was Staff opposed to the recovery of the acquisition adjustment relating to the KCPL and Western Resources merger in rates in Case No. EM-97-515?

A. Yes. Western Resources initially sought recovery of the acquisition adjustment in rates in both states of Missouri and Kansas through their "incentive regulatory plan." To the extent Western Resources attempted to recover from Missouri customers the acquisition adjustment resulting from the proposed KCPL merger, Staff took the position that should be considered a detriment from the proposed merger.

Q. Did Western Resources agree not to include the acquisition adjustment in rates?

A. Yes. In Case No. EM-97-515, Western Resources and KCPL agreed that the acquisition adjustment would not be recovered in rates. The Stipulation and Agreement in that case stated the following regarding the recovery of the merger premium:

> **2. MERGER PREMIUM**
>
> The **amount of any asserted merger premium** (*i.e.*, the amount of the purchase price above net book value) paid by Western Resources for KCPL **shall be treated below the line for ratemaking purposes in Missouri and not recovered in rates**. The Joint Applicants, including Westar, shall not seek to recover the amount of any asserted acquisition premium resulting from this transaction in rates in any Missouri proceeding and the Joint Application shall be considered as amended in this regard. The Joint Applicants have currently estimated this amount as approximately $870 million. In addition, Westar shall not seek to recover in Missouri the amount of any asserted acquisition premium in this transaction as being a "stranded cost" regardless of the terms of any legislation permitting the recovery of stranded costs from ratepayers.
>
> [Stipulation and Agreement in Case No. EM-97-515; emphasis added]

Q. Did the Commission approve the Stipulation and Agreement for the KCPL merger with Western Resources?

A. Yes. On September 2, 1999, the Commission approved the merger along with the Stipulation and Agreement that contained the "no acquisition adjustment recovery" language.

Q. Has there been a more recent merger case involving other utilities where the merging utilities have agreed to merge without recovery of the acquisition adjustment?

A. Recently, April 20, 2000, in Case No. GM-2000-312, the Commission approved the Stipulation and Agreement requesting the acquisition of the natural gas assets located in Missouri of Associated Natural Gas Company (Associated), wholly owned by Arkansas Western Gas Company (Arkansas Western), by Atmos Energy Corporation (Atmos). Atmos agreed not to seek recovery of the acquisition adjustment from Missouri customers. Previously, Arkansas Western's acquisition of Associated was approved by the Commission in Case No. GM-88-100 on May 13, 1988, at a premium but without recovery of the acquisition adjustment, and Arkansas Western recently sold the company to Atmos for a premium. The language in the recent Atmos acquisition – Arkansas Western Stipulation and Agreement is almost identical to the language in the Western Resources-KCPL Stipulation and Agreement. The Unanimous Stipulation and Agreement states, as follows:

> **3. <u>Acquisition Premium</u>**
>
> The amount of any asserted acquisition premium (i.e., the amount of the total purchase price above net book value), including transaction costs, paid by Atmos for ANG [Associated Natural Gas] properties or incurred as a result of the acquisition **shall be treated below the line for ratemaking purposes in Missouri and not recovered in rates**. Atmos shall not seek either direct or indirect rate recovery or recognition of the acquisition premium, including any and all transaction costs (e.g., legal fees, consulting fees and accounting fees), in any future ratemaking proceeding in Missouri. However, Atmos reserves the right to present evidence regarding any purported Sale-related savings in any rate complaint proceeding initiated by Staff or Public Counsel. [emphasis added]

Q. Have other utilities committed to not seek recovery of acquisition premiums in rates related to property acquired in Missouri?

A. Yes. In an application of Union Electric to merge with CIPSCO filed on November 7, 1995, Union Electric entered into a Stipulation and Agreement that contained language that it would not to seek recovery of a purported merger premium. The Commission on February 21, 1997 approved the merger, along with the Stipulation and Agreement. As part of the Stipulation and Agreement was the language that, "UE shall not seek to recover the amount of any asserted merger premium in rates in any Missouri proceeding. UE has identified this amount as $232 million." In addition, alleged benefits ere discussed in the Stipulation and Agreement:

> UE shall retain the right to state, in future proceedings, alleged benefits of the merger but UE **commits to forego any additional specific adjustments to cost of service related to the merger savings or any claim to merger savings** other than the adjustments to cost of service and claims to merger savings resulting from the Commission's approval of this document or the benefits and savings which would occur through regular ratemaking treatment or the current Experimental Alternative Regulation Plan ("ARP") or the new Experimental Alternative Regulation Plan ("the New Plan") effective July 1, 1998 pursuant to this document. [emphasis added]

In an application to acquire APL's Missouri properties, Union Electric also agreed in that case to not seek recovery of the acquisition premium. The parties to this Joint Application designated as Case No. EM-91-29, signed a Stipulation and Agreement on January 25, 1991. As part of the Stipulation and Agreement, Union Electric agreed not to seek recovery of the acquisition premium in any rate case in the future:

> The amount of any acquisition premium (i.e., the amount of the purchase price above net book value) paid by UE to APL for the electric properties of APL shall be treated below the line for ratemaking purposes in Missouri and shall not be sought to be recovered by UE in rates in any

> Missouri proceeding, and the Joint Application should be considered as amended in this regard.

The Staff performed an earnings audit in Case No. EM-91-29, and in Case No. EO-87-175, concurrent with the Stipulation and Agreement in Case No. EM-91-29, Union Electric agreed to absorb a $30 million decrease in revenue requirement allocated to the Small General Service, Large General Service and Primary Service customer classes. Re: Union Electric Co., Case Nos. EM-91-29, et al., Report and Order, 1 Mo.P.S.C. 3d 96,108 (1991) and Re: Union Electric Co., Case No. EO-97-175, Report and Order, 30 Mo.P.S.C.(N.S.) 406,410 (1990).

Also, Southern Union, parent of Missouri Gas Energy, agreed in 1993 to not recover the acquisition premium relating to its purchase of the Missouri properties of Western Resources. On August 5, 1993, Western Resources and Southern Union filed an application with the Commission seeking the authority from the Commission to make this purchase transaction in Case No. GM-94-40. The Stipulation and Agreement states as follows:

> The amount of any acquisition premium (i.e., the amount of the purchase price above net book value) paid by Southern Union to Western Resources for the gas properties of Western Resources shall be treated below the line for ratemaking purposes in Missouri and neither amortization nor inclusion of the premium in rate base shall be sought to be recovered by Southern Union in rates in any Missouri proceeding.

The Commission approved the Stipulation and Agreement on December 29, 1993.

Utilities operating in this State know the position taken by various parties relating to the no recovery of merger premiums/acquisition adjustments in rates and the Commission's approval of this. Yet, despite no utility being permitted direct recovery of a merger premium/acquisition adjustment in rates, mergers continue to be pursued and consummated. Other examples exist.

Q. UtiliCorp witness Robert K. Green cites previous Commission decisions at page 12 of his direct testimony as a basis for UtiliCorp to be "encouraged about the prospect of premium recovery by the policy position articulated by the Commission in these cases." Did the Commission allow recovery of any purported acquisition premium in the cases relied on by UtiliCorp?

A. No. One of the decisions Mr. Green cites is the Missouri-American Water Company case referred to at page 12 of his direct testimony (Case No. WR-95-205). The Commission did not allow recovery of the acquisition adjustment from Missouri-American's customers. The Commission stated in its Report and Order that "[t]he Commission finds in *this case that the Company has failed to justify an allowance for the acquisition adjustment.*" Re: Missouri-American Water Company, Case Nos. WR-95-205 and SR-95-206, Report and Order, 4 Mo.P.S.C. 3d 205,217 (1995).

Another case cited by Mr. Green was Case No. EM-91-213 which is the case authorizing KPL to acquire KGE. The Commission did not allow recovery of the acquisition adjustment from KPL's customers in that case. The Commission also did not adopt a "tracking" proposal presented by KPL that KPL claimed would have identified, verified and quantified purported merger savings and shared those savings equally between shareholders and customers. No part of the KGE acquisition adjustment was recovered by KGE from Missouri customers.

Staff does not believe the Commission's prior decisions on the subject of acquisition adjustments articulated in the above cases in any way served to "discourage companies from actions which produce economies of scale and savings which can benefit ratepayers and shareholders alike." Re: Missouri-American Water Company, 4 Mo.P.S.C. 3d at 216.

Q. Is there another case decided by the Commission where a utility presented savings as result of acquisitions?

A. Yes. In the Missouri Gas Energy (MGE) 1996 rate increase case, (Case No. GR-96-285), the Commission rejected a proposal by MGE to allow MGE to retain purported savings from Southern Union's acquisition of the Missouri properties of Western Resources in 1994. As part of the Stipulation and Agreement in Case No. GM-94-40, MGE could present to the Commission in its rate case purported evidence of savings resulting from the acquisition. The Commission's Report and Order in Case No. GR-96-285 states in part as follows:

> MGE contends that the stipulation and agreement allows MGE to request recovery of the benefits resulting from the acquisition. MGE contends that an equal sharing of these ongoing savings between customers and shareholders is a reasonable ratemaking approach and is consistent with the terms of the stipulation and agreement.
>
> ....
>
> ...Staff recommends that the Commission reject MGE's proposal because it does not represent appropriate or proper ratemaking policy because the alleged savings are not adequately quantified by MGE; the proposal is not fair and equitable; utilities other than MGE have also downsized without expecting any sharing of related savings; the alleged cost reductions benefited MGE at least up until any rate changes resulting from this proceeding; the proposal represents the equivalent of an incentive plan without any safeguards; the proposal shifts risks of MGE's cutbacks and related cost reductions to its customers; the proposal represents an attempted recovery of the acquisition premium from Case No. GM-94-40; and the proposal would take MGE off of cost of service ratemaking (cost-based rates). (Ex. 72, pp. 4-5) The Staff further argues that adoption of MGE's proposal would reward the Company for providing a lower quality of service while at the same time requesting ratepayers to pay higher than cost-based rates.
>
> The Commission finds that MGE's **acquisition savings adjustment should be rejected** in total because adoption of this adjustment would be contrary to the provision of natural gas service based on the costs of providing such service and because MGE's experimental gas cost

> incentive mechanism already rewards MGE's shareholders for making financially sound gas procurement decisions.
>
> [Re: Missouri Gas Energy, Case No. GR-96-285, Report and Order, 4 Mo.P.S.C. 3d 437, 460-461 (1997)]

TERMINATION OF THE KCPL MERGER WITH WESTERN RESOURCES

Q. Did the KCPL merger with Western Resources ever close?

A. No. KCPL terminated the merger after a nearly three-year attempt for those two companies to merge. On January 3, 2000, KCPL announced that it was exercising its rights as identified in the KCPL and Western Resources' merger agreement to terminate the merger.

Q. Do you believe the KCPL merger was terminated because the Commission approved the merger without the direct recovery of the merger premium?

A. No. KCPL terminated the merger with Western Resources because of Western Resources' non-regulated activities. The termination of that merger did not occur because of the Stipulation and Agreement that Western Resources-KCPL entered into with the Staff, Public Counsel and others.

Q. Please provide a history of the KCPL and Western Resources merger.

A. The merger between KCPL and Western Resources had a long history. On May 30, 1997, KCPL filed its initial application with the Commission requesting approval of a merger between KCPL and Western Resources as a result of the Agreement and Plan of Merger (original merger agreement) dated February 7, 1997.

On June 1998 these two companies filed a revised Merger Application as a result of an Amended and Restated Agreement and Plan of Merger (Amended Merger Agreement) between KCPL and Western Resources dated March 18, 1998. Under terms of this merger agreement, KCPL and Western Resources planned to merge, forming a newly created energy company called Westar Energy, Inc. (Westar). Western Resources planned on operating Westar as a holding company, owning approximately 80 percent of Westar. Both Westar and Western Resources would have been publicly traded on the New York Stock Exchange.

Q. Why did KCPL decide not to merge with Western Resources?

A. KCPL indicated that the stock price of Western Resources was significantly below the level negotiated between the two companies that resulted in a material decrease in the value that the KCPL shareholders would have received.

Q. What was the reason that Western Resources stock price was trading significantly below the level KCPL negotiated for its shareholders?

A. Western Resources had invested a substantial part of its assets in a security alarm system business as part of its diversification efforts. Western Resources has an 85% of ownership interest in Protection One. This non-regulated company has experienced substantial operational and regulatory problems that has caused the stock price of Western Resources to have deteriorated. KCPL's Board of Directors believed it had no choice but terminate the merger.

Q. What was Western Resource's common stock price at the time KCPL decided not to merge?

A. Western Resource's price of common stock was $16.50 per share January 3, 2000, the day of the announcement by KCPL that it had made the decision not to complete the merger with Western Resources.

Q. Has Western's Resources common stock price improved since the collapse of the KCPL merger?

A. No. Since the collapse of the KCPL merger, Western Resources' common stock price has continued a generally downward course. As an example, on January 31, 2000, the price per common share was $16.00; on February 29, 2000, the price per common share was $15.437; and on March 31, 2000, the price per common share was $15.812. On April 10, 2000, the price per common share was $15.062. Western Resources has not recovered since the demise of the KCPL merger, hitting a low of $14.937 per common share on April 7, 2000. Western Resources' common stock price for April 28, 2000 closed at $15.75 per share. The yearly high/low tables indicated a range from $29.37 to $14.68 per common share.

At the same time KCPL's stock price has continued to rise. On January 3, 2000, KCPL's stock price closed at $22.437 per common share. On January 31, 2000, the close was $24.312 per common share; on February 29, 2000, the stock closed at $23.00 per common share; on March 31, 2000, it closed at $29.00 per common share. For April 28, 2000, KCPL's common stock price closed at $25.687. The yearly high/low tables indicated a range from $29.00 to $20.81 per common share.

Q. What were the common stock prices of KCPL and Western Resources during the time the merger was pending?

A. The month-end common stock prices for the two companies were:

Date	Western Resources	KCPL
January 30, 1998	$40.75	$28.375
February 27	$41.00	$30.125
March 31	$42.75	$31.50
April 30	$39.062	$29.75
May 29	$38.375	$28.75
June 30	$38.812	$29.00
July 31	$39.00	$28.937
August 31	$40.312	$28.437
September 30	$41.375	$30.437

October 30	$35.00	$28.812
November 30	$34.937	$29.687
December 31	$33.25	$29.625
January 29, 1999	$31.437	$28.312
February 26	$28.187	$25.50
March 31	$26.687	$24.625
April 30	$27.187	$26.75
May 28	$29.062	$27.812
June 30	$26.625	$25.50
July 30	$26.125	$24.625
August 31	$23.875	$24.062
September 30	$21.375	$24.187
October 29	$23.062	$24.50
November 30	$18.687	$23.062
December 31	$16.937	$22.062

Beginning in first quarter of 1999, Western Resources started to release to the public that it was having problems with its non-regulated operations. This started the decline in Western Resources' common stock price. As long as the merger was "in play," KCPL's stock price was tied to Western Resources' stock price so KCPL's stock price also began its descent at this time too.

Q. Did the merger settlements approved by the KCC and the Missouri Commission have anything to do with the collapse of the merger between Western Resources and KCPL?

A. No. All the information I have seen regarding the reason for KCPL terminating the merger related solely to the declining value of the merger to KCPL's stockholders resulting from the substantial reduction in Western Resources common stock price. KCPL's stockholders, who initially approved the merger, would have received far less for their shares than they originally would have received at the time of the shareholder vote on July 30, 1998. The merger agreement between Western Resources and KCPL allowed KCPL to terminate the merger if Western Resources' common stock price fell below a $29.78 level or if the merger was not completed by December 31, 1999. (Amended And Restated Agreement And Plan Of Merger between KCPL and Western Resources dated March 18, 1998, Article XI-Termination, Amendment and Waiver—Section 11.1 Termination (c) and (f).)

A review of Western Resources' common stock prices surrounding the key dates during the regulatory process provides information on the relationship of those events on the stock price.

