Missouri Public Service Commission

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October 3, 2000

FILED[3]
OCT 0 3 2000
Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. EM-2000-292

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and eight (8) conformed copies of the HC version of the **REPLY BRIEF OF STAFF** and the original of the NP version.

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

Steve Dottheim
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SD/lb
Enclosure
cc: Counsel of Record

NP

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

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Missouri Public Service Commission

REPLY BRIEF OF STAFF

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I. INTRODUCTION

The Staff in this reply brief has kept the same organization as in the Staff's initial brief in this case. There are some subject areas for which the Staff is not submitting a reply. This is the case because based on the initial briefs of UtiliCorp United Inc., St. Joseph Light & Power Company, and the other parties, the Staff sees no need to submit a response.

II. BURDEN OF PROOF AND LEGAL STANDARD SECTIONS

A. Burden Of Proof

B. Merger Legal Standard

Counsel for UtiliCorp in his opening comments questioned whether this Commission can bind future Commissions by accepting the Joint Applicants' proposed regulatory plan:

> Are we asking you to bind future Commissions? Well, I certainly understand that you probably can't do that. But UtiliCorp obviously would take a great deal of comfort in a decision approving this proposed regulatory plan. Now we recognize that five years from now all or some of you may be gone. A new Commission may not consider itself bound by your decision. Other parties may want to relitigate these issues in the rate case and perhaps will be allowed to do that.
>
> We'll take that chance. We'll take that chance. Just like we did in the Rolla certificate case. We're certainly better off -- UtiliCorp is certainly better off with a decision approving this regulatory plan on the front end as opposed to a decision which rejects it. Just as in the Rolla gas certificate case, we need some reasonable assurance now that the merger transaction will make economic sense to UtiliCorp.

(Tr. 56). There is nothing in the initial briefs of UtiliCorp or SJLP addressing this issue. It will be interesting to see if there is anything in UtiliCorp's or SJLP's reply brief on this matter. Of course, the Staff will not be able to respond to it as the issue did not appear in UtiliCorp's or SJLP's initial brief.

There is an issue which counsel for UtiliCorp addressed in his opening statement which UtiliCorp did address in its initial brief at page 16; that issue being whether the Commission can or should make ratemaking decisions in a merger case. Counsel for UtiliCorp commented as follows in his opening statement respecting Re UtiliCorp United Inc., 3 Mo.P.S.C.3d 127, Case No. GA-94-325, Report And Order (August 22, 1994):

> Now I've been practicing over her for – maybe not as long as Mr. Conrad, but over 20 years, and I recognize that these items in this regulatory plan are traditionally the type of issues which you all defer to rate cases. But I'm telling you, we need these decisions on these matters now in order to determine whether or not the transaction makes economic sense.
>
> And some argue that you can't do this here. You cannot make these types of decision in this case, that you can't make a rate case type decision in this case, that you can't make a rate case type decision in a non-rate case proceeding, which this is.
>
> Well, my answer to that is, you have done this on at least one occasion with which I am familiar. You've done this very thing. And you did it for UtiliCorp and it wasn't really that long ago. Back in 1994 in Case GA-94-325, you granted UtiliCorp a certificate of public convenience and necessity to provide natural gas service in the City of Rolla, Missouri. At that time Rolla was without natural gas service and those people who were using gas were using propane.
>
> In that certificate case, UtiliCorp argued it couldn't provide service, that it wouldn't make economic sense for it to provide service unless it got approval on the front end for the subsequent rate-making treatment for its costs to convert the Rolla customers from propane to natural gas. And it was estimated that those costs would be about $300 per customer on the average.
>
> You granted the certificate and you also granted the rate-making treatment. You said in your order granting the certificate that UtiliCorp through its operating company is authorized to account for the $300 per customer conversion costs above the line and include those costs in rate base.
>
> An you went on to say, The Commission makes no finding as to the prudence of rate-making treatment to be given any costs or expenses incurred as a result of granting of this certificate except those costs and expenses dealt with specifically in the body of this Report and Order. And you also commended UtiliCorp in that case for its candor in stressing the make or break nature of the rate-making treatment it needed to have for those conversion costs.
>
> So based at least on that case, I would submit to you that the rate-making request that we have in this merger case isn't really a radical departure from what you have been asked to do and from what, in fact, you have done in the past. So those are the components of the regulatory plan.

