

Exhibit No.:

Issues: Affiliate Transactions
& Acquisition Premium

Witness: Jon R. Empson

Sponsoring Party: Missouri Public
Service

Case No.: ER-2001-672

Before the Public Service Commission
of the State of Missouri

FILED³
JAN 08 2002
Missouri Public
Service Commission

Rebuttal Testimony

of

Jon R. Empson

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**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
REBUTTAL TESTIMONY OF JON R. EMPSON
ON BEHALF OF MISSOURI PUBLIC SERVICE,
A DIVISION OF UTILICORP UNITED INC.
CASE NO. ER-2001-672**

1 Q. Please state your name, and business address.

2 A. My name is Jon R. Empson and my business address is 1815 Capitol Avenue, Omaha,
3 Nebraska, 68102.

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

5 A. I am employed by UtiliCorp United Inc. ("UtiliCorp") as Senior Vice President with
6 responsibility for Regulatory and Legislative Services. UtiliCorp presently conducts its
7 Missouri electric business operations as Missouri Public Service ("MPS") and St.
8 Joseph Light & Power ("SJLP").

9 Q. Briefly describe your educational background and employment history.

10 A. I have a Masters degree in Business Administration from the University of Nebraska at
11 Omaha and a BA in Economics from Carleton College in Northfield, Minnesota. From
12 1993 to 1995, I held the position of Vice President of UtiliCorp. I was named a Senior
13 Vice President in March 1995 and assumed my current responsibilities in January 2001.
14 From 1988 to 1993, I was Senior Vice President of Administration with Peoples Natural
15 Gas Company ("Peoples") in Omaha, Nebraska, and in 1986 and 1987, I was Vice
16 President of Regulation, Finance and Administration with Peoples. Before joining
17 Peoples, I was Vice President of Administration with Enron Liquid Fuels from 1983 to
18 1986, and Vice President of Administration for Northern Plains Natural Gas from 1980
19 to 1983.

20 Q. Have you testified before the Missouri Public Service Commission ("Commission") in
21 the past?

1 A. Yes, I have.

2 Q. What is the purpose of your rebuttal testimony in this case?

3 A. To respond to Commission Staff ("Staff") Witness Mark Oligschlaegers' testimony on
4 the affiliate transaction standard and acquisition premium recovery.

5 **Affiliate Transaction Standard**

6 Q. Is there an affiliate transaction involved in this case?

7 A. Yes. I will describe it later in my testimony.

8 Q. Is there a rule that sets the Commission's standard for evaluating an affiliate
9 transaction?

10 A. Yes, Commission rule 4 CSR 240-20.011 purports to establish a standard. I am aware
11 that there's some pending litigation on the affiliate transaction rules.

12 Q. What is your understanding as to the purpose of this standard?

13 A. According to the rule, the stated purpose is "to prevent regulated utilities from
14 subsidizing their nonregulated operations. In order to accomplish this objective, the rule
15 sets forth financial standards, evidentiary standards and record keeping requirements..."
16 In other words, a regulated electrical corporation such as UtiliCorp cannot provide a
17 financial advantage to an affiliated entity.

18 Q. What is the specific standard?

19 A. The rule specifically states the following:

20 "For purposes of this rule, a regulated electrical corporation shall be deemed to
21 provide a financial advantage to an affiliated entity if –

22 1. It compensates an affiliated entity for goods or services above the lesser of

23 A. The fair market price; or

24 B. The fully distributed cost to the regulated electrical corporation to
25 provide the goods or services for itself"; (emphasis added)

1 Q. Why do you emphasize the phrase, "provide the goods or services for itself?"

2 A. Staff Witness Oligschlaeger spends considerable time in his direct testimony attempting
3 to derive the cost for the affiliate to provide the service in an apparent attempt to have
4 the affiliate in this case only charge MPS its cost for the service. This is clearly a
5 misinterpretation of the affiliate standard of comparing the fair market value to the fully
6 distributed cost of the utility to provide the same service.

