Exhibit No.:	
Issue:	Synergy Estimates
Witness:	William J. Kemp
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Great Plains Energy Incorporated and Kansas City Power & Light Company
Case No.:	EM-2007-0374
Date Testimony Prepared:	November 13, 2007

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: EM-2007-0374

SURREBUTTAL TESTIMONY

OF

WILLIAM J. KEMP

ON BEHALF OF

GREAT PLAINS ENERGY INCORPORATED

AND

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
November 2007

SURREBUTTAL TESTIMONY

OF

WILLIAM J. KEMP

Case No. EM-2007-0374

Q: Are you the same William J. Kemp who submitted Supplemental Direct Testimony in this proceeding?

A: Yes, I am.

Q: What is the purpose of your Surrebuttal Testimony?

A: This testimony rebuts certain ill-founded assertions contained in the Missouri Public Service Commission ("Commission") staff report ("Staff Report"), the overview Rebuttal Testimony by Mr. Schallenberg concerning the Staff Report, the Rebuttal Testimony of Mr. Dittmer for the Office of Public Counsel ("OPC"), and the Rebuttal Testimony of Mr. Brubaker for Praxair. Each of these witnesses takes issue with elements of my Supplemental Direct Testimony. I will demonstrate through this Surrebuttal Testimony that their positions are factually incorrect, suffer from serious logical flaws, or advocate bad public policy.

None of their criticisms carry much weight, when evaluated in the light of the factual record and accepted regulatory policy principles. The overall conclusions of my Supplemental Direct Testimony are still very much intact.

Q: What were the conclusions of your Supplemental Direct Testimony?

A: My conclusions were as follows:

1. *Is Great Plains Energy Incorporated's ("Great Plains Energy") and Kansas City Power & Light Company's ("KCPL") method for estimating synergies reasonable, and generally consistent with accepted industry practice?*

   Yes. Great Plains Energy's and KCPL's general approach to estimating synergies is consistent with industry practice, and is in fact more detailed and better supported than in most transactions. Its methodology is comprehensive, current, detailed, attributable, quality assured, and conservative.

2. *Are the estimates of synergies reasonable, and generally consistent with the range of industry experience in similar transactions?*

   Yes. The estimated synergies are modestly above the industry average. They appear reasonable on a stand-alone basis, and in total are in the range that would be expected on the basis of comparable transactions in the utility industry and the circumstances of KCPL and Aquila. At least four lines of evidence support this conclusion.

3. *Is the proposed rate treatment for the merger synergies generally consistent with established regulatory policy in the U.S.?*

   Yes. The applicants propose to share the medium-term synergies roughly equally between customers and shareholders. Most public utility commissions, including this Commission, regard this split as equitable and appropriate. KCPL's proposed mechanism for flowing through these benefits in rates is well-designed for the current rising unit cost environment, and leaves customers with a substantial upside for additional benefits, particularly given the companies' conservative approach to estimating the synergies.

Q: What rebuttal issues do you address in this testimony?

A: I will address the following issues, which were raised by the noted rebuttal witnesses.

1. In comparing pre-transaction and post-transaction operating costs of merged utility companies, should the costs be adjusted for inflation by applying the Consumer Price Index ("CPI")? [Staff Report, pages 77-80]
2. Is it appropriate to exclude uncollectible expense from the comparison of pre-transaction and post-transaction costs for the Customer Service function of merged utility companies? [Staff Report, page 79]
3. Were the workpapers relied upon for my Supplemental Direct Testimony provided on a timely basis to Staff and interveners? [Staff Report, pages 79-80]
4. Are Great Plains Energy's and KCPL's estimates of synergy savings from the proposed merger overstated [Dittmer testimony, pages 36-39] or too aggressive [Brubaker testimony, pages 9-11]?
5. Should enabled synergies be included in the total pool of synergy savings that the applicants propose for sharing between shareholders and customers? [Dittmer testimony, pages 12-16]

Q: Why did you adjust actual costs by the CPI index, in your comparison of pre-transaction vs. post-transaction costs for merged utility companies?