		Western Resources Price	KCPL price
Western Resources and KCPL shareholders approve merger	July 30, 1998	$39.562	$29.375
KCC Staff filing	February 18, 1999	$28.937	$26.625
	19	$29.375	$26.437
Missouri OPC filing	April 22	$26.50	$24.937
	23	$26.937	$24.625
Missouri Staff filing	April 26	$26.812	$24.562
	27	$27.00	$24.937
KCC Staff settlement	May 6	$27.75	$27.187
	7	$28.375	$27.00
	10	$28.687	$27.25
Missouri settlement	July 19	$25.375	$25.75
	20	$25.375	$26.312
	21	$25.937	$26.125
KCC introduces Missouri settlement	August 2	$26.50	$25.25
	3	$26.625	$24.937
	4	$26.187	$24.375
KCC Staff settlement rejected	August 11	$25.50	$23.625
	12	$24.50	$23.50
	13	$24.25	$23.437

KCC decides terms of approval	August 25	$24.00	$24.375
	26	$24.375	$24.375
	27	$24.375	$24.187
Missouri approval Order	September 2	$23.50	$23.937
	3	$23.437	$24.125
	7	$22.562	$24.187
KCC approval Order	September 28	$20.812	$23.437
	29	$20.75	$23.687
	30	$21.375	$24.187
KCPL terminates merger	January 3, 2000	$16.50	$22.437
	4	$17.062	$23.50
	5	$17.937	$23.875

As Western Resource continued to receive bad news about its non-regulated operations of Protection One, its stock price continued to decline. Since KCPL's January 3, 2000 termination of the merger, Western Resources' stock price has not improved and has continued to decline from the $16.50 per common share price on that date to April 28, 2000, closing of $15.75 per share.

There have been several news articles written about the collapse of the KCPL merger and all of them attribute the reason for the termination of the merger to the decline in Western Resources' stock price as result of Protection One operating and regulatory problems. None of the articles I have seen attributes the decline in Western Resources' stock price to the settlements reached in either of the State jurisdictions. In fact, if these decisions were so bad, then one would have expected to see an increase in Western Resource's stock price since the termination of the merger also had the effect of terminating the terms of the conditional approvals of the Missouri Commission and the KCC. Western Resources' common price stock has not increased since the termination of the merger by KCPL, rather the Western Resources stock price has further declined.

Q. *How have the credit rating agencies reacted to Western Resources' financial situation?*

A. Western Resources' ratings were lowered and Western Resources was placed on CreditWatch by the Standard & Poor's rating agency. Western Resources' corporate credit rating was lowered to BB+ from its previous BBB+ rating. Standard & Poor's also placed Western Resources on its CreditWatch with negative implications. Western Resources has also cut its common stock dividend to about $1.20 from the previous $2.14 per share.

Moody's also announced it was placing Western Resources' and KGE's ratings on review for possible downgrade. Fitch placed its ratings of Western Resources and KGE on RatingAlert – Negative. Western Resources filed its Form 10-K with the Securities and Exchange Commission (SEC) on March 29, 2000 identifying downward pressure to Protection One's ratings which affects Western Resources and KGE. Western Resources stated the following:

> In response to liquidity and operational issues and the announcement by Western Resources that it is exploring strategic alternatives for Protection One, in November 1999, Moody's, S&P and Fitch downgraded their ratings on Protection One's credit facility and outstanding securities. On March 24, 2000, Moody's further downgraded their ratings on Protection One's outstanding securities with outlook remaining negative.
>
> [Source: Western Resources Form: 10-K404 filing date: March 29, 2000]

Q. Has KCPL explained the reason for the termination of the merger with Western Resources?

A. KCPL has stated it was because of the problems with Western Resources stock price caused by the non-regulated operations of Protection One. In KCPL's Form

10-K405 filing with SEC on February 10, 2000, KCPL identified the reason its Board of Directors voted unanimously on January 2, 2000 for the termination of the merger as follows:

> A key factor in the KCPL's Board's action was problems at Western Resources' Protection One subsidiary and their impact on Western Resources as a whole. **These problems and the related decline in Western Resources' stock price since the signing of the Merger Agreement had a direct bearing on the value of the contemplated transaction to KCPL's shareholders,** as well as the future prospects of Western Resources and its affiliated companies assuming such transaction was consummated. Western Resources' common stock, which closed at $43.13 per share on March 18, 1998, closed at $16.94 per share on December 31, 1999.
>
> Also critical among the KCPL Board's reasons for their decision was the fact that KCPL's financial advisor, Merrill Lynch & Co., was unable to provide an opinion that the contemplated transaction was fair to KCPL shareholders from a financial point of view.
>
> [Source: KCPL's Form: 10-K405 filing date: February 10, 2000]

In a letter dated January 3, 2000 sent to Western Resources, KCPL's Chairman of the Board and Chief Executive Officer, A. Drue Jennings cited the reasons KCPL was terminating the merger. Mr. Jennings stated the following in his letter to Mr. David Wittig of Western Resources:

> Our Board took this action reluctantly and only after giving extensive consideration to all of the relevant facts and circumstances surrounding the transaction. As you know, our Board has held a number of meetings during the past several months to review and consider the status of the transaction. These meetings included a special meeting on October 28, 1999, at which you addressed the Board concerning the financial condition and future prospects and business plan of Western Resources, Inc. ("Western"), **and in particular, the current problems facing your Protection One subsidiary...**
>
> ....
>
> At these meetings, as well as in other communications between our respective companies and their representatives, **we have expressed**

> **our deep concern with the problems facing Protection One and their impact on Western as a whole...**
>
> ....
>
> While we and our advisors have given careful consideration to the information you conveyed to us in these meetings, I regret to say that our Board has concluded that the transaction contemplated by the Merger Agreement is no longer in the best interests of KCPL and its shareholders. Critical among the Board's reasons for reaching this conclusion was the fact that Merrill Lynch advised that it could not opine that the transaction is fair to KCPL shareholders from a financial point of view. In addition, one of the principal reasons that our Board recommended that KCPL shareholders approve the transaction was that it would provide them with an opportunity to participate, "through their ownership of Western Resources Common Stock, in the growth of a larger, more diversified and strategically positioned holding company," which growth was "expected to derive from diversification into unregulated businesses, including Western Resources' investment in Protection One...." (Joint Proxy Statement of KCPL and Western dated June 9, 1998, at page 42.) **In light of the continuing problems at Protection One, this important strategic rationale for the proposed merger no longer appears to exist.** Finally, we have heard from numerous KCPL shareholders in recent months – both large institutional holders and small individual holders – who, in increasing numbers, have expressed their opposition to the transaction and have strongly urged that we terminate the Merger Agreement.
>
> [Source: Letter dated January 3, 2000 from A. Drue Jennings to David Wittig of Western Resources]

In an article that appeared in The Kansas City Star on March 9, 2000, Mr. Jennings said "doubts about the merger began to rise in the second quarter of 1999 because of problems at Protection One Inc., the monitored-security firm that is 85 percent owned by Western. The continuing decline of Western's stock, which affected what would be paid to KCP&L shareholders, sealed the deal." Another article in the January 4, 2000 edition of the Topeka Capital-Journal, cited the original value of the merger at $2.1 billion at the time of the March 18, 1998 merger agreement was worth approximately $1.4 billion at the time of the termination because of the steep decline in Western Resources stock price.

Without question the reason KCPL terminated the merger with Western Resources was because of the adverse impact Protection One had on the Western Resources' stock price which in turn made the value of the merger to KCPL and its shareholders substantially less than when the Board of Directors approved the Merger Agreement on March 18, 1998 and the shareholders approved the merger on July 30, 1998.

The terms of the merger approved by the Missouri Commission and the KCC were not the reason that the Western Resources-KPL merger was not consummated.

MERGER TRACKING

Q. Are the Joint Applicants proposing to track merger savings?

A. Yes. The Joint Applicants are proposing a regulatory plan that will allow the post-merger UtiliCorp to recover the merger premium through retention of merger and non-merger related savings and direct recovery of the acquisition adjustment through rate base and amortization treatment in a rate case after a five-year moratorium. Under their proposal UtiliCorp and St. Joseph propose to "track" all savings, regardless if they are merger-related or non-merger related. The Joint Applicants' regulatory plan is also addressed in the rebuttal testimonies of Staff witnesses Mark Oligschlaeger and Janis Fischer.

Q. What is tracking of merger savings?

A. Tracking of merger savings is the post-merger process where it is asserted that the results of specific actions relating to the merger are isolated so they can be and are identified, verified and quantified. The purported results of what would have occurred but for the merger can be and are identified, verified and quantified and compared to substantiated non-merger related savings to determine whether there are merger savings and the amount of those savings. Tracking is the phenomenon by which this comparison of post-merger costs with pre-merger stand-alone costs is alleged to be possible.

Q. Can merger savings be "tracked," i.e., quantified and verified after–the–fact?

A. Merger tracking is extremely difficult if it can be done at all and, in actuality, it is probably not possible.

Q. Are you saying that it is difficult to prove and verify the actual savings which are purported to result from acquisitions and mergers?

A. Yes.

Q. Why is that the case?

A. The difficulty in identifying, verifying and quantifying merger savings, as well as merger costs, relates to the true difficulty in distinguishing between merger and non–merger events. Disputes will result which most likely will have to be resolved by the Commission. It is difficult to find agreement among the various parties as to what constitutes actual merger savings and, to a lesser extent, merger costs. Certainly, KPL, under the proposal advanced in the KPL/KGE merger case, Case No. EM–91–213, to share all merger savings on a 50/50 basis, had real incentives to identify and quantify as much savings as merger–related as possible, while ignoring the merger costs. The more merger savings and the less merger costs KPL could identify and quantify, the more dollars KPL believed it was entitled to recover via the acquisition premium rationale.

Utilities are complex organizations with overlapping activities and functional areas. They are dynamic organizations that operate in ever–changing environments. Generally, utilities are constantly organizing and reorganizing functions within their corporate structure to streamline activities and obtain efficiencies where possible. Various terms have been used to identify the restructuring of today's utility organizations such as downsizing, realigning, re-engineering and right-sizing. Most utilities should and do attempt to achieve efficiencies through the implementation of productivity measures. In this environment, it is unrealistic to believe that a tracking system can be put in place to identify and quantify savings and then isolate these savings as merger or non-merger related. It is very difficult to determine and measure the "cause and effect" relationship that may exist between taking an action and identifying and measuring the effects of that action and not taking an action and identifying and measuring the effects of the nonaction.

Any cost savings tracking system would have to be sophisticated enough to not only identify categories of prospective savings and costs, but to create documentation so that an examination can be conducted after-the-fact to recreate the decision–making process surrounding the costs and savings. Disagreements and disputes are certain in the context of an after–the–fact analysis. An efficiency which one party may assert is the result of a merger, another may view as nothing more than an operating efficiency, addressing a pre–existing condition of an on-going concern. Disputes will arise because companies have an incentive to identify as much of the savings as merger-related to capture as much of the merger savings for shareholders. As stated previously, there will be an incentive for the utility to identify as merger-related, as many workforce reductions and corresponding reductions in costs as possible. This inherent incentive makes it increasingly difficult on a going-forward basis to truly identify and quantify merger savings, as opposed to non–merger cost savings, because it is not possible to objectively evaluate what would have happened if the merger had not occurred. Utilities having to prove the existence and the amount of merger savings to justify the inclusion of the acquisition adjustment in rates, will make every effort to take credit for savings that may in actuality be nothing more than non-merger related.

Q. Why is it not possible to "track" merger savings?

A. Realistically, it is probably impossible to "track" merger savings because it requires a comparison of cost structures of the entities being merged on a pre-merger and post-merger basis. This would be extremely difficult at best and to my knowledge has never been done successfully before. The merged entities lose their complete identity post-merger, almost from the first day after the close of the merger. In fact, St. Joseph lost its pre-merger identity the day the merger was announced to the public on March 5, 1999. The pre-merger St. Joseph entity has not existed since.

Upon the announcement of a merger, the merging companies' stock prices are immediately affected. On March 4, 1999, the day before the announcement and the date the merger agreement was completed, the common stock price of St. Joseph was $16.875 per share. On March 5, 1999, the day of the announcement, St. Joseph's stock price increased to $20.375 per share. On March 4, 1999, there were 3,000 shares traded and on March 5, 1999, there were over 173,000 shares traded.

Every decision made by the companies after the merger is agreed to and announced is affected. Spending levels, human resources decisions, construction projects, etc. are all impacted. Every corporate decision is subject to the terms and conditions of the merger agreement, consequently, the corporate entity as it existed prior to the announcement of the merger no longer exists. While the period during the merger approval process generally results in significant changes at the entity being acquired, certainly after the completion of the merger the acquired entity ceases to exist in every sense. To use a still ever-changing pre-merger stand-alone entity for comparison to an emerging post-merger entity presents more than a challenge, it is an incredible task that the Staff's knowledge never has been achieved before.

Q. Is Staff aware of anyone using a "tracking" system to identify merger savings to set rates?

A. No. To best of Staff's knowledge this has never been accomplished.

Q. Explain how disputes will occur relating to "tracking" merger savings?

A. Any after-the-fact analysis will be very contentious. Disagreements will occur at every turn as to the identification, the verification and quantification of any alleged merger savings. Generally, these quantifications are self-serving in that the utility will have every incentive to identity as much merger savings as possible. Their rate structure and earnings levels will depend on it. Not to mention that the utility will have an especially strong desire to demonstrate the achievement of the merger savings because it wants to "prove" to the regulators that the merger was successful so that regulatory plans to "pay" for the merger will be implemented.

Q. Did KPL request the recovery of an acquisition adjustment when it proposed the merger with KGE in Case No. EM-91-213?

A. No. However, KPL expected to recover the acquisition premium in rates through a merger savings sharing proposal. In that case, KPL believed there would be sufficient merger savings, that could be used to allow recovery of the acquisition adjustment.

KPL proposed, in that case, a unique approach to "share" merger-related savings. The proposal was intended to allow KPL a partial or a full recovery of the acquisition premium, i.e., acquisition adjustment.

Although KPL never specifically stated that the sharing proposal would allow recovery of the acquisition premium, this in essence is what would have happened if such a proposal had been implemented. The only reason that KPL needed such a proposal in place was for regulatory purposes, i.e., to make positive adjustments to test year results in future rate cases. Thus, the merger savings sharing proposal was nothing more than a ratemaking vehicle to set rates at higher levels than the actual costs incurred by KPL.

Q. Why did KPL not directly request any recovery of the acquisition adjustment from the Missouri Commission?

A. KPL, in response to Data Request No. 147, Case No. EM–91–213, stated that its proposed future treatment of merger costs and benefits was based on a number of considerations, including "the jurisdiction's prior treatment of both negative and positive acquisition adjustments." KPL was indicating that the reason that it was not directly proposing to recover the acquisition adjustment in Missouri was because of the Commission's prior treatment of acquisition adjustments, i.e., the Missouri Commission's decision not recognizing a negative acquisition in KPL's purchase of Gas Service Company in 1983.

Q. Did the Commission adopt KPL's proposal to recover the acquisition premium through the sharing of the merger savings?

A. No. Although the Commission in its Report and Order in Case No. EM–91–213 initially stated its interest in the merger savings sharing concept, no part of the cost savings tracking system (CSTS) was ever implemented. The Commission stated at page 9 of that order:

> **. . . the Commission will not approve at this time the savings sharing proposal.** Staff has persuasively argued that KPL has a strong incentive to view savings as merger–related even if they are not and to classify them in the CSTS so as to increase the pool of savings subject to the sharing plan. **Staff demonstrated several flaws in the**

> **CSTS which could allow nonmerger savings to seep into the pool of savings to be shared.**
>
> **The Commission is not opposed to the concept of the savings sharing plan provided that only merger-related savings are shared.** The Commission does not wish to discourage companies from actions which produce economies of scale and savings which can benefit ratepayers and shareholders alike. However, **the Commission wishes to ensure that savings which would have been offset against the cost of service without the merger, benefit ratepayers one hundred percent. To avoid any detriment to ratepayers it is imperative that only savings which would not have occurred absent the merger be shared by ratepayers with shareholders.**

[Re Kansas Power & Light Co., Case No. Em-91-213, Report and Order, 1 Mo.P.S.C. 3d 150, 156-57 (1991); emphasis added.]