7 Q. Does the rule provide an evidentiary standard for affiliate transactions?

8 A. Yes. The specific evidentiary standard for affiliate transactions is stated as follows:
9 "When a regulated electrical corporation purchases information, assets, goods, or
10 services from an affiliated entity, the regulated electrical corporation shall either obtain
11 competitive bids for such information, assets, goods or services or demonstrate why
12 competitive bids were neither necessary nor appropriate." (emphasis added)

13 Q. Please explain the affiliate transaction in this case.

14 A. UtiliCorp, doing business as MPS, signed a Power Sales Agreement (PSA) with MEP
15 Pleasant Hill, LLC. (MEPPH). MEPPH is a special purpose limited liability company
16 organized under the laws of the State of Delaware. MEPPH is owned equally by Aquila
17 Energy Corporation, which is a wholly owned subsidiary of UtiliCorp, and Calpine
18 Corporation.

19 Q. Did the Staff review the contracting process?

20 A. Yes. Staff Witness Oligschlaeger in his direct testimony testified that, "MPS currently
21 has need for increased capacity, both from load growth and the expiration of several
22 long-term purchased power agreements it had entered into earlier with other regional
23 utilities" (Oligschlaeger direct p. 3, lines 12 – 15). Then he acknowledged that
24 "competitive bids for the supply of MPS's incremental capacity needs starting 2001"
25 were taken (p. 8, lines 1 – 2). Finally, Mr. Oligschlaeger acknowledges that "the Staff

1 reviewed the bidding process used by MPS as well as its decision to choose MEPPH at
2 the supplier of power. Based upon that review, the Staff concluded that MEPPH's bid
3 was a reasonable selection when compared to the other bids received."(p. 8, lines 15 –
4 18). In other words, the best option for the customer was selected by MPS after a
5 competitive bid process.

6 Q. Did the Staff submit a memorandum to the Commission on April 5, 1999 concerning its
7 review of the PSA?

8 A. Yes. In fact on page 7 of the memorandum, Staff concluded the following:

9 "Based on the information presently available, the competitive bidding/negotiation
10 process used by MPS appears to be consistent with obtaining the needed purchased
11 power at least cost."

12 Q. Did the Staff attach conditions to its recommended approval?

13 A. Yes. Staff stated that the conditions would permit a detailed review of the transaction in
14 the context of a rate increase or earnings complaint case (p. 8). Even though MPS used
15 a third party to help evaluate the proposals in order to ensure objectivity, Staff again
16 reserved its judgment (p. 8 – 10). So, even though the Staff concluded, "that the process
17 followed by MPS is adequate to meet the public interest standard," (p. 10) it was not
18 willing to accept the outcome.

19 Q. Given that apparent uncertainty, why would MPS accept the ratemaking risk that Staff
20 used as a condition for approval?

21 A. As Staff indicated, MPS needed the power and a generation plant had to be built to meet
22 the needs. Time was of the essence. MPS was confident that given the endorsement of
23 the process by Staff, the validation by a respected third party, and its compliance with
24 the affiliate rules, the costs of the PSA would be approved. This feeling was reinforced
25 by Staff's discussion of public interest:

1 "The public interest is met when electricity is provided to end-use consumers at the
2 lowest expected cost consistent with reasonable levels of risk associated with cost
3 varying from its expected level. In today's environment of competitive wholesale
4 power, properly implemented competitive bidding and/or negotiation for purchased
5 power is a process by which least-cost acquisition of resources can be obtained. Based
6 on the information presently available, the competitive bidding/negotiation process
7 used by MPS appears to be consistent with obtaining the needed purchased power at
8 least-cost." (p. 7)

9 So while the Staff did have its conditions and caveats, there was no reference to any
10 concerns about awarding the contract to an affiliate or any hint that if a bidding process
11 was an acceptable process, anything other than the low bid would be deemed prudent.

12 Q. Why then is the Staff attempting to redetermine what a "new bid" should have been if
13 the lowest cost option for the customer was already selected?

14 A. That is a mystery to me. Staff did not submit any testimony denying that the accepted
15 bid was the lowest priced bid. Instead, it appears that Staff believes that the cost to
16 MEPPH is the appropriate price to MPS.