(Volume 3, Tr. 53-55).

The discussion of this matter in UtiliCorp's initial brief at page 16 is consistent with UtiliCorp counsel's opening statement. The Staff responds that the Commission should not use its decision in Case No. GA-94-325 as the basis for fashioning in the instant merger proceeding a truly major exception to the Commission's long-held practice of not deciding ratemaking issues in non-rate cases. Case No. GA-94-325 can be distinguished from the instant merger case. The caption of the case is as follows: In the Matter of the Application of UtiliCorp United, Inc., d/b/a Missouri Public Service, for Permission, Approval, and a Certificate of Convenience and Necessity Authorizing it to Construct, Install, Own, Operate, Control, Manage and Maintain a Gas Distribution System for the Public in the City of Rolla, Missouri and the Surrounding Unincorporated Area Located in Phelps County, Missouri.

The Staff asserts that Case No. GA-94-325 is distinguishable from the instant case on a number of grounds. The issues in the case were as follows: (1) the economic feasibility of natural gas to compete with propane as an energy source, the potential anticipated load, the potential anticipated number of customers, who will convert from propane to natural gas, and the expense necessary to complete and operate the proposed project, (2) the potential for subsidization of the proposed Rolla system by the remainder of the ratepayers in the MPS service territory, (3) the rates to be charged in the Rolla service area by MPS (MPS recommended the use of existing filed and approved gas rates for the Rolla service area -- MPS also proposed a potential surcharge should conversion not occur at projected levels) and (4) the granting of a variance from the Commission's promotional practice rules for the purpose of providing free installation and recalibration of existing customer equipment to facilitate and promote the conversion of the Rolla area from propane to natural gas (MPS indicated that an average of $300 per customer, on the customer's side of the meter, would be required for the conversion).

The Commission ruled as follows:

> ...The Commission sees no advantage in setting rates specific to the Rolla area prior to completion of construction and will, therefore, authorize for service in the Rolla area the existing filed and approved gas rates for the northern and southern district of MPS, until such time as a general rate case is requested or a complaint filed.
>
> Further no surcharge will be authorized in this case. The Commission is of the opinion that, should a financial problem arise that would provoke the levy of such a surcharge, such a financial problem would more appropriately be dealt with in a general rate proceeding.

3 Mo.P.S.C.3d at 132.

. . . .

> . . . the Commission will grant a variance from the proposed prohibited promotional practice in these specifics: MPS will be allowed to provide a maximum of $300.00 free conversion, installation and recalibration, per customer, on the customer's side of the meter only. Any remaining customer conversion costs paid by the Company should be appropriately borne by the shareholders, and will be accounted for below the line.
>
> This variance will be limited to a period of three years from the effective date of this order. As MPS proposes to complete the project in three years' time, this should be sufficient to ensure the necessary number of conversions. The Commission stresses that this variance is only for the proposed Rolla service area and will not be extended to any other UtiliCorp service area in Missouri.

Id. at 133.

The Commission noted that there are approximately 5200 households in Rolla itself. Therefore, if all of these households were on propane and decided to convert to natural gas in three years time, then the maximum conversion, installation and recalibration cost, on the customers' side of the meter would be $1.56 million. Id. at 129. This figure is immaterial in comparison to number of the dollars for which SJLP – UtiliCorp want ratemaking treatment in the merger case ($92 million for the acquisition premium in the SJLP – UtiliCorp merger case).