Q. Why was the cost savings tracking system never implemented?

A. The Commission, in its Report and Order in Case No. EM–91–213, directed "the parties to meet for the purpose of attempting to devise a method for tracking merger–related savings." 1 Mo.P.S.C. 3d at 157. No agreement could be reached among the parties to assure the Commission that nonmerger–related savings would be excluded from the cost savings tracking system. The Commission issued a follow–up Order Adopting Staff's Suggestion And Closing Docket on December 13, 1991 which placed this issue in KPL's next rate case. This two page Order stated in part as follows:

> Based upon these pleadings, the Commission determines that Staff's suggestion should be adopted, to forego consideration of this issue in this docket. If KPL wishes to have the possibility of receiving a share of the merger savings it may use a system it considers appropriate for excluding nonmerger savings from the pool of savings which might be shared and present that approach to the Commission in its next rate case complete with the amounts to be shared. At that time the Commission will consider whether the device employed by KPL is sufficiently foolproof to permit sharing of merger savings with shareholders.

Q. Did KPL address the merits of using the cost savings tracking system to identify merger savings in its next rate case?

A. Yes. KPL's next Missouri rate case was Case No. GR–93–240. KPL had taken the name Western Resources, Inc. In that case, Western Resources' Controller, Jerry D. Courington, indicated that Western Resources discontinued the use of the cost savings tracking system because of "the level of effort necessary to measure the savings and maintain the tracking system was relatively high when compared to the expected level of merger related savings in the jurisdictions in which it would be used." (Courington direct testimony, pages 14-15). Mr. Courington recognized in his direct testimony that merger costs and savings netted each other out with the Missouri allocated costs being "virtually unaffected in total by the merger." (Courington direct testimony, page 15). Western Resources made no adjustments in its rate case to reflect any recovery of the acquisition premium associated with the KGE merger in rates.

Q. Will it be difficult to "track" merger savings for the post-merger UtiliCorp?

A. Yes. UtiliCorp, not unlike many utilities today, has in the past, and continues at present, to engage in a very aggressive growth strategy through mergers and acquisitions. The constant changes resulting from acquiring new properties, in the situation of UtiliCorp, makes it even more difficult to identify, verify and quantify merger savings.

Q. Has UtiliCorp indicated that the Commission has established a "standard" for evaluating for the recovery of acquisition adjustments in the context of mergers?

A. Yes. At page 12 of UtiliCorp witness Robert K. Green's direct testimony he states that "the Commission has articulated a standard for premium recovery in its Case No. EM-91-213 (September 24, 1991)….". Both UtiliCorp witnesses Green and McKinney cite the Commission Order approving the 1992 KPL and KGE merger as basis for UtiliCorp's view that the Commission will be receptive to the inclusion of the acquisition adjustment resulting from the St. Joseph merger. Staff believes this reliance of the Commission's Order is misplaced and that UtiliCorp has not fully reflected the opinion of the Commission relating to merger savings in that case.

Q. Why do you believe that UtiliCorp has not fully reflected the wishes of the Commission as the result of the merger between KPL and KGE?

A. The Commission in the September 24, 1991 Order approving the KPL and KGE merger, clearly set out the "standard" that merger savings had to be segregated from non-merger related savings. UtiliCorp has indicated this separation was not necessary. In an interview held on March 2, 2000 with Staff and Public Counsel, UtiliCorp witness Siemek, indicated that:

> the distinction between merger synergies and other synergies, or other costs, is not very important, other than that hurdle rate [of $1.577 in years six through ten.]....in our case, it doesn't make any difference as long as....that hurdle rate. And even that makes no difference, because we've already committing to having that guaranteed reduction in the revenue requirement.
>
> [source: March 2, 2000 Siemek transcribed interview – pages 82 and 83]

From this discussion Staff is concerned that UtiliCorp has no intentions of attempting to track the merger and non-merger related savings. This is the very basis that forms the assessment as to the success or failure of the merger itself from a regulatory point of view, in particular if the company is requesting ratemaking treatment of an acquisition adjustment.

Q. Why did the Commission want to ensure merger savings were segregated from non-merger savings?

A. In its Order in Case No. EM-91-213, the Commission was explicit that there must be a segregation of merger and non-merger related savings. In fact, when KPL was unable to devise a "tracking" system which would separate the merger savings from the non-merger savings, the Commission issued its December 13, 1991 Order indicating that the savings sharing proposal would be rejected.

The Commission's reasons for requiring this separation is that it wanted to ensure that all the non-merger related savings generated by the company would be fully passed on to customers in rates. In the same paragraph cited by UtiliCorp as the basis for what it believes is the merger "standard" the Commission established to evaluate mergers, the Order stated "the Commission wishes to ensure that savings which would have been offset against the cost of service without the merger, benefit ratepayers one hundred percent."

The Commission made it very clear in the KPL/KGE merger Order that savings had to be identified between merger and non-merger related savings as a condition of the initial approval of the savings tracking proposal presented by KPL in that merger request. KPL was unable to demonstrate the ability to track costs, i.e., identify, verify and quantify savings between merger and non-merger related. Because of this inability to distinguish between the types of savings, the tracking proposal presented by KPL was rejected.

Q. Are merger and non-merger related savings different?

A. Yes. While they are both "savings" they are two very different types of savings. Merger related savings are those savings that can only occur as a result of the combining of two or more separate entities that were previously operating as separate and distinct from one another. Once the combination of the entities occurs there will be savings that will exist over time from the elimination of duplication and the economies of scale that happens through system and process improvements. Through out the organization. An example will be the position of corporate president. There is need for only one president of the company. One of the positions can be eliminated once the merger takes place. System improvements may result in the combining of activities such as the consolidation of customer call centers. Instead of operating two separate call centers because both pre-merger company has the need to operate their own call centers, the merger can result in savings from the elimination of one the call centers that is no longer needed. Process improvements would be the automation of certain functions such as in the areas of purchasing, accounting or human resource functions that may enable savings to occur as the direct result of the merger.

Non-merger related savings are those savings that occur over time as a result from improvements in the technology and the efficiencies from a better trained and skilled work force. Savings from the reorganization and re-engineering that occurs periodically. These type of savings also result from negotiating improved contract terms such as those relating to fuel supply, building leases and health and medical benefits. Reductions in cost of capital and tax rates can result in savings that having nothing to do with merger and acquisition activities. System and process improvements can take place absent a merger and would result in non-merger related savings. Non-merger related savings result on an on-going basis and occur, as labor becomes more efficient and productive. These savings occur absent mergers.

These two types of savings are viewed differently and are afforded different treatment in merger applications. Non-merger related savings are considered outside the scope of the merger. There is a widely accepted view that customers are entitled to these savings and that cost savings will eventually be provided to customers in the form of rate reductions. An example of reflecting non-merger related through reduced rates is the recent $15 million rate reduction passed on to KCPL's customers in 1999 (Case No. ER-99-313). Another example would be the $17 million rate reduction in UtiliCorp's Missouri Public Service division in 1997 (Case No. ER-97-394). In both of these cases the companies experienced cost reductions and revenue growth over a period of time not related at all to mergers. Both companies enjoyed the benefits of these cost reductions until the rates were changed.

Q. Did these companies voluntarily reduce rates?

A. In the case of KCPL, it did. Staff performed an earnings audit of KCPL and the parties reached an agreement on the dollar amount of reduction. In the case of UtiliCorp's Missouri Public Service division's rates, Staff had to file a complaint case to reduce rates. After Staff filed its complaint case, designated as Case No. EC-98-126, UtiliCorp filed a rate case designated as Case No. ER-97-394. The Commission issued its Order reducing Missouri Public Service's rates on March 6, 1998.

Q. Has the Commission had other concerns that indicated the importance of maintaining a distinction between mergers and non-merger related events?

A. Yes. In the KPL merger with KGE (Case No. EM-91-213), the Commission wanted to be certain that no merger related costs would be passed to customer. In the same Order cited by UtiliCorp, the Commission stated the following relating to the segregation of merger and non-merger costs:

> The Commission had also found that there is the potential for a detrimental effect on Missouri ratepayers from the merger through increased A&G and capital costs. Therefore, the Commission, in order to shield Missouri ratepayers from such detriment, has made it clear to KPL that such costs will be carefully scrutinized in any future, postmerger rate case to assure that no such detriment is suffered by Missouri ratepayers.
>
> ....

> The Commission will direct its Staff to carefully audit KPL in future rate cases to screen out costs caused by the merger and to suggest methods, if necessary in future rate cases, such as those recommended herein, which might be used to shield Missouri ratepayers from costs arising from the merger.
>
> The Commission will also direct KPL to keep its books so that costs associated with the merger are clearly segregated. Abnormal increases in A&G expenses will be carefully scrutinized and, unless persuasively explained as not related to the merger, will be associated with the merger.

[Commission Order in Case No. EM-91-213, pages 10 and 13]

In addition, UtiliCorp has been aware of the importance the Commission has given of the distinction between merger and non-merger related activities in prior Commission decisions affecting it rate applications. In UtiliCorp's 1990 rate case involving Missouri Public Service division, the Commission issued its Report and Order in Case No. ER-90-101 stating its decision on the importance of segregating UtiliCorp's merger and acquisition costs so those costs would be excluded from rates.

These merger and acquisition activities have been examined in each of UtiliCorp's rate filings and were specifically identified as an issue in Case No. ER-90-101. In that case, the Commission found that:

> The evidence indicates that Company has removed from its A&G costs most of the known expenses associated with M&A activities. The Commission believes that UtiliCorp's expenses for M&A activities should be removed from the expenses reflected in MPS' rates. When UtiliCorp was formed Company assured the Commission that the ratepayers would suffer no detriment from UtiliCorp's activities but would experience the benefits associated with UtiliCorp's activities. The Commission believes that it is inconsistent with this pledge to include M&A costs in the expenses reflected in MPS' rates. <u>The Commission is of the opinion that it is inappropriate for MPS' ratepayers to pay for these activities which have little to do with MPS' goal of providing safe and adequate electric service in Missouri.</u> Therefore, the Commission finds that the $70,280 of additional costs for M&A activities should be excluded from the cost of service. Finally, the Commission is concerned that Company has not been

> *accounting for these costs separately.* Accordingly, the Commission will direct Company to account for M&A costs separately so that they can be readily excluded in future rate cases from A&G costs reflected in MPS' rates.

[Source: 30 Mo.P.S.C. (N.S.) 320, 350; emphasis added]

Q. You have discussed the KPL cost savings tracking proposal that the Commission rejected in the KPL/KGE merger case. Does UtiliCorp believe it has a system that can "track" savings, merger or non-merger?

A. UtiliCorp claims it has the capability to "track" savings and will use this process to demonstrate that the merger will provide benefits sufficient to justify the inclusion of the acquisition adjustment in rates. UtiliCorp has proposed an "guarantee" of at least $1.6 million reduction to St. Joseph expense levels in each of the Years 6 through 10 of the merger. UtiliCorp is making this commitment so it can receive rate treatment of the acquisition adjustment. UtiliCorp witness Jerry D. Myers claims UtiliCorp's accounting system is able to "track" savings relating to this merger.

Q. Does Staff believe that UtiliCorp's accounting will be able to "track" merger savings?

A. No. UtiliCorp's accounting system, just like any other bookkeeping system will be able to categorize costs, and identify those costs to specific accounts when the system is told through a coding process where those costs should go. This same process is expected to be used to "track" merger savings. The accounting system still will require individuals to identity, verify and quantify the savings segregating those savings between merger and non-merger related events. UtiliCorp personnel will have to be able to determine what the pre-merger St. Joseph operations were to compare the costs the post-merger St. Joseph operations. Those individuals making "coding" decisions will have to make all kinds of judgments about assumptions and costs on how the impacts of the merger affected the post-merger St. Joseph's operations. During an interview with Mr. Myers on March 1, 2000, he indicated that coding would have to completed by individuals to enter into the accounting system. [Transcribed interview pages 19 through 26].

Q. What is the significance of individuals making the coding decisions to the accounting system?

A. These decisions are made in an after-the-fact fashion about a company that no longer exist. The many judgements that have to be made to identity and verify the existence of merger related savings will undoubtedly cause much disagreement and dispute. That would be the case as individuals are making the determinations as the information is entered into the accounting system. Unfortunately, the review process that takes place so that merger costs, and ultimately, merger savings, can be "carefully scrutinized" as required by the Commission in the KPL/KGE merger, takes place well after the decisions are made (coded) and information is entered into the accounting system. The ability to identify the merger savings will be even more difficult with under the UtiliCorp proposal because the regulatory plan proposed by UtiliCorp provides for a five-year moratorium that will mean the first time anyone will have an opportunity to "carefully scrutiniz[e]" the merger savings will be in excess of five-years from the close of the merger. This will not provide the kind of review the Commission expected the Staff to perform in the KPL/KGE merger as contemplated in Case No. EM-91-213.

CUSTOMERS ARE ENTITLED TO SAVINGS GENERATED BY UTILITIES FOR EITHER MERGER OR NONMERGER EVENTS

Q. Are St. Joseph's customers entitled to rate reductions related to cost savings?

A. Yes. Historically, customers have enjoyed the benefits of cost reductions, as well as declines in rate base and growth in revenues. As utilities experience productivity gains through technology improvements and downsizing of their work forces, cost increases have been kept in check. Through restructuring, reorganizations and re-engineering programs, utilities have been experiencing cost decreases (or, at least, cost increases have been kept to a minimum, allowing for revenue gains to out pace them) through improvement in methods and processes which have occurred over time. This is not to say that decreasing costs are not the result of developments other than efficiencies, such as decreasing interest rates.

Q. Why are customers entitled to benefit from savings?

A. Through the regulatory process, the utilities generally benefit most immediately from cost reductions and growth in revenues. When significant cost reductions take place over time, utility commission staffs or offices of consumer advocate may perform earnings reviews to determine the need for possible rate reductions. There are several factors that may cause reductions in rates:

1. Reduction in capital costs is one of the most significant causes for declining revenue requirements.
2. Early retirement programs and cost efficiencies have resulted in steady reductions in employee levels.
3. Renegotiations and aggressive negotiation of fuel supply contracts and railroad freight rates have resulted in a steady decline in actual fuel costs which has contributed significantly to cost savings.

> 4. With reduction in construction programs from the levels of the 1970s and 1980s, utilities have experienced declining rate base, and thereby decreasing revenue requirements.
>
> 5. Shifting allocations involving multi–state jurisdictions can, and do, result in declining jurisdictional costs and rate bases when growth occurs in other jurisdictions as a result of adding new customers and usage increases and adding service as a result of mergers and acquisitions.
>
> 6. Reductions in corporate income taxes have had a significant impact on utilities' cost declines.

All these factors can have a substantial impact on rates, causing the need to review rates periodically. St. Joseph has seen several rate reductions (and the elimination of the need for rate increases) since the mid-1980s after the construction of the Iatan Generating Station was completed in 1980.

Q. Have St. Joseph customers enjoyed the benefits of rate reductions?

A. Yes. Over the last decade, St. Joseph has reduced rates several times. As costs continue to decline, there is no reason to expect that further rate reductions would not occur.

Q. Has there been any recent reduction to St. Joseph's fuel costs?

A. Yes. In 1999, St. Joseph experienced a reduction in fuel costs at the Iatan Generating Station due to KCPL renegotiating the fuel supply agreement resulting in a substantial savings. This event is discussed in the rebuttal testimony of Staff Accounting witness V. William Harris.

Q. Will the merger allow for future rate reductions?

A. This is uncertain. The regulatory plan presented by UtiliCorp does not allow for any future rate reductions for at least five years (because of the proposed moratorium). UtiliCorp's savings tracking position as part of the proposed regulatory plan will not differentiate between merger and non–merger savings. Under the regulatory plan, the Iatan fuel cost reduction, which is clearly a non–merger related event, would not be reflected in rates under the five-year moratorium and would be "tracked" as an overall savings determination by UtiliCorp for the post–merger entity St. Joseph. It is the treatment of non-merger savings, in the proposed regulatory plan, such as the Iatan fuel cost reduction, that is most troubling to Staff.