17 Q. Why do you conclude this?

18 A. Starting on page 22, line 18, Staff Witness Oligschlaeger begins his calculation of "an
19 appropriate starting point for analyzing the 'cost' basis of Aries capacity, for purposes
20 of evaluating the MPS – MEPPH PPA." MEPPH cost is irrelevant. The power was
21 competitively bid and MEPPH won. The Staff appears to believe that an affiliate is not
22 entitled to make a profit on a transaction even when its bid, in a competitive bidding
23 process, is the lowest cost option for the customer.

24 In other words, the Staff is taking a position that basically eliminates an affiliate from

1 participating in a competitively bid process and, which in this case, will result in an
2 increase in cost to ratepayers.

3 Q. Why?

4 A. There is no rational basis for the Staff to take such a position. When the Commission
5 finalized the affiliate transaction rules, it stated in its Order of Rulemaking "it is not the
6 intent or purpose of the proposed rules to handicap any competitor. Doing so would be
7 detrimental to both ratepayers and consumers, resulting in higher costs or less
8 information for ratepayers and consumers." I interpret this statement by the
9 Commission as an acknowledgement that the Commission wanted to avoid what the end
10 result would be if the Staff pursues its PSA disallowance -- the elimination of any
11 UtiliCorp affiliate as a bidder to supply future energy needs to MPS. As discussed by
12 MPS Witness Steve Ferry many steps were taken to keep Staff informed about the bid
13 process, the role of MPS's affiliate, and the precautions to ensure compliance with
14 affiliate regulations. MPS customers received the lowest competitive bid consistent
15 with the regulations and evidentiary standard created by this Commission. For Staff
16 Witness Oligschlaeger to repeatedly state that awarding the lowest price bid to an
17 affiliate is an example of "affiliate abuse", is unfortunate. MPS has been completely
18 open about the entire process and strongly disagrees with Mr. Oligschlaegers'
19 statements. At no time during the PSA approval process did Staff even hint there would
20 be issues concerning awarding a bid to an affiliate. The Commission should confirm
21 that the selection of MEPPH by MPS as the winning bidder was both prudent and in the
22 best interest of the customer.

23 **Acquisition Premium**

24 Q. Is MPS attempting to recover in this case any acquisition premium associated with the
25 UtiliCorp/SJLP merger?

1 A. No.

2 Q. What approach is MPS taking in this case relative to the acquisition premium?

3 A. Basically, since the merger with SJLP did not become effective until January 2001,
4 MPS has presented its rate case as if the merger had not occurred. That is, none of the
5 savings or costs were included in the test year or in the known and measurable changes
6 for 2001. MPS Witness Vern Siemek addresses this issue in more detail.

7 Q. Why did MPS decide not to seek premium recovery in this case?

8 A. The MPS and SJLP operating divisions are not "fully integrated" and the merger
9 savings have not been fully realized. However, most of the transaction and transition
10 costs have been incurred. In order to effectively match the costs with the benefits
11 (savings), a timeframe beyond 2001 is needed.

12 Q. What do you mean by "fully integrated"?

13 A. Mr. Siemek has defined this term in his testimony.

14 Q. What position has the Staff taken?

15 A. The Staff has attempted to capture the savings being currently realized by MPS as a
16 result of the merger, but has not allowed any of the costs to achieve the savings.

17 Q. What is Staff's position on the appropriate rate treatment of merger/acquisition costs
18 and savings in rate proceedings?

19 A. Staff Witness Oligschlaeger outlines Staff's position starting on page 28, lines 4 – 10 of
20 his direct testimony. He states that:

21 "Merger and acquisition savings, to the extent they are reflected in a utility's actual test
22 year, update period or true-up period financial results, generally should be reflected in
23 customer rates." A utility's "cost to achieve"; also known as transition cost, incurred to
24 bring about savings should be allowed recovery in customer rates, usually through an
25 amortization to expense. (Transition costs generally include items such as severance

1 pay for employees, and costs to integrate the two former utilities computer and
2 telecommunication systems.)

3 He goes on to explain how regulatory lag gives the company an opportunity to retain
4 savings and in effect, fund the acquisition premium.