The Commission also noted that "[i]t is the official position, taken apparently after popular vote, that the City of Rolla is fully supportive of the application of UtiliCorp." *Id.* There has been no popular vote taken to determine that it is the official position of SJLP's customers that they support the merger with UtiliCorp and support the payment in their electric rates of UtiliCorp's recovery of the acquisition adjustment that is being paid to SJLP's shareholders.

In addition, it should not be lost sight of that in Case No. GA-94-325 the variance period was three years, while the SJLP – UtiliCorp proposal in the instant merger case is for a regulatory plan period of ten years.

SJLP – UtiliCorp view the "not detrimental to the public interest standard" as a de minimus matter. UtiliCorp states in its initial brief at pages 4-6 as follows respecting the applicable standard:

> Based on this standard established by the Courts and followed by the Commission, it is clear that the transaction should be approved. This is true because there is no evidence which would tend to show that UtiliCorp will be unable to provide safe and adequate utility service in the SJLP service area. . . .
>
> In past cases, the Commission has recognized that the status quo, with no change in rates or quality of service, at least for the <u>immediate future</u>, would satisfy the "not detrimental to the public interest test." *See Re Laclede Gas Company*, Case No. 17,267, December 16, 1971; 92 P.U.R.3rd 426. Also, the Missouri Supreme Court has held that utility customers are not guaranteed the status quo in the furnishing of their utilities. *See Public Service Commission of Missouri v. State*, 715 S.W.2d 482 (Mo. banc. [sic] 1986). Under the Regulatory Plan, there will be no change in rates for a period of <u>five years</u>. As such, the proposed transaction not only meets the "no detriment" test but it also gives the customers more protection than is required under the law, at least for the first five year period. Finally, under its proposed Regulatory Plan, UtiliCorp has guaranteed that the synergies will create a $1.6 million reduction in the cost of service for the SJLP

> unit in the sixth year after the merger, thus clearly creating a benefit from the transaction. (Ex. 4, p. 7).

(UtiliCorp Initial Brief, pp. 4-5; emphasis In UtiliCorp's Initial Brief).

. . . .

> While it is the position of UtiliCorp that merger savings will exceed the merger costs. [sic] Moreover, the question is not relevant to the approval because, under the proposed Regulatory Plan [sic] UtiliCorp will bear the responsibility and risk of generating merger synergies, quantifying them properly and providing that information to the Commission in future rate proceedings. . . .

UtiliCorp Initial Brief, pp. 5-6; Emphasis in UtiliCorp's Initial Brief).

. . . .

> .... Obviously there will be no rate impact on customers during this five year rate freeze regardless of whether costs exceed benefits. Consequently, the "not detrimental to the public interest" test is clearly satisfied for the initial five year period after the merger from a rate standpoint. . . .

(UtiliCorp Initial Brief, p. 6).

SJLP at page 13 of its initial brief states that the "not detrimental to the public interest standard" requires the Commission to review only the rate moratorium aspect of the regulatory plan proposed by UtiliCorp.

The folly of adopting the SJLP – UtiliCorp approach is that it requires the Commission and the parties to ignore the effect of the terms of the merger and any regulatory plan as long as rates are not increased and the quality of service does not deteriorate for some artificial period of time, regardless of whether the merger is uneconomic. A merger and any regulatory plan the terms of which resulted in the surviving utility filing for emergency rate relief at the end of a moratorium period would not be detrimental to the public interest under the SJLP – UtiliCorp approach. The Commission's long applied standard for emergency rate relief, also referred to as interim rate relief, is "'where a showing has been made that the rate of return being earned is so unreasonably low as to show such a deteriorating financial condition that would impair a utility's ability to render adequate service or render it unable to maintain its financial integrity.'" *State ex rel. Laclede Gas Co. v. Public Serv. Comm'n*, 535 S.W.2d 561, 568-69 (Mo.App. 1976).