A: Correcting for the effects of inflation is a basic logical requirement, when analyzing costs across a time series. Otherwise, cost comparisons will be distorted by the effects of inflation. Inflation represents increases in the prices of goods and services (and the inputs required to produce them), not increases in the volume of those goods and services. To take an extreme example, if the U.S. government instantaneously devalued the U.S. dollar by 50%, the prices of goods and services would appear to have increased by 100%. But this does not mean that suddenly it takes twice as many man-hours or units of equipment to produce the same goods. The increase in price and nominal cost relates to the change in the value of the currency.

My realized synergies analysis is intended to shed light on whether merged utility companies increased their operational efficiency after the transaction. That is, were they able to meet a given level of customer needs with fewer resources? I was not trying merely to measure the effects of inflation on these companies.

Inflation, or the decrease in the value of the currency (the U.S. dollar in this case) was running in the range of 2 to 4 percent per year in the time period of my realized synergies analysis. It would have been irresponsible for me not to adjust for the effects of such inflation on the operating costs (in nominal dollars) that were reported to the Federal Energy Regulatory Commission ("FERC") by the utilities covered in my analysis. Dollars adjusted for inflation are called "real dollars" for a good reason. Comparisons using real dollars are not distorted by inflationary effects. As I said, this is basic economic logic.

Q: Has the Commission adopted the use of inflation or escalation indices is prior proceedings?

A: Yes. For example, in KCPL's most recent rate case, Case No. ER-2007-0291, Staff used the Handy Whitman Index in calculating the Company's non-labor production and transmission and distribution adjustments. In its Cost-of-Service Report in that case, Staff stated that these adjustments were consistent with the methodology adopted by the Commission in Case No. ER-2006-0314.

Q: Why then does Staff advocate not adjusting for inflation in comparing pre-transaction and post-transaction costs of merged utility companies?

A: Staff apparently believes that the Commission should consider only "actual" (*i.e.*, nominal) costs [Staff Report, page 77]. The basis for this position is stated on page 79. Staff cites a number of Commission decisions in which it declined to allow historical test year costs to be adjusted for inflation through use of a CPI index.

Q: Did your realized synergies analysis compare historical test year costs?

A: No. My analysis compared inflation-adjusted actual operating costs, as reported to the FERC. I did not compare allowed revenue requirements. A revenue requirements comparison would show how costs were treated for ratemaking purposes, but would be subject to serious shortcomings as a method for analyzing whether the merged companies reduced their costs and became more efficient.

Q: Has the staff used sound logic in extrapolating from Commission policy regarding use of CPI to adjust historical test year costs to the reasonableness of inflation adjustments for actual cost comparisons?

A: No. The Commission's general policy against adjusting historical costs for inflation, when determining historical test year costs, does make some sense in the intended context. The reason that many commissions prefer a historical test year is that cost forecasts are considered too speculative. Use of a historical test year avoids disputes about how to move from recorded actual (i.e., historical) costs to future costs during the effective rate period.

However, that situation is a far cry from the widely accepted practice of restating costs from nominal dollars to real dollars, when making comparisons (outside of a ratemaking context) of costs across time. Staff's logic does not apply.

Q: Why is it reasonable to use the CPI to adjust utility operating costs for the effects of inflation?

A: The CPI is the most widely cited measure of inflation. It is commonly used as a basis for restating nominal dollars into real dollars. I chose to use CPI because it is broadly reflective of utility non-fuel operating and maintenance ("NFOM") costs, enjoys wide acceptance, and is easily understood.

Use of the CPI is also reasonable because about one-half of the typical utility's NFOM expenses are labor-related. The price of that labor is closely related to changes in the CPI, as employees seek to keep themselves whole for the effects of inflation on their living expenses. Their expenditures range across the cost categories included in the CPI. In fact, many labor agreements reference the CPI as the basis for changes in labor rates. So as the CPI changes, so do the labor-related costs of utilities.

The non-labor portion of utility NFOM expenses is made up mainly of purchases of goods, equipment, and services. The CPI also includes some of these types of expenses, such as housing (offices/facilities), transportation (trucks, travel), medical care (company portion thereof), and education/communications (telecom, IT, training).

I did consider whether to use the Handy-Whitman index of utility construction costs as an inflation adjustment factor, since it tracks utility industry costs specifically. It may be viewed as a partial proxy for the non-labor portion of NFOM, as the Commission has apparently accepted. However, the Handy-Whitman index represents the costs of new plant and equipment, not non-fuel operations and maintenance. The costs of new utility plant and equipment generally have risen faster than CPI, especially with the commodities boom in recent years. I decided that the CPI would be a more conservative measure of inflation in the utility industry.