5 Q. Did Staff include any of the "costs to achieve" which Staff Witness Oligschlaeger
6 indicated should be included?

7 A. No. Staff just included the merger savings and, by doing so, not only ignored the costs
8 to achieve the merger but also eliminated any benefit from regulatory lag.

9 Q. Were you surprised by the Staff's position?

10 A. Yes. In the UtiliCorp/SJLP merger case, Case No. EM-2000-292, Staff Witness
11 Oligschlaeger filed rebuttal testimony in which he stated the following beginning at
12 page 48, line 14 and ending on page 49, line 19:

13 Q. Are there instances in which regulatory lag may not provide for a fair sharing of merger
14 savings to a utility?

15 A. That is possible. In particular, when a company undergoing a merger faces increasing
16 revenue requirements even when estimated net merger savings are factored in, rate
17 increase cases may serve to pass on achieved merger savings to customers without a
18 chance for the utilities to retain a share of merger savings for a reasonable period. In
19 these instances, the Staff would not be opposed in concept to proposals by utilities to
20 "share" merger savings in the context of a rate proceeding.

21 Q. How would the Staff view such proposals if they were made by UCU in future rate
22 proceedings?

23 A. The Staff's position on such proposals would depend upon the specific facts and
24 circumstances surrounding the request at that time. Any future Staff consideration of
25 merger savings sharing proposals would be tied to production of evidence

1 demonstrating incremental net customer benefits that can clearly be tied to the SJLP
2 merger, and that would not have been possible without the merger occurring. The
3 amount of any savings retained by the utility should not be tied to the amount of the
4 consideration paid by UCU for the SJLP properties (i.e. acquisition adjustment).
5 Finally, the Staff would evaluate the past ability of UCU to retain merger savings
6 through means of regulatory lag before considering any proposals to share merger
7 savings in rate cases. (emphasis added)

8 Q. During the UtiliCorp/SJLP merger proceeding, was Staff aware that MPS had an
9 increasing revenue requirement?

10 A. Yes. Staff was well aware that MPS needed new generation capacity since the filing
11 involving MEPPH (the affiliate transaction) had occurred on March 1, 1999. The Staff
12 was also aware that MPS would be filing a rate case to recover the higher capacity costs
13 soon after the merger was completed.

14 Q. What savings from the merger did the Staff include in this case?

15 A. MPS witness Vern Siemek discusses this in detail in his rebuttal testimony, but one
16 significant savings included by the Staff was the change in corporate allocations as a
17 direct result of having SJLP factors included in the allocation formula.

18 Q. How do you respond?

19 A. Clearly, there can be no disagreement that this category of savings is a direct result of
20 the merger, by definition. However, MPS has not had the opportunity to gain any
21 benefit from these savings through regulatory lag and is not being given the opportunity
22 to include the "costs to achieve" as Staff Witness Oligschlaeger initially recommended.
23 In fact, Mr. Oligschlaeger now says that "The Commission should base MPS's rates on
24 the company's actual cost of service, including SJLP merger savings incurred to date
25 and reflected in MPS's revenue requirement if any."

1 Q. Were "costs to achieve" included by the Staff or MPS in this case?

2 A. No

3 Q. Did MPS have a "reasonable period" of retaining the merger savings?

4 A. No

5 Q. How should the Commission address these obvious inequities and inconsistencies?

6 A. Mr. Siemek addresses the solution in detail, but the simplest solution is to accept the
7 financials as filed in this case by MPS, which exclude the impact of the SJLP merger.
8 An alternative is to include the costs from the merger as an offset to the savings, which
9 result from the merger.

10 Q. Has the Commission indicated that it has an open-mind on considering recovery of the
11 transaction premium as well as the transition cost in a rate case?

12 A. Yes. In its order approving the UtiliCorp/SJLP merger, the Commission stated:

13 "The Commission will give due consideration to a proposal to provide for recovery of a
14 merger premium if that proposal is presented in a rate case."

15 Q. Have you testified before about the recovery of a merger premium?

16 A. Yes. Attached, as Schedule JRE-1 is my testimony from Case No. EM-2000-369. As I
17 explained in the testimony, Staff ignores the fact that the savings from a merger only
18 occur if the transaction is completed and in order for a transaction to occur, a premium
19 had to be paid.