The non-merger related savings certainly should not be retained by UtiliCorp for the recovery of the acquisition adjustment. For further discussion regarding the proposed regulatory plan, see Staff witness Oligschlaeger's rebuttal testimony.

Q. If the potential for future rate reductions will be reduced or eliminated, will that be a detriment to the public interest as a result of this merger?

A. Yes. *To the extent St. Joseph will continue to experience reductions in costs,* reductions in the cost of the capital structure and the cost of money, or increases in revenues for Missouri customers, then those items should result in future reductions in rates. If this merger adversely impacts St. Joseph's ability to reduce rates in the future, then Staff believes that this would be a detriment to the public interest resulting from the merger.

Q. UtiliCorp witness John W. McKinney states at page 16 of his direct testimony that "when the premium and resulting cost savings are analyzed together, the Commission will see that inclusion of the premium in the cost of service will not increase SJLP's customers rates. It will even lower rates." Is this a reasonable view of what will be the actual results of UtiliCorp's regulatory plan?

A. No. What Mr. McKinney is failing to convey to the Commission in his comments is that under the Joint Applicants' regulatory plan, it is impossible to lower rates for a period of almost six years. UtiliCorp wants rates frozen for five years, and sometime during the fifth year will file a rate case. All savings, merger and non-merger related, will be fully retained by UtiliCorp. It is inconceivable how the Joint Applicants' regulatory plan will result in lower rates, especially if restructuring of the electric industry occurs in Missouri during the five-year moratorium as proposed under certain bills introduced this session. If such restructuring occurs during the time frame of the Joint Applicants' Regulatory Plan, any future lowering of rates will be precluded. The opportunities for St. Joseph's customers experience whatever benefits of the merger will be much less if substantial changes in the industry occur.

Q. Are St. Joseph's rates low?

A. Yes. St. Joseph has one of the lowest electric rates in this region. It is a low-cost company generating electricity on a low-cost basis and its corporate overheads are among the lowest in the region. For further discussion on rate levels of St. Joseph compared to the rate levels other utilities in this region, see the rebuttal testimony of Staff witness Williams.

COMMITMENTS MADE/ PROMISES KEPT

Q. UtiliCorp witness Robert Green states at page 14 of his direct testimony that "it has always been and continues to be UtiliCorp's position that Missouri ratepayers would not be adversely or detrimentally affected by our merger and acquisition strategy. That is just as true today as it was 15 years ago. Seeking premium recovery is not inconsistent with this position." Does Staff agree that UtiliCorp has maintained those commitments?

A. No. The commitment Mr. Green is referring to is one that UtiliCorp made to the Missouri Commission that UtiliCorp would provide any upside benefits to Missouri customers and insulate those same customers from any downsides of UtiliCorp's merger and acquisition activities. The Commission in its Report and Order in Case No. ER-90-101, referenced this pledge of UtiliCorp wherein the Commission stated that "[w]hen UtiliCorp was formed Company assured the Commission that the ratepayers would suffer no detriment from UtiliCorp's activities but would experience the benefits associated with UtiliCorp's activities." Re: Missouri Public Service, Case Nos. ER-90-101, et al., Report and Order, 30 Mo.P.S.C. (N.S.) 320,350 (1990).

In fact, in a 1989 speech given by Mr. Richard C. Green, Jr., then UtiliCorp President and Chief Executive Officer, before the National Association of Regulatory Utility Commissioners (NARUC), he identified the UtiliCorp philosophy regarding its growth strategies. In response to Office of Public Counsel's Data Request No. 216 in Case No. ER-90-101, UtiliCorp stated the "overall corporate strategy has been consistently implemented since the inception of the UtiliCorp name change. It is most comprehensively described in a speech before NARUC" as follows:

> In 1983, [Mr. Richard C. Green] went to the Missouri Public Service Commission with a plan to add value for the customers and shareholders of my company. A principal component of this plan was to expand through utility acquisitions. Of course, the concern of the Missouri commission was whether this plan would be a detriment to Missouri ratepayers.
>
> The Missouri commission has shown a willingness to allow us to pursue this plan because UtiliCorp made a commitment to flow only benefits to Missouri customers and not to pass on any new problems that may arise. At no time will we jeopardize our own financial integrity. We recognize that it is vitally important not to put Missouri's sound utility infrastructure at risk.
>
> Six years later, this commitment still stands. Our record shows we have lived up to everything we have promised. This process has worked well. By taking a different regulatory approach, the Missouri Commission has allowed us to serve our customers better and build value for our shareholders.
>
> ....

> **UtiliCorp has followed a firm policy of not seeking to recover any of its acquisition-related premiums through rates.** We have made a very persuasive case to investors that any premium costs or share dilution they experience will be for the short-term. We believe we can demonstrate that UtiliCorp will financially outperform the industry in the long-term.
>
> [Source: OPC Data Request No. 216, Case No. ER-90-101; emphasis added]

The entire speech before the NARUC is attached as Schedule 4.

In response to a Data Request submitted in Case No. ER-90-101, UtiliCorp stated in reference to a question regarding commitments to pass on benefits, not problems/costs to Missouri consumers:

> Mr. [Richard C.] Green's commitment to the Missouri commission was (1) **that premiums paid for utility acquisitions would not be recovered through Missouri rates**, and (2) that there would be no cross subsidization of the company's various division and subsidiary operations. These commitments have been kept.
>
> **Premiums paid for acquired utility properties** are amortized by the corporation over varying periods of time and **are not being recovered through rate structures in any of our service jurisdictions**. In addition, each division and subsidiary exists as a stand-alone entity with its own allocated capital structure.
>
> Benefits which have been passed along to Missouri ratepayers include: easier access to capital through lower debt costs and marketable equity securities; economies of scale in such areas as pension and health benefits, centralized purchasing and consolidations of computer and purchase contracts and other areas enumerated in Mr. Green's pre-filed direct testimony in this case.

[Source: Response to Data Request No. 368, Case No. ER-90-101; emphasis added]

Q. Has UtiliCorp understood that its merger and acquisition policies would have to develop without assurances of recovery of the merger premiums?

A. Yes. In March 1987, at a investor analyst meeting in San Francisco, Mr. Richard C. Green, Jr., made a statement regarding the recovery of merger premiums as it related to UtiliCorp's merger and acquisition strategies. Mr. Green stated the following:

> No, how do we look at new acquisition properties is the question. No, its more the traditional utility sense because whether you like it or not, you're going to be traditionally regulated. So you've got to play by those rules and when you tack a premium on you got to know you're **not** going to be allowed to earn a return, so you've got to squeeze that out of other places. So you want to look at things differently and be more aggressive, but the realities of life is that that Commission is not there yet and they're going to do it the old traditional way...

[Source: Transcript of video relating to the San Francisco Analyst meeting March 1987 provided by UtiliCorp in response to Data Request No. 476 (Case No. ER-90-101); emphasis added]

Another example of this commitment not to seek recovery of acquisition premiums in rates is a May 21, 1990 interview with Mr. Richard Green by members of the Office of the Public Counsel and Staff. Mr. Green indicated once again that UtiliCorp would exclude acquisition premium from rates. In the interview, Mr. Green was asked about the discussion he had with the Commissioners in early 1986, wherein he made his commitment to insulate the Missouri customers from the "downside risks" relating to UtiliCorp's merger and acquisition strategy:

> In a meeting with the Commissioners and Staff members held at the Commission offices in Jefferson City in late 1985/ early 1986, Green stated that MOPUB's Missouri ratepayers would be insulated from all "downside risks" associated with the corporate M&A strategy. In part, those discussions with the Commission focused on UtiliCorp's need to receive timely financing authorization regarding its acquisition strategy. At that time, Green said he would be coming back before the Commission for additional financing for acquisitions. In the agenda meeting before the Commission, Mr. Green pledged that at no time would Missouri ratepayers be adversely or detrimentally impacted by UtiliCorp's M&A strategy. In the context of needing future financing, Green stated that all benefits would flow to the ratepayers and that they would be insulated from all "downside risks." In that meeting Mr. Green explained this meant that all benefits relating to a larger, less risky consolidated UtiliCorp would flow to Missouri ratepayers while these ratepayers would be insulated from any negative or detrimental impacts.
>
> Green said he concurred with the above assessment of that meeting, and still holds that view today. **He said he has not only made that**

> **pledge but has kept it. Green said evidence of this was that at no time has or would UtiliCorp attempt to seek recovery in rate base, premiums** (acquisition costs in excess of book value) **paid for M&A properties by way of a positive acquisition adjustment.**
>
> Green believed it was reasonable that UCU make this commitment. There is no reason that a problem found elsewhere would provide a reason to seek higher rates from MOPUB's ratepayers. Green believes that the commitment not only can be made, but was, and still is being made.

[Source: Richard Green May 21, 1990 interview in Case No. ER-90-101 - Data Request No. 591; emphasis added]

It is clear from the statements made to the Commission and elsewhere in speeches that in order to gain support for UtiliCorp's merger and acquisition growth strategy, UtiliCorp was willing commit to not seek recovery of merger premiums resulting from this growth strategy. While UtiliCorp can certainly change its position and go back on this commitment, as now appears to be the case with the proposed regulatory plan being pursued as outlined in Mr. McKinney's direct testimony, the fact of the matter is that UtiliCorp's merger and acquisition activities have not been questioned by this Commission over the many years that UtiliCorp's hold harmless merger and acquisition philosophy has been in place. Mr. Green sought support from the Commission when he needed the financing of UtiliCorp's growth strategy. He made a promise not to seek recovery of the merger premiums that resulted from this growth strategy. The Staff hopes UtiliCorp will reconsider its position relating to the regulatory plan that it has filed in this case and renew its pledges to not seek recovery of merger premiums from its Missouri customers.

UtiliCorp on numerous prior occasions made it clear it would not seek recovery of merger and acquisition premiums from its Missouri customers. Evidently, something has happened to cause UtiliCorp to no longer honor that commitment it made to the Commission in the past. Regardless of the reasons for this change in position, the former position of UtiliCorp whereby it insulated its retail utility customers from the risks of UtiliCorp's merger and acquisition strategy was appropriate, and still is appropriate, if not more so considering all of the non-regulated activities of UtiliCorp as well as the changes occurring as a result of electric restructuring. UtiliCorp's growth strategy is even more pronounced today then it was just even a few years ago.

As this growth strategy intensifies, seemingly UtiliCorp intends to ask this Commission to provide UtiliCorp assistance in these activities so that UtiliCorp's shareholders will be protected from earnings dilution. The Staff does not believe UtiliCorp's Missouri retail ratepayers should be provide such assistance which would place these customers in the position of subsidizing UtiliCorp's merger and acquisition policies.

Q. Was the May 21, 1990 interview with Mr. Green verified?

A. Yes. Staff conducted several interviews of UtiliCorp officials in the 1990 rate case. As part of the process, before court stenographers were used, participants compiled their notes from the meeting and submitted these notes to each person interviewed for verification of accuracy. Mr. Green's interview was submitted for verification in Data Request No. 591 (Case No. ER-90-101), an excerpt from which appears above. The following statement was agreed to by UtiliCorp in order to authenticate the content of the interview write-up: "While not necessarily all-inclusive, the attached summary of the interview of Mr. Richard Green, as amended, **is accurate in all material respects** and represents factual information." [emphasis added]

CAPITAL STRUCTURE

Q. Mr. McKinney indicates at page 28 of his direct testimony that part of the Joint Applicants' proposal in this case is for the Commission to agree to use St. Joseph's existing stand-alone capital structure in UtiliCorp's future rate cases involving the post-merger St. Joseph division. What does this proposal of the Joint Applicants relate to?

A. This proposal seeks to "freeze" the capital structure of the pre-merger St. Joseph in any future post-merger rate case respecting the St. Joseph division of UtiliCorp. In effect, this procedure results in any potential savings relating to the capital structure resulting from the merger to be fully retained by UtiliCorp and not be reflected for the post-merger St. Joseph division of UtiliCorp. All future rate cases would "freeze" the capital structure at 47% debt and 53% equity. Essentially, this proposal would keep the capital structure for the St. Joseph division of UtiliCorp at a level as though the merger never took place. Staff believes this proposal is patently unreasonable and is opposed to this recommendation. Staff views an attempt to capture the merger benefits relating to one of the more substantive merger savings for UtiliCorp.

UtiliCorp is attempting to retain the benefits of any perceived lowering of capital costs through the use of a consolidated capital structure by proposing to impute a hypothetical stand-alone divisional capital structure to the post-merger St. Joseph that will not actually exist after the merger takes place. Consequently, one of the major benefits of UtiliCorp's growth strategy (lower capital costs) will be denied to St. Joseph's customers because UtiliCorp wants to retain all of the merger savings associated with the post-merger St. Joseph capital structure. This is an example where UtiliCorp is picking and choosing what merger benefits to pass on to post-merger divisions' customers. The "frozen" capital structure is certainly not an example of

UtiliCorp's former commitment to insulate ratepayers from the "downside risks" of its growth strategy and flow benefits to the customers.

Q. Why are merger benefits resulting from the post-merger capital structure changes considered to be one of the more substantive types of merger savings?

A. The merger savings associated with the post-merger capital structure are one of the more easily defined and easily achieved of any of the other purported merger savings categories. As discussed elsewhere in my rebuttal testimony, as well as in other Staff witnesses' testimonies, merger savings are at best speculative. Merger savings are not easily identified or quantified with any degree of certainty. However, capital structure benefits will be immediate when the merger is finalized. St. Joseph will cease to exist as a stand-alone entity and will be capitalized by UtiliCorp's capital structure.

Q. Mr. McKinney states at page 28 of his direct testimony, that "absent the merger, [the 47% debt and 53% equity] capital structure would not have changed appreciably. Retaining that capital structure results in no new cost to the existing SJLP customers." Does Staff agree?

A. No. This would be tantamount to saying that if any aspect of the merger "results in no new cost to the existing SJLP customers," then none of the merger benefits should be passed on to these customers. Typically, no merger proposal would be taken seriously by regulatory bodies if there were no prospects of merger savings benefiting customers.

Q. Will there be any benefits to St. Joseph's post-merger financing costs from being part of a much larger UtiliCorp entity?

A. Yes, generally there are. In fact, in the very early stages of developing UtiliCorp's merger and acquisition strategy, financing the corporation through a larger organization was cited as one of the major benefits of this strategy.

Throughout the late 1980's, UtiliCorp's position was that one of the advantages and benefits to growing its business through its merger and acquisition strategy was better access to the capital markets in financing its short- and long-term commitments. UtiliCorp asserted that this strategy had direct benefits in lowering UtiliCorp's risk and ultimately its cost of money. This strategy would have an effect of lowering overall revenue requirements because UtiliCorp requiring a lower return as a result of its diversification and growth strategy.

Q. Where did UtiliCorp indicate that one of the benefits of its growth strategy was a reduction in the cost of capital?

A. UtiliCorp has made the claim in internal documents and public documents that its growth strategy has resulted in lower capital costs. UtiliCorp stated that its growth strategy would provide significant benefits in lowering its cost of money. In a 1985 financing application filing approved by the Commission in Case No. EF-86-73, UtiliCorp received permission to acquire Peoples Natural Gas Company (Peoples) from InterNorth. In response to a Data Request in that case, UtiliCorp stated that a lower cost of capital was a benefit, which would be derived from the growth strategy. In response to Data Request No. 6 in Case No. EF-86-73, UtiliCorp stated the following:

> The acquisition is expected to, after assimilation of the information by financial markets, lead to a reduction in capital costs for UtiliCorp United. <u>This expected reduction in capital costs will eventually produce reductions in rates of return</u> claimed by Missouri Public Service Company in proceedings before the Missouri Public Service Commission.