Q: Why is it doubly conservative to use CPI to adjust for inflation in utility NFOM expenses?

A: Use of CPI to calculate real synergy savings is conservative for two reasons. First, the CPI understates the level of inflation in the non-labor portion of utility NFOM expense, as pointed out in my previous answer. If an index with greater increase than CPI had been used to deflate the post-transaction costs of the utilities in my analysis, the decreases in real costs would have been larger.

Second, my analysis compares total costs, not unit costs. To the extent that unit sales (kwh) and numbers of customers increased in the four years between the pre-transaction cost data and the post-transaction cost data – as they did in all cases – adjusting the post-transaction costs by only CPI would not capture the full gains in efficiency realized by the merging utilities. A more comprehensive (but less conservative) measure of gains in input-output efficiency would involve increasing the pre-transaction costs of the separate companies by both inflation and an index of increased output levels, and comparing those adjusted costs to the post-transaction costs of the combined company. I chose not to include this output-related adjustment to keep my analysis simpler, and to be more conservative.

Q: Staff criticizes you for excluding Uncollectible Accounts from the Customer Service expense figures that you compared in your realized synergies analysis. [Staff

Report, page 79] Why is it appropriate to exclude this expense item from your analysis?

A: I chose to exclude Uncollectible Accounts cost for three reasons:

- First, Uncollectible Accounts cost is more properly characterized as a contra-revenue item, not an expense item. My realized synergies analysis deals with NFOM expenses.
- Second, the levels of Uncollectible Accounts cost are heavily influenced by the rules of the local regulatory jurisdiction, primarily those regarding disconnection procedures (multiple warning notices, time periods to disconnect). These rules can expand or shrink a utility's revenue exposure on overdue accounts, vs. other utilities in other states, for reasons not directly related to a company's effectiveness in managing such accounts. Uncollectible Accounts costs are less controllable by utility management.
- Third, Uncollectible Accounts costs are more closely related to the level of fuel and purchased power costs than the level of NFOM expenses. When fuel and purchased power costs are high, and push up the total bill to customers, one would expect more customers to have difficulty paying their bill.

Due to these factors, Uncollectible Accounts cost should not be included in an analysis of the effects of utility mergers on non-fuel O&M expenses.

I also note that inclusion of Uncollectible Accounts, whether or not adjusted for inflation, would not make a material difference in the conclusions of my synergy savings comparison. The average reduction in real costs of the Customer Service function would still be quite large, and the applicants' estimated savings in that function and overall would be above the median.

Q: Were you consistent in your treatment of Uncollectible Accounts cost in the applicants' synergy savings estimates and the synergy saving of other utility merger transactions?

A: Yes. Uncollectible Accounts cost was excluded from both sets of synergy savings figures. None of the synergy "projects," which generated the synergy savings estimates, addressed Uncollectible Accounts.

However, in the interest of full disclosure, the synergy savings estimated do account for decreased write-off expense from capturing assistance funds for those most in need. This is a benefit of KCPL adopting Aquila's automated assistance agency interface. This interface will permit KCPL's customers to more readily access assistance programs such as the Low Income Home Energy Assistance Program.

Q: The Staff Report complains that your workpapers were incomplete and did not allow a complete review of your analysis [Staff Report, pages 79-80]. Did you provide complete workpapers on a timely basis?

A: Yes. The workpapers that I relied upon directly for my exhibits were filed with my Supplemental Direct Testimony These workpapers are tables that show pre-transaction and post-transaction costs by functional area for the parent utility companies in the relevant transactions. The charts in my exhibits were derived from these tables.

In response to Staff's request for further details, I provided on a timely basis the underlying cost data for the individual utility operating companies that reported cost data to the FERC. I also explained how the data from the individual utility operating companies were aggregated by parent utility, and listed the FERC accounts that were included in each functional area of NFOM expense. My data were obtained from the SNL data base service, which groups the accounts as they are grouped in the FERC Uniform System of Accounts. The data aggregation process is quite straightforward.

Finally, I provided three examples of how the reported FERC costs track through from the more detailed level to the aggregate level, and offered to speak with Staff over the telephone if they had any unanswered questions. Staff did not take me up on my offer.