20 Q. Why didn't MPS propose premium recovery in this case?

21 A. Since the merger was just completed and all of the known savings have not been
22 included in the time periods under consideration in this case, it was not appropriate to
23 make such a proposal at this time.

Kansas Corporation Commission

Q. Staff Witness Oligschlaeger uses the order of the Kansas Corporation Commission in a recent WestPlains rate case as an example of how other jurisdictions are having difficulties assessing complex power plant lease arrangements for rate purposes. Do you agree with his conclusions?

A. No.

Q. What is the proper context for understanding the quote used by Mr. Oligschlaeger on p. 26, lines 1 – 15 of his direct testimony?

A. When UtiliCorp purchased WestPlains Energy in 1991, the Kansas Corporation Commission (KCC) order addressed the recovery of the acquisition premium in future rate cases. Embedded in the Jeffrey Energy Center (generation plant partly owned by WestPlains) lease was the acquisition premium. The KCC stated on page 17 of its order in Docket No. 175,456-U, 91-UCUE-226-MER, the following:

“34. Under the terms of the S & A, UtiliCorp has agreed not to seek recovery of any acquisition premium and transaction costs related to the Centel acquisition, except, at a maximum, to the extent that it can demonstrate and quantify savings in the cost of service due to the acquisition.” (emphasis added)

Q. When did the KCC address the premium recovery issue?

A. In Docket No. 99-WPEE-818-RTS, the KCC compared the lease payments for Jeffrey to the cost of having Jeffrey in rate base and determined that the premium was \$5 million annually (p. 7, paragraph 15). After reviewing the cost savings identified by UtiliCorp, the KCC concluded that merger savings totaled \$2,350,000 annually and that UtiliCorp would be allowed “to recover \$2,350,000 of the lease payments attributed to the acquisition premium.” (p. 11, paragraph 25). In other words, UtiliCorp had been allowed to benefit from regulatory lag from the time the KCC approved the acquisition

1 on September 18, 1991, until the rate case decision on January 19, 2000. Going forward
2 UtiliCorp was able to recover about 50% of the premium in rates based upon the
3 documented savings provided to customers.

4 Q. What Kansas order is Mr. Oligschlaeger referring to in his testimony?

5 A. UtiliCorp filed another rate case and attempted to document further merger savings to
6 collect more of the premium in rates. At UtiliCorp's request, the Commission adopted a
7 methodology for comparing the lease payments to the cost of service rate base treatment
8 of Jeffrey. The change was not due to the confusing and complex nature of the lease per
9 se, but rather the necessity for having a consistent framework for determining the level
10 of merger premium that should be recovered in rates. UtiliCorp is recovering in rates
11 the Jeffrey Energy Center costs as if it had been included in rate base since the time of
12 acquisition, plus \$2,350,000 of quantifiable merger savings to offset the merger
13 premium.

14 Q. Is Mr. Oligschlaeger correct when he states at page 26 of his testimony that "... the
15 KCC changed its position on rate treatment of the Jeffery generating unit, stating that it
16 was to be treated as if it were in the rate base for WestPlains, instead of having the costs
17 recovered through lease expense"?

18 A. No, he is not. The same concepts were used in both WPE rate cases. The difference
19 was a confirmation in the most recent case of the going-forward methodology for
20 determining the premium being paid and the amount to be recovered in rates.

21 Q. Does that conclude your rebuttal testimony?

22 A. Yes.

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

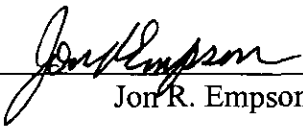
In the matter of Missouri Public Service)
of Kansas City, Missouri, for authority)
to file tariffs increasing electric rates)
for service provided to customers in the)
Missouri Public Service area)

Case No. ER-2001-672

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF JON R. EMPSON

Jon R. Empson, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Jon R. Empson;" that said testimony was prepared by him and under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.



Jon R. Empson

Subscribed and sworn to before me this 7th day of January, 2002.



Notary Public

My Commission expires:

7/4/05