[Schedule 5, emphasis added]

In response to follow-up Data Request No. 6a, UtiliCorp stated:

> Based upon its utility business experience, management also concluded that UtiliCorp's capital costs should be reduced as the result of the acquisition because UtiliCorp should then be viewed more favorably by the financial community as it should be of a sufficient size so as the permit it to qualify for higher financial ratings than those now available to the Company absent the acquisition. <u>Higher financial ratings should, in turn, lead to lower rates of return claimed in regulatory proceedings.</u>

[Schedule 6; emphasis added.]

Even though UtiliCorp believed in 1985 that there would be reductions in capital costs which would in turn reduce rates of return that UtiliCorp would request in future rate proceedings, UtiliCorp has consistently requested in MPSC rate filings the use of the divisional stand-alone capital structure, similar to the position UtiliCorp is presenting in this merger case. Just as the use of a divisional capital structure has the effect of increasing the revenue requirement UtiliCorp requests in MPS rate cases, the frozen pre-merger St. Joseph capital structure will have the same effect on post-merger St. Joseph's divisional revenue requirement.

Q. Why or how does the UtiliCorp growth strategy result in lower cost of capital?

A. UtiliCorp stated that one of the major benefits of its growth strategy is a perception among investors that UtiliCorp is a less risky enterprise because of its diversification efforts. This is due in part to the perception that spreading the risk of UtiliCorp's operations throughout several regulatory jurisdictions to protect earnings from adverse regulatory decisions of specific regulatory bodies, spreading the asset base over several States, and expanding the earnings base between summer and winter peaking utilities, would result in greater earnings stability. To the extent that this spreading of risk does result in a lowered cost of capital, then that should be reflected in the rate structure of the existing MPS division as well as the post-merger rate structure of the St. Joseph division.

Q. Does Staff believe that UtiliCorp's position relating to its proposed frozen St. Joseph capital structure, is inconsistent with the commitment given by Mr. Richard Green that benefits of the growth strategy will be given to Missouri customers?

A. Yes. If St. Joseph's post-merger rates are higher as a result of using the proposed frozen capital structure than by using UtiliCorp's consolidated capital structure, then one of the major benefits of UtiliCorp growth strategy will not be provided to customers of St. Joseph.

Q. Is the freezing of the capital structure for the post-merger St. Joseph division similar to the divisional stand-alone capital structure presented by UtiliCorp in its 1997 rate increase case, Case No. ER-97-394?

A. Yes. Both the position presented by UtiliCorp in its 1997 rate case and the frozen St. Joseph pre-merger capital structure position being pursued by UtiliCorp in this case as identified in Mr. McKinney's direct testimony are intended to have the same results.

Q. Did the Commission adopt in Case No. ER-97-394 UtiliCorp's position on a divisional stand-alone capital structure?

A. No. The Commission rejected UtiliCorp's proposal in Case No. ER-97-394 just as it did in Case No. ER-90-101.

Q. Is any other Staff members providing rebuttal testimony on UtiliCorp's proposal for a post-merger frozen capital structure for the proposed St. Joseph division of UtiliCorp?

A. Yes. Staff witness David P. Broadwater of the Commission's Financial Analysis Department will provide testimony on this issue.

Q. Does this conclude your rebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company With and Into UtiliCorp United Inc. and, In Connection Therewith, Certain Other Related Transactions.)	Case No. EM-2000-292

AFFIDAVIT OF CARY G. FEATHERSTONE

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Cary G. Featherstone of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 92 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Cary G. Featherstone

Subscribed and sworn to before me this 20 day of May 2000.

Toni M. Willmeno
Notary Public, State of Missouri
County of Callaway
My Commission Expires June 24, 2000

TONI M. WILLMENO
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

Cary G. Featherstone

SUMMARY OF RATE CASE INVOLVEMENT

Year	Case No.	Utility	Type of Testimony	
1980	Case No. ER-80-53	St. Joseph Light & Power Company (electric)	Direct	Stipulated
1980	Case No. OR-80-54	St. Joseph Light & Power Company (transit)	Direct	Stipulated
1980	Case No. HR-80-55	St. Joseph Light & Power Company (industrial steam)	Direct	Stipulated
1980	Case No. GR-80-173	The Gas Service Company (natural gas)	Direct	Stipulated
1980	Case No. GR-80-249	Rich Hill-Hume Gas Company (natural gas)	No Testimony filed	Stipulated
1980	Case No. TR-80-235	United Telephone Company of Missouri (telephone)	Direct Rebuttal	Contested
1981	Case No. ER-81-42	Kansas City Power & Light Company (electric)	Direct Rebuttal	Contested
1981	Case No. TR-81-208	Southwestern Bell Telephone Company (telephone)	Direct Rebuttal Surrebuttal	Contested
1981	Case No. TR-81-302	United Telephone Company of Missouri (telephone)	Direct	Stipulated
1981	Case No. TO-82-3	Investigation of Equal Life Group and Remaining Life Depreciation Rates (telephone-- depreciation case)	Direct	Contested

Year	Case No.	Utility	Type of Testimony	
1982	Case Nos. ER-82-66 and HR-82-67	Kansas City Power & Light Company (electric & district steam heating)	Direct Rebuttal Surrebuttal	Contested
1982	Case No. TR-82-199	Southwestern Bell Telephone Company (telephone)	Direct	Contested
1983	Case No. EO-83-9	Investigation and Audit of Forecasted Fuel Expense of Kansas City Power & Light Company (electric-- forecasted fuel true-up)	Direct	Contested
1983	Case No. ER-83-49	Kansas City Power & Light Company (electric)	Direct Rebuttal Surrebuttal	Contested
1983	Case No. TR-83-253	Southwestern Bell Telephone Company (telephone)	Direct	Contested
1984	Case No. EO-84-4	Investigation and Audit of Forecasted Fuel Expense of Kansas City Power & Light Company (electric-- forecasted fuel true-up)	Direct	Contested
1985	Case Nos. ER-85-128 and EO-85-185	Kansas City Power & Light Company (electric)	Direct	Contested
1987	Case No. HO-86-139	Kansas City Power & Light Company (district steam heating-- discontinuance of public utility)	Direct Rebuttal Surrebuttal	Contested
1988	Case No. TC-89-14	Southwestern Bell Telephone Company (telephone-- complaint case)	Direct Surrebuttal	Contested
1989	Case No. TR-89-182	GTE North, Incorporated (telephone)	Direct Rebuttal Surrebuttal	Contested

Year	Case No.	Utility	Type of Testimony	
1990	Case No. GR-90-50	Kansas Power & Light - Gas Service Division (natural gas)	Direct	Stipulated
1990	Case No. ER-90-101	UtiliCorp United Inc., Missouri Public Service Division (electric)	Direct Surrebuttal	Contested
1990	Case No. GR-90-198	UtiliCorp United, Inc., Missouri Public Service Division (natural gas)	Direct	Stipulated
1990	Case No. GR-90-152	Associated Natural Gas Company (natural gas)	Rebuttal	Stipulated
1991	Case No. EM-91-213	Kansas Power & Light - Gas Service Division (natural gas-- acquisition/merger case)	Rebuttal	Contested
1991	Case Nos. EO-91-358 and EO-91-360	UtiliCorp United Inc., Missouri Public Service Division (electric-- accounting authority orders)	Rebuttal	Contested
1991	Case No. GO-91-359	UtiliCorp United Inc., Missouri Public Service Division (natural gas)	Memorandum Recommendation	Stipulated
1993	Case Nos. TC-93-224 and TO-93-192	Southwestern Bell Telephone Company (telephone-- complaint case)	Direct Rebuttal Surrebuttal	Contested
1993	Case No. TR-93-181	United Telephone Company of Missouri (telephone)	Direct Surrebuttal	Contested
1993	Case No. GM-94-40	Western Resources, Inc. and Southern Union Company (natural gas-- sale of Missouri property)	Rebuttal	Stipulated

Year	Case No.	Utility	Type of Testimony	
1994	Case No. GM-94-252	UtiliCorp United Inc., acquisition of Missouri Gas Company and Missouri Pipeline Company (natural gas--acquisition case)	Rebuttal	Contested
1994	Case No. GA-94-325	UtiliCorp United Inc., expansion of natural gas to City of Rolla, MO (natural gas-- certificate case)	Rebuttal	Contested
1995	Case No. GR-95-160	United Cities Gas Company (natural gas)	Direct	Contested
1995	Case No. ER-95-279	Empire District Electric Company (electric)	Direct	Stipulated
1996	Case No. GA-96-130	UtiliCorp United, Inc./Missouri Pipeline Company (natural gas-- certificate case)	Rebuttal	Contested
1996	Case No. EM-96-149	Union Electric Company merger with CIPSCO Incorporated (electric and natural gas--acquisition/merger case)	Rebuttal	Stipulated -
1996	Case No. GR-96-285	Missouri Gas Energy Division of Southern Union Company (natural gas)	Direct Rebuttal Surrebuttal	Contested
1996	Case No. ER-97-82	Empire District Electric Company (electric-- interim rate case)	Rebuttal	Contested
1997	Case No. EO-97-144	UtiliCorp United Inc./Missouri Public Service Company (electric)	Verified Statement	Commission Denied Motion
1997	Case No. GA-97-132	UtiliCorp United Inc./Missouri Public Service Company (natural gas—certificate case)	Rebuttal	Contested
1997	Case No. GA-97-133	Missouri Gas Company (natural gas—certificate case)	Rebuttal	Contested

Year	Case No.	Utility	Type of Testimony	
1997	Case Nos. EC-97-362 and EO-97-144	UtiliCorp United Inc./Missouri Public Service (electric)	Direct	Contested
1997	Case Nos. ER-97-394 and EC-98-126	UtiliCorp United Inc./Missouri Public Service (electric)	Direct Rebuttal Surrebuttal	Contested
1997	Case No. EM-97-395	UtiliCorp United Inc./Missouri Public Service (electric-application to spin-off generating assets to EWG subsidiary)	Rebuttal	Withdrawn
1998	Case No. GR-98-140	Missouri Gas Energy Division of Southern Union Company (natural gas)	Testimony in Support of Stipulation And Agreement	Contested
1999	Case No. EM-97-515	Kansas City Power & Light Company merger with Western Resources, Inc. (electric, natural and industrial steam acquisition/ merger case)	Rebuttal	Stipulated (Merger eventually terminated)

AUDITS WHICH WERE SUPERVISED AND ASSISTED:

Year	Case No.	Utility
1986	Case No. TR-86-14 (telephone)	ALLTEL Missouri, Inc.
1986	Case No. TR-86-55 (telephone	Continental Telephone Company of Missouri
1986	Case No. TR-86-63 (telephone)	Webster County Telephone Company
1986	Case No. GR-86-76 (natural gas)	KPL-Gas Service Company
1986	Case No. TR-86-117 (telephone)	United Telephone Company of Missouri
1988	Case No. GR-88-115 (natural gas)	St. Joseph Light & Power Company
1988	Case No. GR-88-116 (industrial steam)	St. Joseph Light & Power Company

THE STATE CORPORATION COMMISSION

OF THE STATE OF KANSAS

BEFORE COMMISSIONERS: MICHAEL LENNEN, CHAIRMAN
RICHARD C. (PETE) LOUX
PHILLIP R. DICK

IN THE MATTER OF THE JOINT APPLICATION OF THE KANSAS POWER AND LIGHT COMPANY AND THE GAS SERVICE COMPANY FOR A CERTIFICATE AUTHORIZING THE KANSAS POWER AND LIGHT COMPANY TO ISSUE PROMISSORY NOTES AND FOR AN ORDER AUTHORIZING THE KANSAS POWER AND LIGHT COMPANY TO ACQUIRE ALL OF THE COMMON STOCK OF THE GAS SERVICE COMPANY.	)	DOCKET NO. 138,495-U

JOINT SUBMISSION BY KPL AND GAS SERVICE
PURSUANT TO ORDER OF SEPTEMBER 20, 1983

ON SEPTEMBER 20, 1983, THE STATE CORPORATION COMMISSION OF THE STATE OF KANSAS, UPON THE JOINT APPLICATION OF THE KANSAS POWER AND LIGHT COMPANY ("KPL") AND THE GAS SERVICE COMPANY ("GAS SERVICE"), AUTHORIZED THE ACQUISITION BY KPL OF THE COMMON STOCK OF GAS SERVICE FOR $16.00 CASH PER SHARE. IN THAT ORDER, THE COMMISSION DIRECTED KPL AND GAS SERVICE TO PROVIDE, WITHIN ONE HUNDRED TWENTY (120) DAYS OF THE TRANSACTION'S CLOSING, A LEGAL ANALYSIS OF WHETHER THE COMMISSION SHOULD CONSIDER ADJUSTING THE RATE BASE OF GAS SERVICE TO REFLECT THE PURCHASE PRICE OF GAS SERVICE COMMON STOCK. THE CLOSING DATE OF THE TRANSACTION WAS DECEMBER 28, 1983. KPL AND GAS SERVICE HEREWITH SUBMIT THIS LEGAL ANALYSIS IN COMPLIANCE WITH THE COMMISSION'S ORDER.

I. INTRODUCTION

KPL ACQUIRED GAS SERVICE STOCK IN A TWO-STEP CORPORATE PROCEDURE. FIRST, KPL PURCHASED THE STOCK TENDERED BY GAS SERVICE SHAREHOLDERS PURSUANT TO KPL'S TENDER OFFER. SECOND, TO OBTAIN THE REMAINING GAS SERVICE SHARES, KPL MERGED INTO GAS SERVICE A NEWLY-FORMED, WHOLLY-OWNED SUBSIDIARY OF KPL, KP&L ACQUISITION CORP. KPL THEREBY BECAME THE OWNER OF 100% OF THE OUTSTANDING GAS SERVICE COMMON STOCK. ALL GAS SERVICE SHAREHOLDERS RECEIVED $16.00 PER SHARE. THE TRANSFER OF COMMON STOCK OWNERSHIP WAS EFFECTED AT APPROXIMATELY 89% OF NET BOOK VALUE.

SCHEDULE 2-1

~~Gas Service was the surviving corporation of the merger with KP&L Acquisition~~ Corp., and is now operated as a wholly-owned subsidiary of KPL. The acquisition has not changed the capital structure of Gas Service. Because Gas Service is the surviving corporation, all of its corporate rights, powers, privileges, and franchises remain undisturbed. The certificates of convenience and necessity granted to Gas Service by the Commission and all the Commission's orders pertaining to Gas Service remain in full force and effect. All of Gas Service's contractural rights and liabilities continue.

II. A STOCK PURCHASE CANNOT AFFECT VALUATION OF THE RATE BASE BECAUSE THERE IS NO TRANSFER OF UTILITY PROPERTY

The Commission has the "duty to ascertain the reasonable value of all property of any [regulated public utility] whenever it deems the ascertainment of such value necessary in order to enable the commission to fix fair and reasonable rates...." K.S.A. 66-128. The rate base of a public utility represents the reasonable value of all property which is in service and devoted to the public use. Southwestern Bell Telephone Co. v. Kansas State Corporation Commission, 192 Kan. 39, 386 P.2d 515 (1963).[1] Because the value of the corporation's property remains unchanged as the corporation's stock is bought and sold, the transfer of a utility's stock, the indicia of ownership in a corporate entity whose stockholders are separate and distinct from the entity itself, does not affect the value of its property in service and devoted to the public use. Thus, no recalculation of the utility's property, or rate base, is appropriate.

The current rate base of Gas Service is derived from the original cost of the property when first dedicated to public

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[1]The due process clause of the Fourteenth Amendment to the U.S. Constitution requires regulators to fix rates that as a minimum "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed...." Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 605 (1944).