Q: OPC witness Dittmer asserts that KCPL's estimates of synergy savings from the proposed merger are "overstated" [Dittmer Rebuttal Testimony, pages 36-39]. Why does your analysis show that they are not overstated?

A: Mr. Dittmer's testimony makes little attempt to rebut the analysis contained in my Supplemental Direct Testimony, regarding the reasonableness of Great Plains Energy's and KCPL's methods for estimating synergies and the reasonableness of its estimates of total achievable synergies.

I reviewed the synergy estimates both on a stand-alone basis and in the context of industry experience. At least four separate lines of corroborating evidence support the conclusion that the estimates are reasonable and conservative: [1]

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[1] As stated in pages 22-23 of my Supplemental Direct Testimony:

1. Its synergy estimation methodology is sound. The synergy teams have drilled down to a unusually deep level of detail, and have identified and vetted reasonable levels of synergies. The sources of savings that they cited are credible.
2. KCPL's estimated total synergies (including fuel) are modestly higher than the median <u>announced</u> synergies for 26 other energy utility transactions (5% vs. 3% of total O&M, 11% vs. 9% of non-fuel O&M).
3. KCPL's estimated synergies for non-fuel O&M expense are significantly higher than the median <u>realized</u> synergies for 15 other electric utility transactions (10% vs. 2%).

- The soundness of the estimating methodology.
- The reasonableness of the synergy estimates vs. announced synergies for comparable transactions
- The reasonableness of the synergy estimates vs. realized synergies from comparable transactions
- The reasonableness of the synergy estimates in the context of my company's substantial experience in advising utility management on expectations for merger synergies.

The total estimated level of synergy savings are modestly above the industry average. This is just about where one would expect them to be, given the fact that KCPL and Aquila have adjoining territories and can access higher levels of proximity-related synergies (mainly in the generation and T&D areas) than many of the transactions included in the industry data.

Mr. Dittmer is also inconsistent in his logic about economies of scale. He admits [page 36] that Aquila's electric operations enjoy reduced costs due to economies of scale from being part of a larger organization, yet he discounts the possibility that the KCPL-Aquila combination could also produce scale synergies. There is no magic size at which scale economies cease, especially in the corporate overhead areas that he mentions.

Q: Praxair witness Brubaker labels the synergy savings estimates as "quite aggressive." [Brubaker Rebuttal Testimony, page 10] Why is this characterization unfounded?

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4. KCPL's estimated synergies are at the upper end of the range that we have advised utility clients, based on our experience, is reasonable to expect in merger transactions (10% vs. 7-10%).

A: Mr. Brubaker appears to equate "above average" with "quite aggressive." He argues that the synergy estimates should be thrown out merely because they are above the median of industry experience. As summarized in my previous response and explained in more detail in my Supplemental Direct Testimony, the synergies should indeed be expected to be above the industry average. Mr. Brubaker chose not to address any of the lines of evidence that I presented to demonstrate that the estimates of total synergies are reasonable and conservative.

Q: Will Mr. Brubaker's client (Praxair) and other customers of KCPL and Aquila benefit in the long run if the realized synergy savings are above average?

A: Yes. Substantially all savings from the transaction will accrue to the benefit of KCPL and Aquila customers after the expiration of the synergy sharing mechanism, i.e., after five years.

Q: Is there another factor that leads you to believe that the synergy estimates are conservative, and not "overstated" or "quite aggressive?"

A: Yes. As stated in page 27 of my Supplemental Direct Testimony, the realized synergies are likely to be greater than Great Plains Energy's and KCPL's estimates. Competent utility managers almost always find more synergies as they dig deeper after the transaction, and several significant sources of synergy savings were not included in KCPL's estimates. These observations were not rebutted by any opposing witness.

Q: OPC witness Dittmer asserts that "enabled synergy savings should be removed from any analysis that attempts to evaluate whether the merger will result in a benefit or detriment to ratepayers." [Dittmer Rebuttal Testimony, page 32] Why do you disagree with his position?

A: At the most basic level, Mr. Dittmer's position is contrary to the interests of his clients, the customers of KCPL and Aquila. He would have the Commission reject a transaction that will produce significant benefits for these customers, and that provides financial and operational benefits to both companies.