USE. THE PURCHASE OF ITS STOCK DOES NOT AFFECT ORIGINAL COST. A NEW STOCKHOLDER DOES NOT PURCHASE THE ASSETS OF THE CORPORATION. NOR DOES A CHANGE IN, OR SUBSTITUTION OF STOCKHOLDERS ESTABLISH A NEW BUSINESS ENTITY. TRANSFER OF OWNERSHIP OF COMMON STOCK DOES NOT AFFECT THE OWNERSHIP OF THE CORPORATION'S PROPERTY, WHICH STILL BELONGS TO THE CORPORATION.[2]

IN A STOCK TRANSFER, NO ASSETS ARE REMOVED FROM PUBLIC SERVICE OR TRANSFERRED TO ANOTHER BUSINESS ENTITY. THE SAME ASSETS WILL CONTINUE TO BE USED TO PROVIDE THE SAME SERVICES TO THE SAME RATEPAYERS AND THE ASSETS WILL REMAIN SUBJECT TO THE SAME RATEMAKING JURISDICTION OF THE SAME REGULATORS. THIS CONTINUITY MAKES A RECALCULATION OF GAS SERVICE'S RATE BASE INCONGRUOUS.

ASIDE FROM THE LEGAL ISSUES RAISED BY THE COMMISSION'S INQUIRY, REVALUATION OF UTILITY PLANT MEASURED BY THE PRICE PAID FOR COMMON STOCK WOULD PRODUCE PRACTICAL DIFFICULTIES OF POTENTIALLY SIGNIFICANT DIMENSIONS. REVALUATION, WHETHER ON A STOCK ACQUISITION OR PURCHASE OF UTILITY ASSETS, ~~WOULD~~ ULTIMATELY TEND TOWARD HIGHER COSTS TO CONSUMERS, SINCE IT WOULD PROVIDE NO INCENTIVE TO MAKE ACQUISITIONS AT LESS THEN BOOK VALUE. IF IT IS APPROPRIATE TO WRITE DOWN RATE BASE WHEN STOCK IS PURCHASED BELOW BOOK VALUE, IT WOULD BE EQUALLY CORRECT TO WRITE UP RATE BASE WHEN THE STOCK IS ACQUIRED AT A PREMIUM. THIS PROBLEM WILL BE EXPANDED ON IN THE DISCUSSION THAT FOLLOWS

IT SHOULD BE BORNE IN MIND THAT, EXCEPT FOR THE MAGNITUDE OF THE TRANSACTION, KPL'S ACQUISITION OF GAS SERVICE'S OUTSTANDING COMMON STOCK IS NO DIFFERENT IN KIND FROM DAY TO DAY TRADING BY SMALLER INVESTORS. THE PRICE IS, IN BOTH INSTANCES, BASED ON AN EVALUATION OF THE EARNING POWER OF THE ASSETS OF THE UTILITY AS

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[2] CF. RE ROCHESTER GAS & ELECTRIC CORP., 41 PUB. UTIL. REP. (PUR) 4TH 463 (N.Y. P.S.C. 1981) (ASSETS OF MERGED UTILITY VALUED AT BOOK VALUE BEFORE MERGER RATHER THAN MUCH LOWER MARKET VALUE OF STOCK RECEIVED IN EXCHANGE); RE COMMONWEALTH EDISON CO., 66 PUB. UTIL. REP. (PUR) 3D 417 (F.P.C. 1966) (ASSETS OF MERGED UTILITY ACCOUNTED FOR AT BOOK RATHER THAN HIGHER PURCHASE PRICE).

THOSE ASSETS ARE EMPLOYED AND TREATED FOR RATEMAKING PURPOSES. THIS INVESTOR EVALUATION BECOMES NOT ONLY FRUITLESS, BUT COUNTER-PRODUCTIVE IF IT IS USED AFTER THE FACT TO REVALUE THE RATE BASE UPON WHICH A FAIR RATE OF RETURN IS DETERMINED.

THE FACTS OF THIS CASE ARE VERY SIMILAR TO THOSE OF _IN RE TOWNE HILL WATER CO._, 422 A.2D 927 (VT. 1980). THERE ALL OF THE STOCK OF A UTILITY WAS ACQUIRED BY A SOLE STOCKHOLDER FOR $27,025, SUBSTANTIALLY LESS THAN THE NET ORIGINAL COST OF THE PLANT AND EQUIPMENT OF $41,194. UPON THE UTILITY'S REQUEST FOR A RATE INCREASE, THE PUBLIC SERVICE BOARD DETERMINED THAT THE AMOUNT OF THE STOCKHOLDER'S INVESTMENT WAS INDICATIVE OF THE VALUE OF THE PROPERTY DEVOTED TO PUBLIC SERVICE AND RECALCULATED THE RATE BASE TAKING INTO ACCOUNT THE PURCHASE PRICE OF THE STOCK. ON APPEAL, THE VERMONT SUPREME COURT REVERSED, HOLDING THAT CONSIDERATION OF THE STOCK'S PURCHASE PRICE WAS IMPROPER. THE COURT REJECTED THE BOARD'S CONCLUSION THAT THE PURCHASE PRICE OF THE UTILITY'S STOCK REFLECTED THE VALUE OF THE UTILITY'S PROPERTY. THE COURT DECLINED TO TREAT THE PURCHASE OF STOCK AS A PURCHASE OF PROPERTY.

> THE BOARD'S FINDING THAT THE STOCKHOLDER'S INVESTMENT IN THE COMPANY WAS LESS THAN THE HISTORIC COST IS NOT GERMANE TO THE DETERMINATION OF A RATE BASE. THE PROPERTY IN QUESTION WAS NOT ACQUIRED [AT THE TIME OF THE STOCK TRANSFER]. _ORIGINAL ACQUISITION AND DEVOTION TO PUBLIC USE IS THE TIME OF "INVESTMENT" IN THAT PROPERTY._ THE STOCKHOLDER PURCHASED STOCK EXPECTING A REASONABLE RETURN ON _THAT_ INVESTMENT, NO MORE AND NO LESS. WHETHER HE PURCHASED THE STOCK AT A DISCOUNT OR AT A PREMIUM IS IRRELEVANT.

_ID._ AT 929. THE COURT WAS NOT CONVINCED BY THE BOARD'S CONTENTION THAT THE NET ORIGINAL COST RATE BASE VALUATION WOULD ALLOW THE WATER COMPANY A WINDFALL. IT REASONED THAT THE RATE BASE IS ONLY ONE VARIABLE: "IT IS SIMPLY IMPOSSIBLE TO MEASURE WHETHER A GIVEN RATE OF RETURN IS REASONABLE OR UNREASONABLE WHOLLY WITHOUT REFERENCE TO A RATE BASE." _ID._

III. EVEN IF STOCK PURCHASE COULD BE EQUATED WITH ASSET PURCHASE, RATE BASE SHOULD REPRESENT ORIGINAL COST WHEN ASSETS FIRST DEDICATED TO PUBLIC SERVICE BY GAS SERVICE

EVEN IF THE NATURE OF THIS TRANSACTION COULD BE DISREGARDED AND TREATED AS A PURCHASE OF THE ASSETS OF GAS SERVICE, THERE SHOULD BE NO CHANGE IN THE RATE BASE IN RECOGNITION OF THE GENERAL RULE THAT THE RATE BASE REPRESENTS THE ORIGINAL COST OF UTILITY PROPERTY WHEN DEDICATED TO PUBLIC USE REGARDLESS OF THE PRICE AT WHICH IT IS PURCHASED BY ANOTHER UTILITY. SEE RE SOUTHWESTERN BELL TELEPHONE CO., 19 PUB. UTIL. REP. (PUR) 4TH 1, 11 (KAN. S.C.C. 1977). ACCORD MONTANA POWER CO. V. FERC, 599 F.2D 295 (9TH CIR. 1979); RE UTAH POWER AND LIGHT CO., 53 PUB. UTIL. REP. (PUR) 4TH 461, 469 (UTAH P.S.C. 1983); RE DAVENPORT WATER CO., 76 PUB. UTIL. REP. (PUR) 3D 209, 217 (IA. S.C.C. 1968).

IN KANSAS THE RATE BASE IS NOT RECALCULATED EVEN WHEN THE ASSETS ARE PURCHASED AT LESS THAN THE ORIGINAL COST. IN RE SOUTHWESTERN BELL TELEPHONE CO., THIS COMMISSION DETERMINED THAT THE REASONABLE VALUE OF PROPERTY PURCHASED FROM OTHER UTILITIES WAS NOT ITS PURCHASE PRICE BUT RATHER THE HIGHER ORIGINAL COST TO THE FIRST ENTITY WHICH DEVOTED THE PROPERTY TO PUBLIC SERVICE. 19 PUB. UTIL. REP. (PUR) 4TH AT 11. THE COMMISSION ACCEPTED STAFF'S PROPOSED ADJUSTMENT TO INCREASE THE UTILITY'S RATE BASE FROM THE PURCHASE PRICE OF PROPERTY ALREADY DEVOTED TO PUBLIC SERVICE TO ITS ORIGINAL COST WHEN FIRST DEVOTED TO PUBLIC SERVICE. THE COMMISSION CONSIDERED THE INCREASE TO BE "A TRADITIONAL ADJUSTMENT WHICH RECOGNIZES FOR RATE-MAKING PURPOSES THAT THE RATE BASE SHOULD BE THE ORIGINAL COST OF PLANT WHEN DEDICATED TO PUBLIC USE REGARDLESS OF PRICE AT A SUBSEQUENT SALE." ID. ACCORD, PROVIDENCE GAS CO. V. BURMAN, 376 A.2D 687 (R.I. 1977) (PROPERTY INCLUDIBLE IN RATE BASE AT BOOK VALUE, NOT LOWER PURCHASE PRICE).

THIS CARRYOVER OF BOOK VALUE IS AN APPROPRIATE VALUATION METHOD BECAUSE ORIGINAL COST IS AN APPROPRIATE DETERMINANT OF REASONABLE VALUE, AND BECAUSE THE PURCHASE PRICE OF GAS SERVICE'S

STOCK DOES NOT ACCURATELY REFLECT THE VALUE OF ITS ASSETS. FIRST, EVEN ASSUMING THAT THE PURCHASE PRICE OF GAS SERVICE'S STOCK ACCURATELY REFLECTED THE MARKET VALUE OF ITS ASSETS, THERE IS NO SOUND REASON FOR DEVIATING FROM THE ORIGINAL COST OR BOOK VALUE METHODOLOGY ADOPTED OR GIVEN GREAT WEIGHT IN KANSAS AND MOST OTHER JURISDICTIONS. *SEE, E.G.*, *FEDERAL POWER COMMISSION V. HOPE NATURAL GAS CO.*, 320 U.S. 591 (1944); *RE SOUTHERN BELL TELEPHONE & TELEGRAPH CO.*, 30 PUB. UTIL. REP. (PUR) 4TH 261 (S.C. 1979); *RE NEW YORK TELEPHONE CO.*, 84 PUB. UTIL. REP. (PUR) 3D 321 (N.Y. 1970); *RE PACIFIC TELEPHONE & TELEGRAPH CO.*, 53 PUB. UTIL. REP. (PUR) 513 (CAL. 1964); *SOUTHWESTERN BELL TELEPHONE CO. V. KANSAS STATE CORPORATION COMMISSION*, 192 KAN. 39, 386 P.2D 515 (1963). THE PRIMARY REASON FOR THE GENERAL PREFERENCE OF THE NET BOOK VALUE OVER MARKET VALUE IS THAT IT IS READILY ASCERTAINABLE WHILE MARKET VALUE IS MUCH MORE DIFFICULT TO COMPUTE. KANSAS PLACES GREAT VALUE ON THE ORIGINAL COST OF UTILITY PROPERTIES PRECISELY BECAUSE IT IS READILY ASCERTAINABLE. *SEE, E.G.*, *RE SOUTHWESTERN BELL TELEPHONE CO.*, 34 PUB. UTIL. REP. (PUR) 3D 257 (KAN. S.C.C. 1960), *AFF'D*, *SOUTHWESTERN BELL TELEPHONE CO. V. KANSAS STATE CORPORATION COMMISSION*, 192 KAN. 39, 386 P.2D 515 (1963); *RE UNITED TELEPHONE CO. OF KANSAS*, 27 PUB. UTIL. REP. (PUR) 3D 128 (KAN. S.C.C. 1958). BECAUSE THE MARKET VALUE OF ASSETS SELDOM CHANGES PRECISELY IN ACCORDANCE WITH DEPRECIATION, DEPRECIATED ORIGINAL COST IS OFTEN NOT AN ACCURATE PROXY OF CURRENT FAIR MARKET VALUE. NONETHELESS, ORIGINAL COST ACCOUNTING IS EMPLOYED TO AVOID THE DIFFICULTIES OF MORE SUBJECTIVE METHODS OF PROPERTY VALUATION. THE USE OF THE DEPRECIATED ORIGINAL COST VALUATION METHOD PROVIDES AN OBJECTIVE METHOD OF VALUATION WITHOUT THE NEED FOR INDEPENDENT ASSESSMENTS OF THE FAIR MARKET VALUE OF ACQUISITIONS.

THE UNFORTUNATE RESULT OF UTILIZING PURCHASE PRICE IN THIS CASE WOULD BE TO ENCOURAGE THE FUTURE TRANSFER OF PROPERTIES AT A PREMIUM ABOVE ORIGINAL COST REGARDLESS OF FAIR MARKET VALUE. FOR

EXAMPLE, HAD KPL PAID ABOVE BOOK VALUE FOR GAS SERVICE'S STOCK, GAS SERVICE'S RATE BASE WOULD HAVE INCREASED, RESULTING IN GREATER COSTS TO CONSUMERS. ONE REASON FOR THE APPLICABILITY OF ORIGINAL COST CONCEPT TO ACQUISITIONS WAS TO PREVENT UTILITIES FROM ARTIFICIALLY INFLATING THEIR RATE BASES BY ACQUIRING PROPERTIES AT UNREALISTICALLY HIGH PRICES. SEE RE UNITED GAS PIPE LINE CO., 25 F.P.C. 26, 64 (1961). EXCEPTIONS TO ORIGINAL COST VALUATION WHERE THE PURCHASE PRICE OF ASSETS EXCEEDS NET BOOK VALUE GENERALLY REQUIRE A SHOWING THAT BENEFITS ACCRUE TO THE ACQUIRING PUBLIC UTILITY AND ITS RATEPAYERS SUFFICIENT TO JUSTIFY DEVIATION FROM ORIGINAL COST. SEE, E.G., MISSISSIPPI EX REL. ALLAIN V. MISSISSIPPI PUBLIC SERVICE COMMISSION; RE PUBLIC SERVICE CO. OF NORTH CAROLINA, 55 PUB. UTIL. REP. (PUR) 4TH 53 (NO. CARO. U.C. 1983); RE DAVENPORT WATER CO., 76 PUB. UTIL. REP. (PUR) 3D 209 (IA. S.C.C. 1968); RE MONMONTH CONSOLIDATED WATER CO., 75 PUB. UTIL. REP. (PUR) 3D 225 (N.J.P.U.C. 1968).

SECOND — THE PURCHASE PRICE OF THE COMMON STOCK OF GAS SERVICE WAS A COMPOSITE OF MANY FACTORS, INCLUDING CREDIT WORTHINESS, MARKET VALUE, EARNINGS, SALES, MANAGEMENT, REPUTATION WITH REGULATORS AND THE PUBLIC, AND GENERAL BUSINESS PROSPECTS.[3] IN THIS CASE, THE MARKET VALUE OF THE STOCK WAS INFLUENCED MORE BY THE POOR FINANCIAL RECORD OF GAS SERVICE THAN BY THE VALUE OF THE ASSETS DEVOTED TO PUBLIC USE. THE FACT THAT GAS SERVICE STOCK ONLY COMMANDED A PRICE LESS THAN NET BOOK VALUE

[3] IT IS UNIFORMLY RECOGNIZED THAT THE PURCHASE PRICE OF UTILITY PROPERTY DOES NOT REFLECT ITS MARKET VALUE. SEE E.G., STATE EX REL. SOUTHWESTERN BELL TELEPHONE CO. V. MISSOURI PUBLIC SERVICE COMMISSION, 262 U.S. 276, 292 (1923) (BRANDEIS, J., CONCURRING OPINION) ("IT IS IMPOSSIBLE TO FIND AN EXCHANGE VALUE FOR A UTILITY, SINCE UTILITIES, UNLIKE MERCHANDISE OR LAND, ARE NOT COMMONLY BOUGHT AND SOLD IN THE MARKET."); ARIZONA CORPORATION COMMISSION V. ARIZONA WATER CO., 335 P.2D 412 (ARIZ. 1959) (PUBLIC UTILITIES NOT ROUTINELY SOLD ON MARKET; MARKET VALUE DEPENDENT UPON REGULATED RATE OF RETURN; LARGE TAX SAVINGS FACTOR IN BELOW BOOK PURCHASE PRICE). SEE ALSO, TOWN OF JAMESTOWN V. KENNELLY, 100 A.2D 649 (R.I. 1953) (PURCHASE PRICE ONE FACTOR; PROPERTY'S FAIR VALUE EQUALLED 165% OF PURCHASE PRICE).

SHOULD NOT BAR KPL FROM THE RIGHT TO A REASONABLE RETURN ON THE FAIR VALUE OF THE UNDERLYING PROPERTY.

IV. DEVALUATION OF GAS SERVICE RATE BASE TO REFLECT CURRENT STOCK VALUE CONSTITUTES UNCONSTITUTIONAL TAKING

PARTICULARLY IN A REGULATED INDUSTRY THERE IS THE ADDITIONAL PROBLEM OF THE INTERDEPENDENCE BETWEEN RATES AND MARKET VALUE. SPECIFICALLY, THE MARKET VALUE OF AN ASSET DEPENDS UPON THE REVENUE IT GENERATES, AND IN A REGULATED INDUSTRY THE AMOUNT OF REVENUE IS DEPENDENT ON THE LEVEL OF RATES SET BY REGULATORS. SEE HOPE NATURAL GAS CO., 320 U.S. AT 601. IF GAS SERVICE'S RATE BASE WERE WRITTEN DOWN TO 80% OF NET BOOK VALUE TO REFLECT THE VALUE OF ITS STOCK IN 1983, THE MARKET WOULD DROP TO COMPENSATE FOR GAS SERVICE'S REDUCED EARNING POWER. THIS WOULD IN TURN PRODUCE A FURTHER REDUCTION IN RATE BASE TO THE NEW MARKET VALUE WHICH WOULD CAUSE A STILL FURTHER REDUCTION OF EARNING POWER AND THUS OF MARKET VALUE. SUCH A SELF-FULFILLING PROPHECY EVENTUALLY DRIVES THE MARKET VALUE TO ZERO AND DESTROYS THE UTILITY. THIS INTERDEPENDENCE BETWEEN RATES AND MARKET VALUE COULD RENDER THE ADJUSTMENT OF GAS SERVICE'S ASSETS TO THE MARKET VALUE OF STOCK AN UNCONSTITUTIONAL TAKING WITHOUT COMPENSATION.

COMMON STOCKS, PREFERRED STOCKS AND FIRST MORTGAGE BONDS OF ALL PUBLICLY HELD UTILITIES IN KANSAS, INCLUDING KPL, ARE BOUGHT AND SOLD NEARLY EVERY DAY AT PRICES WHICH FLUCTUATE NEARLY EVERY DAY. SOME ARE TRADED ABOVE BOOK VALUE AND SOME BELOW BOOK VALUE. COMMISSION CONSIDERATION OF A RATE BASE ADJUSTMENT IN THIS CASE WOULD, IF PERMITTED TO STAND, LOGICALLY DICTATE SIMILAR ADJUSTMENTS--UP OR DOWN--FOR EACH UTILITY REGULATED BY THE COMMISSION IN EACH RATE CASE. THE COMMISSION, OF COURSE, HAS NEVER BASED RATE BASE VALUATION ON THE FLUCTUATING TRADING PRICE OF A UTILITY'S STOCKS OR BONDS. CLEARLY, IT SHOULD NOT CONSIDER SUCH UNWARRANTED AND UNLAWFUL ADJUSTMENTS FROM HENCEFORTH.

THIS INQUIRY HAS CONFIRMED THE PROPRIETY OF COMMISSION USE OF ORIGINAL COST AS THE BASIS OF THE VALUE OF PROPERTY DEVOTED TO UTILITY SERVICE.

WHEREFORE, KPL PRAYS THAT THE COMMISSION NOT COMMENCE PROCEEDINGS TO CONSIDER WHETHER OR NOT THE RATE BASE OF GAS SERVICE SHOULD BE ADJUSTED IN ORDER TO REFLECT THE COST OF ASSETS PURCHASED.

DATED AT TOPEKA, KANSAS THIS 20 DAY OF APRIL, 1984.

THE KANSAS POWER AND
LIGHT COMPANY AND THE GAS
SERVICE COMPANY

BY David S. Black

DAVID S. BLACK, ESQUIRE
SENIOR VICE PRESIDENT, LAW

BY

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ATTORNEYS FOR THE KANSAS POWER
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SERVICE COMPANY

Larry ✓
Phil

RECEIVED

JAN 24 1989

ACCOUNTING DEPT.
PUBLIC SERVICE COMMISSION

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of U.S. Water Lexington, Missouri, Inc. to file tariffs designed to effectuate a general revenue increase attributable to the meter rate for water service provided to customers inside and outside of the City of Lexington, Missouri.	Case No. WR-88-255

INITIAL BRIEF OF U.S. WATER/LEXINGTON, MISSOURI, INC.

FILED

JAN 23 1989

PUBLIC SERVICE COMMISSION

Gary W. Duffy
HAWKINS, BRYDON, SWEARENGEN
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January 23, 1989

"normal" years. There can be no dispute that 1987 is abnormal with 20.3 percent, and any use of that year's figures will unreasonably skew the percentages. The manager of USW has testified that it has little or no funds with which to pursue major construction activity in 1989, absent almost all of the rate increase request being granted (Exhibit 9, p. 2), so there is no competent and substantial evidence that 1989 and future years will be a repeat of 1987. The evidence requires that the Commission find 12 percent to be an appropriate percentage to utilize for this purpose.

IV. Negative Acquisition Adjustment

Staff calculated $1,601,987 as a reasonable figure for net original cost rate base for USW, and USW has not challenged that figure in this case. However, Public Counsel proposes, by imputing interest to the promissory note representing the majority of the purchase price of USW from Missouri Water Company, to reduce net rate base by $382,312. When given full effect, this reduces the revenue requirement of USW by $74,079 when a 12.25 percent return is considered and income taxes are computed based upon 100 percent equity. USW opposes this adjustment. The Staff is not proposing any acquisition adjustment.

In essence, the Public Counsel proposes that the ratepayers be given the benefit resulting from the fact that this utility was arguably purchased for less than depreciated original cost. Since the Public Counsel is opposed to having the ratepayers bear any responsibility in the opposite situation, i.e. where a utility is purchased for <u>more</u> than net original cost, the Public Counsel position on this issue may be succinctly put as follows: "Heads, the ratepayers win; tails, the shareholders lose."

USW believes that it is inappropriate for the Commission to accept the Public Counsel's proposal for several reasons. First, and obviously of great importance to USW, is that acceptance of the proposal would financially cripple the company because it would wipe out almost all of the increase in rates that even the Staff is proposing here. Considering the current cash flow position of USW as testified to by its accountants, such an action would cause very serious consequences.

Second, the acceptance of the proposal is not appropriate ratemaking treatment either in general, or in this specific instance. As explained by Mr. Drees in his rebuttal testimony (Exhibit 6), the Commission specifically approved the sale of this utility from Missouri Water Company to U.S. Water/Lexington, Missouri, Inc. in Case No. WM-84-37, by Order dated October 21, 1983.[6] That the sale price was <u>below</u> the net book value of the assets was clearly stated in the fourth paragraph of the order, so all parties were aware of that. The sale price was stated as $1,186,139 plus accounts receivable. The net book value of the assets was $1,207,014. The order went on to state that the sale would result in a small loss to Missouri Water Company, and that

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6 A copy of the order appears as Schedule 1 to Exhibit 19.

its shareholders would bear that loss and incur the tax effect of the sale. (Order, p. 1)

Further, the materials furnished to the Commission clearly stated that the parties did not intend to treat the transaction in the manner proposed by Mr. Riley here. Mr. Drees provided copies of those accounting materials in his Schedule LFD-4.1 and 4.2 attached to Exhibit 6. Beginning at the bottom of Schedule LFD-4.1 appears the following text:

> The purchase price described in the foregoing is less than the "rate base" of the assets acquired as determined by the Missouri Public Service Commission (PSC). Management does not intend to discount the purchase obligation to present value as required by generally accepted accounting principles. If the notes were stated at present value, the cost of utility plant would be reduced by approximately $425,000. ... Should the PSC elect to reduce the Company's "rate base" to cash expended plus the present value of the purchase obligation, projected levels of revenue would be adversely affected and projected operating results and cash increase might be materially overstated.

Thus, the very argument that Mr. Riley is making here five years later was explicitly laid out for the Commission. It was put on notice that any reduction in rate base on this basis would <u>adversely affect</u> projected revenues. This supports the statements made by Mr. Drees that if the investor had known this acquisition adjustment were going to be made, he would have been advised not to make the purchase. (Tr. 202)

Instead, the Commission in its Order made no mention of requiring the rate base to be reduced due to the sale price, or to consider the present value of the non-interest bearing note. Instead, it made a specific finding of the rate base, and specifically approved the sale at the specified sale price. And conspicuously absent from the Order of October 21, 1983 was the usual disclaimer concerning an order's impact for ratemaking purposes. Thus, USW believes that the Commission fully understood the special circumstances surrounding these properties; that Missouri Water was so anxious to rid itself of them that it took a loss on the sale and that special financing with a non-interest bearing note was appropriate to achieve a sale of the properties. For the Commission to find exactly to the contrary five years later would be to perpetrate the cruelest of hoaxes.

As mentioned, a negative acquisition adjustment would not be appropriate for general ratemaking principles either. Mr. Drees provided a brief review of the situations which gave rise to the "original cost when first devoted to public service" rules. (Exhibit 6, p. 6) This principle has served to protect ratepayers from utilities selling at inflated prices and then seeking to have the regulators revalue the properties at the higher level, just to produce greater profits. Although there are always exceptions, Mr. Drees concludes that sales of utility property at higher than net book value should be borne by the shareholders. USW is under the impression that is the general principle utilized by this Commission, although there may have been a few exceptions.

A review of authorities from other jurisdictions highlights the beneficial effect of the original cost principles. In Re New York Telephone Company, 5 PUR 3d 53 (1954), the New York Public Service Commission was faced with a utility's arguments that it should consider evidence of market value in rate base evaluation. This Commission emphasized the unacceptable circularity in valuing the property of an earnings-related enterprise on the basis of purchase price. It said, at p. 44:

> Long and well-established fundamentals should not be lightly brushed aside in the absence of the most compelling reasons or clearly demonstrable error.
>
> In competitive enterprise, free from regulation, the value of any commercial property is usually measured by its capitalized prospective earnings. In the utility field, of course, there is no free competition.
>
> In determining the value of a telephone company's plant, we cannot use the standards of competition in the industry because these do not exist. There is however, another standard of competition and that is competition in the money market for capital. If the rates fixed are too low and the income is insufficient, there will be a flight of capital from the telephone industry to other types of investment. The converse is equally true.

The Court in Vincennes Water Supply Company v. Public Service Commission, P.U.R.1930B, 216, 219-220, 34 F.2d 5, rejected the use of market value of securities in determining the value of utility property.

> Such questions as capitalization and the amount and kind of securities and the market value of the same, can have, in any event, only remote evidential value. In many instances, capitalization bears no particular relation to invested or present value, and the market price of securities depends upon the rates charged for service. If rates are lowered by regulatory bodies, the market value of securities will fall. If rates are raised, within reasonable limits, the value of securities will rise. As pointed out by some Commission, to determine the value of a public utility for rate-making purposes, the using of the market value of securities to make such determination, would involve reasoning in a circle. It is usually now held to be not a legal basis for determining present value, as is pointed out in the case of Monroe Gas Light & Fuel Co. v. Michigan Public Utilities Commission (D.C. 1923) 292 Fed. 139, 150 PUR 1923E, 66T."
>
> If the purchaser paid too much for his stock, the public should not, as a result, be imposed upon by rates

> to fix a reasonable return upon such purchase price. If the purchaser paid too little, he is entitled to the benefit of his bargain. To determine value from the purchase price of stock at private sales is, as indicated above, to reason in a circle, for if rates charged be unreasonably low, the value of the property upon that basis is depressed; if unusually high, it is inflated. The test always is the present fair value of the property. As the Supreme Court says in the case of McCardle v. Indianapolis Water Co. (1926) 272 U.W. 499, 410, 71 L.Ed. 154, PUR 1927A, 15, 23, 47 S.Ct. 144, 148, "It is well established that value of utilities properties fluctuate, and that owners must bear the decline and are entitled to the increase." (emphasis supplied)

More recently, the Vermont Supreme Court said in Re Towne Hill Water Co., 422 A.2d 927 (1980):

> Generally rate base is determined by the formula that so-called historical or original cost plus capital improvements minus depreciation equals the net value of the property. Using the cost of the 1973 acquisition of the capital stock would substitute a new original cost . . . .
>
> The Board's finding that the stockholder's investment in the company was less than the historic cost is not germane to the determination of a rate base. The property in question was not acquired in 1973. Original acquisition and devotion to public use is the time of "investment" in that property. The stockholder purchased stock expecting a reasonable return on that investment, no more and no less. Whether he purchased the stock at a discount or a premium is irrelevant.
>
> We are unimpressed by the Board's contention that calculating a rate of return on the rate base which the Company argues for will allow the Company a windfall. It is simply impossible to measure whether a given rate of return is reasonable or unreasonable wholly without reference to rate base.

We therefore have several valid arguments for rejecting the Public Counsel's position on this issue: (1) the specific terms of the sale of these properties were approved by the Commission five years ago, with all relevant facts disclosed, and no mention by the Commission of any negative acquisition adjustment (2) the circularity of reasoning inherent in deviating from net original cost valuation of rate base, not to mention the demands that would be placed on the Commission by other utilities for corresponding treatment if that were to occur; (3) the reasoning expressed that if an investor pays too much, the ratepayer is shielded, while if the investor pays "too little", he should be entitled to the benefit of his bargain; and finally, (4) that the impact of such an adjustment on this utility would be extremely severe and mean that it would not be able to meet its debt service payments.

V. Management Fee

As indicated earlier, there was a "management fee" discussed and approved in the October 1983 order approving the sale and transfer. On page 2 of the order, the Commission specifically recognized how the management agreement would function and how the fee would be calculated:

> U.S. Utilities Management & Services, Inc. will manage the water facilities under the agreement and will receive a fee qual to the lesser of: 15 percent of the actual costs of providing water service to the customers of the system, the rate of return on equity allowed by the Commission, or the cash available after the payment of all expenses of operation, exclusive of the management fee itself. (Exhibit 6, pp. 9-10)

The management agreement itself was made a part of the record in WM-84-37, and was described in the direct testimony of Frank Hawkins. (Exhibit 6, p. 10) The agreement has been in place, and payments have been made from USW to U.S. Utilities Management & Services, Inc. ("the management company") since the inception of

No. 216

DATA INFORMATION REQUEST
UTILICORP UNITED, INC.
MISSOURI PUBLIC SERVICE DIVISION
CASE NO. ER-90-101

REC'D

MAR 0 6 1990

GLC

Requested From: Brad Lewis

Date Requested: March 6, 1990

Information Requested:

Provide the most complete available written overall corporate strategy statement for Utilicorp, including explanations of strategy changes that have occurred since the inception of the Utilicorp name change and a statement of any anticipated future changes in corporate strategy that are now planned.

Requested By: Michael L. Brosch

Information Provided: SEE ATTACHED

The attached information provided to the consultants and technical staff of the Office of the Public Counsel in response to the above data information request is accurate and complete, and contains no material misrepresentations or omissions, based upon present facts of which the undersigned has knowledge, information or belief. The undersigned agrees to immediately inform the consultant and technical staff of The Office of the Public Counsel if, during the pendency of Case No. ER-90-101 before the Commission, any matters are discovered which would materially affect the accuracy or completeness of the attached information.