Q: Mr. Dittmer recommends that only "savings that are quantifiable and clearly related to structural differences in ownership or operations" should be attributed to the proposed transaction. [Dittmer Rebuttal Testimony, page 33] Is this an easy distinction to make?

A: No. Both created and enabled synergy savings are unlocked by the merger, and both require management initiative and action before they can be realized. The difference is not clear-cut, which is why Great Plains Energy and KCPL did not distinguish between created and enabled synergies in their estimates. As Mr. Marshall states, all these savings are in some sense created by the merger.

Q: Is it realistic to expect that KCPL and Aquila could separately achieve all the enabled synergies that Mr. Dittmer argues are not merger-related?

A: No. The merger process is a change enabler. The management and employees of both companies become more open to considering and implementing changes, which they otherwise might not have pursued. The benefits associated with enabled synergies are larger and faster in the merger context than they would be on a stand-alone basis.

Mr. Dittmer argues that the Commission should consider only those merger-related benefits that go beyond a hypothetical level of stand-alone savings, but he does not explain how those stand-alone savings can be achieved as effectively without a merger. His suggested method of counting benefits is logically equivalent to setting rates for KCPL and Aquila based on an unproven assumption that their costs are equal to those achieved by best-in-class utilities, without allowing KCPL or Aquila to recover any costs that might be incurred in order to achieve such performance. As the saying goes, there is no free lunch.

Q: Mr. Dittmer essentially argues that only synergy savings that could not be achieved but for the transaction should be considered by the Commission. Why is this bad regulatory policy?

A: It is bad regulatory policy because it greatly reduces the incentive of utility management to pursue savings initatives that will benefit customers. The benefit sharing mechanism proposed by the applicants is designed to ensure that both customers and shareholders will benefit from aggressive pursuit of the full level of benefits that can be achieved from the merger. Such alignment of interests is the essence of good regulatory policy.

Q: Another reason offered by Mr. Dittmer for excluding enabled synergy savings from Commission consideration is that regulation should act as a surrogate for competition. Is this a good reason to follow his recommendations?

A: No. Mr. Dittmer cites a sound regulatory principle, but reaches a wrongheaded conclusion. I agree that regulation should try to emulate competitive outcomes. In this case, however, there is no need to act as a surrogate. Mergers and acquisitions are part of the "creative destruction" that drives capitalism. The proposed merger is direct outcome of the competitive market. The Commission has legitimate public interest criteria to consider, but if these are satisfactorily addressed, the marketplace should be do what is does best. Which is to allocate our productive resources most efficiently and produce the maximum benefits for consumers over the long run.

Q: What conclusions do you reach on the issues you address in this testimony?

A: My conclusions are:

1. It is appropriate and conservative to adjust nominal dollar costs for inflation by the Consumer Price Index, when comparing pre-transaction and post-transaction operating costs of merged utility companies.
2. It is appropriate to exclude uncollectible expense from the comparison of pre-transaction and post-transaction costs for the Customer Service function of merged utility companies.
3. The workpapers that I relied upon for my supplemental direct testimony were provided on a timely basis to MSPC staff and interveners.
4. KCPL's estimates of synergy savings from the proposed KCPL/Aquila merger are not overstated or too aggressive, but are reasonable and conservative.
5. Both created and enabled synergies should be included in the total pool of synergy savings that KCPL proposes for sharing between shareholders and customers.

Q: Does that conclude your testimony?

A: Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of Great Plains Energy Incorporated, Kansas City Power & Light Company, and Aquila, Inc. for Approval of the Merger of Aquila, Inc. with a Subsidiary of Great Plains Energy Incorporated and for Other Requester Relief	)	**Case No. EM-2007-0374**

AFFIDAVIT OF WILLIAM J. KEMP

STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

WILLIAM J. KEMP, being first duly sworn on his oath, states:

1. My name is **WILLIAM J. KEMP**. My office is in Sarasota, Florida. I am employed by Black & Veatch Corporation as a Managing Director.
2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of Great Plains Energy Incorporated and Kansas City Power & Light Company consisting of fifteen (15) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.
3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

William J. Kemp
WILLIAM J. KEMP

Subscribed and sworn before me this 13th day of November 2007.

Sherry L. Lane
Notary Public

My commission expires: July 24, 2009

SHERRY L. LANE
Notary Public, State of Florida
My Comm. Expires July 24, 2009
No. DD453813