If these data are voluminous, please (1) identify the relevant documents and their location (2) make arrangements with requester to have documents available for inspection in the Utilicorp United, Inc., Missouri Public Service Division, Kansas City, Missouri office, or other location mutually agreeable. Where identification of a document is requested, briefly describe the document (e.g., book, letter, memorandum, report) and state the following information as applicable for the particular document: name, title, number, author, date of publication and publisher, addresses, date written, and the name and address of the person(s) having possession of the document. As used in this data request the term "document(s)" includes publication of any format, workpapers, letters, memoranda, notes, reports, analyses, computer analyses, test results, studies or data, recordings, transcriptions and printed, typed or written materials of every kind in your possession, custody or control or within your knowledge. The pronoun "you" or "your" refers to Utilicorp United, Inc., Missouri Public Service Division and its employees, contractors, agents or others employed by or acting in its behalf.

Date Response Received: 3/27/90

Signed By: Brad Lewis

Prepared By: Williams

Schedule 4-1

No. OPC 216

DATA INFORMATION REQUEST
MISSOURI PUBLIC SERVICE
CASE NO. ER-90-101

Requested From: Brad Lewis

Date Received: March 6, 1990

Information Requested: Provide the most complete available written overall corporate strategy statement for UtiliCorp, including explanations of strategy changes that have occurred since the inception of the UtiliCorp name change and a statement of any anticipated future changes in corporate strategy that are now planned.

Requested By: Michael L. Brosch

Information Provided: The overall corporate strategy has been consistently implemented since the inception of the UtiliCorp name change. It is most comprehensively described in a speech before the NARUC by Mr. Richard C. Green, Jr. (attached). Other descriptions of strategy can be found in the company's Annual Report to Shareholders and Form 10-K.

Date Provided: March 23, 1990

FRAMING REGULATION IN AN ERA OF UTILITY TRANSITION

When UtiliCorp was formed in 1985, not many people understood what we were trying to accomplish. We had been doing business successfully for about 70 years as Missouri Public Service Company. Our mission had been to keep the lights on and the gas flowing, to make sure our rates were affordable and that our shareholders were earning reasonable returns.

Those original business objectives haven't changed under UtiliCorp. But we've added one important element. Today, we are out to become a value-added utility--a good, tough competitor in what is becoming a market-driven industry.

About five years ago we saw that we needed to react to a new reality in our industry. That reality was, and is, competition. It forced us to ask ourselves: "What is our best strategy to meet this challenge?" The answer was simple. We had to grow.

That presented us with a second question: "Should this growth occur within our industry or outside of it?" In our minds, the answer again was clear. Our best hope for success was to stay with the business we knew--the utility business.

Most everyone here has some familiarity with the forces that have changed the way that gas and electric utilities must do business today.

The electrics have been whipsawed by unstable capital markets, high interest rates, rapid inflation and volatile fuel prices. Today, we are faced with environmental pressures and technological changes. This had a chilling effect on new power plant construction and consequently, some regions of the country now face capacity shortages. At the same time, economic conditions and federal laws have allowed the emergence of independent power producers and cogenerators that now may compete for some of the utilities' largest customers.

On the gas side, years of well-meaning but ill-conceived regulations have created great imbalances of supply and demand. In the late 1970s, artificially low prices for gas transported across state lines led to shortages on the East Coast. The resulting political pressures culminated in the Natural Gas Policy Act--a law that created some extreme pricing disparities for old and new gas. Pushed by fears of being caught again with inadequate supplies, pipelines began locking into the take-or-pay contracts that have proven to be so burdensome today. Gas utilities also face the competitive threat of losing their largest customers to system bypass.

How should regulators respond to these changing conditions? There are many compelling arguments in favor of deregulating the industry--adopting a market-based approach for dealing with these challenges. At UtiliCorp, we are not convinced that utilities can be entirely deregulated. Because gas and electricity are vital commodities, utilities will always remain under some obligation to provide service.

However, Adam Smith's invisible hand of competition is clearly at work. For that reason, flexible regulatory approaches will be necessary. At UtiliCorp, We believe that regulations should be designed and implemented to allow for the emergence of value-added utilities. This can be accomplished through a process of re-regulation, and not necessarily de-regulation.

It is our view that the basic mission and objectives of regulation should not change significantly during this time of transition. Regulatory agencies will still strive to protect the least powerful end user. Regulation also will need to fulfill its other vital function--helping American industry remain competitive through access to reliable and reasonably priced gas and electric service.

Flexible regulatory approaches will allow utilities to compete effectively for customers, to expand their businesses in new ways and to grow through the prudent acquisition of other utilities. Regulators can best protect the public interest by moving in sync with the evolution of the industry.

What do I mean when I say re-regulation? It is simply a matter of changing perspective--an approach in which the commissions view regulation in a new light while applying the same traditional, fundamental values.

In 1983, I went to the Missouri Public Service Commission with a plan to add value for the customers and shareholders of my company. A principal component of this plan was to expand through utility acquisitions. Of course, the concern of the Missouri commission was whether this plan would be a detriment to Missouri ratepayers.

The Missouri commission has shown a willingness to allow us to pursue this plan because UtiliCorp made a commitment to flow only benefits to Missouri customers and not to pass on any new problems that may arise. At no time will we jeopardize our own financial integrity. We recognize that it is vitally important not to put Missouri's sound utility infrastructure at risk.

Six years later, this commitment still stands. Our record shows we have lived up to everything we have promised. This process has worked well. By taking a different regulatory approach, the Missouri commission has allowed us to serve our customers better and build value for our shareholders.

Change and competition are happening now. It can't be stopped at this point in time. The utility industry faces the risk of having competition skim the cream business away from its customer base. State regulators have a real opportunity to set the tone on utility regulation and thereby play a part in this changing environment.

State commissions could perhaps face reductions in their jurisdictional authority if they ignore the changes that are already in motion. Partnerships need to be created between utilities and their state regulators. The traditional attitudes of each will need to change. The force that binds us together is our mutual responsibility to maintain this country's utility infrastructure to meet future needs.

This is hard work. Change does not come easily. While re-regulation will keep in place the fundamental values of regulation, it calls for us to try new approaches--to experiment. These approaches could range from flexible rate structures to the support of a specific acquisition or acquisition program.

Because any new regulatory approach cannot be guaranteed initial success, commitment will be a key ingredient in the process.

Will the same fundamental regulatory values still apply as regulators evaluate mergers and acquisitions? We believe they will. In many cases, regulators will find that a merger or acquisition represents an opportunity to drive an even better bargain for customers. They can demand improvements in service and take steps to insure prudent management of the assets for years. In many cases, a reasonable and economic rate structure can be negotiated as part of the acquisition.

Should regulators consider the economic health of the combined companies in evaluating an acquisition's impact on customers? It is our view that this may be a part of regulatory responsibility. An acquisition that weakens the financial outlook for the combined entity may very well have a long-term detrimental impact on customers. On the other hand, an acquisition that strengthens a company financially can reduce the cost of capital and indirectly benefit customers in many ways.

We are convinced that the growth strategy we've adopted is our best hope of living up to our responsibility to provide affordable and reliable utility service. We have significant new incentives to keep rates at affordable levels. Yet, There must be a balance between the demands of the customer and demands of the shareholder. Meeting the needs of one group to the exclusion of the other will ultimately hurt everyone concerned.

For several years, UtiliCorp has been aggressively seeking new utility operations in this country and other countries, and expanding in non-regulated areas of the utility business. Five years ago, this was a somewhat non-traditional approach. Today, more and more utilities seem to be adopting similar business plans. We believe it's a strategy that will best prepare us for the future.

UtiliCorp has followed a firm policy of not seeking to recover any of its acquisition-related premiums through rates. We have made a very persuasive case to investors that any premium costs or share dilution they experience will be for the short-term. We believe we can demonstrate that UtiliCorp will financially outperform the industry in the long-term.

What do I mean when I say UtiliCorp is in better position to serve its customers by building financial strength?

By becoming a larger and more diversified entity, UtiliCorp achieves economies of scale in such areas as financing costs, employee retirement and health benefits, centralized purchasing, consolidations of billing and computer services and, not insignificantly, negotiation of gas purchase contracts.

We are continually asked whether we are better off now than if we had continued to do business solely as Missouri Public Service. The answer is absolutely yes.

To illustrate that, we can point to some costs that would be very burdensome right now if Missouri Public Service was a stand-alone company. We are presently looking at financing about $100 million for power plant life extension and acid rain compliance projects. Because of our size, UtiliCorp can carry those costs on its books as short-term debt and convert it to long-term when interest rates and market conditions are right. As Missouri Public Service, we would have been required to finance those projects immediately with long-term debt regardless of market conditions. Those projects would have represented about a third of our total capitalization, instead of the one-eighth that we're looking at now. As you can see, our size gives us the potential to save millions of dollars.

In addition to the benefits we realize as a larger, more diversified and more competitive company, we believe our various constituencies also benefit.

Acquisitions in the utility industry truly have to be in the public interest before they can occur. We must convince customers that an acquisition won't adversely affect rates. We must convince regulators that regulated operations are not subsidizing non-regulated businesses. We must convince the respective boards of directors and shareholders that we have the financial resources to consummate a deal. And, we must convince our potential new employees that they won't lose their jobs or see their benefits reduced.

We have a deeply ingrained incentive to ensure that regulation accomplishes its mission. We are out to prove that we can do an outstanding job of managing the utility operations we acquire. Both our customers and our shareholders will benefit. We know that regulators are watching us carefully--to see that we live up to our service obligations and any other promises we have made in the process of an acquisition. In short, we are deeply committed to serving the public interest. I can say with no hesitation that our track record proves that.

The driving force in our industry is to become more competitive by following whatever formula it takes. We are learning that we need to focus on service and the price of the product. That market-driven philosophy will create quality utilities, responsive to the needs of their customers and to the performance demands of their shareholders.

Clearly, the merger and acquisition movement will be subject to a considerable amount of regulation. Not only will state regulators pass judgement on these transactions, many constituencies will be represented through the intervention process. Again, the need for balance must be emphasized. We must submit a balanced package of benefits for everyone when pursuing a utility acquisition.

At UtiliCorp, we are now having the good fortune to see acquisition opportunities come our way because of the way we've done past transactions. We have pursued all of our opportunities on a non-adversarial basis, we have lived up to our promises and commitments and we have retained existing management and employees. Today, at any given time, we may be screening a half-dozen opportunities that are being presented to us.

Our acquisition program is not cutting into our commitment to maintain the integrity of our systems. In 1984, our construction expenditures were equal to about 10.3 percent of revenues. In 1988, construction spending was 11.7 percent of revenues.

We are committed to improving the communities we serve through active economic development programs and civic involvement by employees. We believe that strengthening the local economies of our service areas and generally improving the quality of life will pay business dividends.

In conclusion, I would like to challenge the regulatory community to consider ratemaking approaches that will allow utilities to continue fulfilling their vital obligations. We must be allowed to become better competitors, to diversify through acquisitions and to start up non-regulated utility businesses.

My message is one of partnership. Utilities and regulators need to make the commitments necessary to deal with change. This is not an option. The process has started and the momentum is increasing. Other industries have recently gone through dramatic transitions and now it is our turn. We control very important commodities.

We would be wise to learn from the experiences of other industries as we work together to manage our time of transition so that customers, employees and shareholders all benefit.

Utilicorp United, Inc.
EF 86-73

No. 6

Data Information Request

Requested From: Dale J. Wolf

Date Requested: 11/15/85

Information Requested:

Please provide documentation (including work papers) of quantitative and qualitative considerations used to determine that this stock issuance is in the public interest and that it is necessary "in order that Applicant may continue to render adequate and efficient public utility service to its present and future customers" (Item No. 10 in Company's Application).

Specifically provide benefits and costs accruing to Missouri customers associated with the purchase of Peoples Natural Gas Company, and the methods by which these benefits and costs will be passed along to Missouri customers.

.equested By: Bruce Schmidt, Office of Financial Analysis

ıformation Provided: See Attached.

The information provided to the Missouri Public Service Commission Staff in response to the above information request is accurate and complete, contains no material misrepresentations or ommissions based upon present facts known to the undersigned. The undersigned agrees to immediately rm the Missouri Public Service Commission, if any matters are discovered which would materially affect the accuracy or completeness of the :mation provided in response to the above information request.

Signed By: Mary A. Samayon

Received:

Proceeds from the sale will be used to replenish internally generated funds which were used for repayment of short-term debt incurred for construction, which construction was necessary for the Company to render adequate and efficient service. The internally generated funds were also used to pay taxes, to pay for coal and for other significant items. Thus, the sale is in the public interest.

Proceeds will also be used to acquire Peoples Natural Gas Company. The acquisition of Peoples should assure the realization of all economies of scale available to Missouri Public Service Company and UtiliCorp United, both in the administrative and operational areas. The acquisition is expected to, after assimilation of the information by financial markets, lead to a reduction in capital costs for UtiliCorp United. This expected reduction in capital costs will eventually produce reductions in rates of return claimed by Missouri Public Service Company in proceedings before the Missouri Public Service Commission.

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AREA CODE 314
TELEPHONE 635-7166

December 6, 1985

Mr. Cary Featherstone
Missouri Public Service Cmmission
P. O. Box 360
Jefferson City, Missouri 65102

Re: Case No. EF-86-73

Dear Mr. Featherstone:

Enclosed is a copy of Data Request No. 6a in the above-referenced case.

Very truly yours,

HAWKINS, BRYDON & SWEARENGEN P.C.

By: James C. Swearengen

James C. Swearengen

JCS/da
Enclosure

Utilicorp United, Inc.
EF 86-73

No. 6a

Data Information Request

Requested From: Dale J. Wolf

Date Requested: 12/2/85

Information Requested:

Respecting Company's response to MPSC Staff Data Information Request No. 6 in Case No. EF 86-73, please provide all analyses, studies, reports, etc., that Utilicorp United, Inc. relied on to support its statements:

The acquisition of Peoples should assure the realization of all economies of scale available to Missouri Public Service Company and Utilicorp United, both in the administrative and operational areas. The acquisition is expected to, after assimilation of the information by financial markets, lead to a reduction in capital costs for UtiliCorp United. This expected reduction in capital costs will eventually produce reductions in rates of return claimed by Missouri Public Service Company in proceedings before the Missouri Public Service Commission.

Requested By: Cary Featherstone

Information Provided:

The information provided to the Missouri Public Service Commission Staff in response to the above information request is accurate and complete, nd contains no material misrepresentations or ommissions based upon present facts known to the undersigned. The undersigned agrees to immediately form the Missouri Public Service Commission, if any matters are discovered which would materially affect the accuracy or completeness of the formation provided in response to the above information request.

Signed By: John R Baker

ate Received:

3844

No study exists upon which UtiliCorp relied to support the statements contained in its response to Data Request No. 6 concerning economies of scale, reduction in capital costs and reduction in rate of return claimed. The statements and conclusions are based on common sense and business judgment.

Prior to making the offer to acquire the Peoples assets, UtiliCorp's management considered whether or not benefits might result from the acquisition which could accrue to UtiliCorp and to the Company's customers. Based upon its utility business experience, management concluded that as a result of the acquisition, economies of scale in operations should result which should, in turn, lead to benefits to existing customers. Based upon its utility business experience, management also concluded that the acquisition should diversify UtiliCorp's operations in such a manner that fluctuations in weather should not create as significant an impact on earnings as now exists, thus resulting in financial benefits to the Company and ultimately its customers. Based upon its utility business experience, management also concluded that UtiliCorp's capital costs should be reduced as the result of the acquisition because UtiliCorp should then be viewed more favorably by the financial community as it should be of a sufficient size so as to permit it to qualify for higher financial ratings than those now available to the Company absent the acquisition. Higher financial ratings should, in turn, lead to lower rates of return claimed in regulatory proceedings.