Another phenomenon might occur under the Joint Applicants' interpretation of the legal standard. Remember that the key for the Joint Applicants' interpretation of the legal standard is solely maintenance of the status quo, not the conference of a benefit in any manner. Therefore, the Commission would have to approve two rival merger proposals one of which maintained the status quo respecting customer rates and quality of service and the other of which did better than maintain the status quo. The Commission could not choose between the two proposals. Rather the Commission would have to approve both of the rival proposals. Or would SJLP – UtiliCorp argue that merger terms and a regulatory plan that are better than merger terms and a regulatory plan that maintain the status quo mean in this particular instance that maintaining the status quo is detrimental to the public interest?

Fortunately, there is a Missouri Supreme Court case which indicates that the Joint Applicants' interpretation of the legal standard is not correct. State ex rel. Consumers Public Service Co. v. Public Serv. Comm'n, 352 Mo. 905, 180 S.W.2d 40 (Mo.banc 1944) is a decision of the Missouri Supreme Court in an appeal from a judgment of the Cole County Circuit Court. The judgment of the Cole County Circuit Court affirmed an order of the Commission authorizing the sale of electric properties by the Iowa Utilities Company to the Grundy Electric Cooperative. Appellants were Consumers Public Service Company, Missouri Public Service Corporation and Missouri Power & Light Company. A joint application had been made to the Commission by Iowa Utilities to sell and Grundy Electric Co-op to purchase that part of the electric system of

Iowa Utilities located in Mercer County, Missouri. Consumers Public Service Company, Missouri Public Service Corporation and Missouri Power & Light Company objected to approval of the proposed sale.

The Missouri Supreme Court held as follows:

> Therefore, when two utilities can reasonably be said to be operating in the same general territory, and the question before the Commission is whether or not one of them should be allowed to take additional locations which either might make arrangements to serve, the other must be held interested in the matter in the sense the term 'interested' is used in Section 5689. That was the situation in this case. Both the Cooperative and the Consumers Company had lines approximately seven miles of the property sought to be acquired. Both were operating in the same area, even in the same county, in which this property was located and both (according to the evidence) had negotiated to acquire it and could make arrangements to do so and to operate it. **The question of which one should be permitted to acquire it must be decided on the basis of whose operation of the area would best serve the public interest under all the circumstances and not merely upon which could first obtain a contract for purchase.** A contract found to be against public interest or the Commission's regulatory policy could not be permitted to stand in this situation any more than a contract for unapproved rates. We hold that Consumers Company was sufficiently 'interested' to have the right to intervene and likewise the right to apply for a rehearing, when the Commission decided that a competitor could take over these new locations adjoining the general territory in which both were operating. Our conclusion also is that this company had the further right, because of such interest, to seek a review in the circuit court and appeal to this court from its adverse decision. The motion to dismiss must be overruled as to the Consumers Company.

180 S.W.2d at 46; Emphasis supplied.

The holding in the *Consumers Public Service Company* case is supported by a case cited by UtiliCorp at page 4 of its initial brief. UtiliCorp cites the case as follows: "Also, the Missouri Supreme Court has held that utility customers are not guaranteed the status quo in the furnishing of their utilities. *See Public Service Commission of Missouri v. State,* 715 S.W.2d 482 (Mo.banc. [sic] 1986)." The Staff refers to this case as *Love 1979 Partners v. Public Serv. Comm'n*, 715 S.W.2d 482 (Mo.banc 1986). The case involves Union Electric Company's sale of its Downtown St. Louis steam heating facilities. After an evidentiary hearing, the Commission approved the transactions. Certain steam users successfully challenged in Cole County Circuit Court the Commission's Report And Order. The Missouri Supreme Court reversed the decree of the Circuit Court and sustained the Report And Order of the Commission. The Court indicated that the simple maintenance of the status quo for some artificial period, irrespective of the particular facts of the situation, is not necessarily the appropriate analysis required to be performed and that the Commission may choose among competing plans:

> The final suggestion is that the governing contracts will subject steam customers to unreasonable rate increases. **As we have said earlier, the customers are not entitled to a guarantee of the status quo in the furnishing of steam. The Commission could conclude that the present facilities are obsolescent and uneconomic**, and that rate increases would be anticipated even if UE were to continue the operation. It is also possible that UE would seek to discontinue the furnishing of steam, without the prospect of a successor, if it continued to lose customers. The contract documents provide for initial price increases, but with future increases to be controlled by a formula. The users complain of a "ratchet" effect, in which the new rates may go up but not down. **The Commission might well conclude, however, that the new level had to be guaranteed in order to provide a stable project, and that the over-all plan provides the most reliable method for assuring a continued, reliable and economical supply of steam.**

715 S.W.2d at 490; Emphasis supplied.

At page 8 of its initial brief, citing cases dealing with corporations that are not public utilities, SJLP focuses on non-public utility case law that relates the fiduciary duty of corporations to the shareholders of the corporation. SJLP next asserts that "[s]ome opponents of this transaction . . . presumably argue that if the shareholders benefit too much, the merger should be disapproved." SJLP then states at pages 8-9 of its initial brief that "[a]s a matter of law, once the decision was made to enter sale negotiations, the board of directors of SJLP was under a duty to sell control of the company at a premium, and the body of Missouri regulatory law should not be interpreted to bar or restrict that duty." The principal problem with SJLP's argument is the implication in SJLP's initial brief, the implication in UtiliCorp's initial brief and the implication throughout UtiliCorp's and SJLP's cases that there is some obligation for SJLP's and MPS' ratepayers, rather than the shareholders of the acquiring entity, to pay the acquisition premium, and, in the words of SJLP's initial brief at page 9, "the magnitude of the benefit to the shareholders is not relevant."

III. OVERALL REGULATORY PLAN

A. Elements of the SJLP—UtiliCorp Regulatory Plan

The Staff has not wasted its time nor will the Staff chance trying the Commission's patience by listing the pages in UtiliCorp's initial brief where UtiliCorp claims that (i) SJLP's customers are "guaranteed" an annual revenue requirement benefit of $1.6 million in Years 6-10 under the proposed regulatory plan, and that (ii) UtiliCorp's shareholders are assuming all of the risk of the transaction under the proposed regulatory plan. UtiliCorp goes as far as to say in its initial brief at page 35 that "[c]ustomers cannot be harmed" under the regulatory plan. All of this is rhetoric and is simply untrue.

UtiliCorp's claims depend upon the existence of a merger savings tracking mechanism that truly does what the Joint Applicants claim that it is able to do. Such a merger savings tracking mechanism does not exist presently, and there is no reasonable basis to believe that it will be devised in the next five years. Further, UtiliCorp's pledge not to expose its customers to merger related harm suffers from a glaring flaw: the "guarantee" of merger related rate benefits totally ignores the increased costs associated with corporate allocations that will be charged to SJLP customers after the merger.

The SJLP-UtiliCorp assertion that the Commission can ensure that customers are unharmed, and that in fact customers will receive a $1.6 million annual benefit from the merger under the proposed regulatory plan ($1.6 million is basically immaterial given the size of the transaction), is conceptually dependent upon the existence of a merger savings tracking system that is capable of accurately identifying and quantifying actual merger savings that may result from the SJLP – UtiliCorp transaction (Oligschlaeger Rebuttal, Ex. 13, p. 26). The Joint Applicants have not taken the effort in this proceeding to put forward a formal proposal for tracking, or to demonstrate that tracking is indeed feasible. An essential linchpin of the regulatory plan, the customer protection mechanism, is entirely missing from UtiliCorp's proposal.

The constant refrain premise of the Joint Applicants' argument is that if the Commission does not find evidence of merger savings in future SJLP rate proceedings in excess of merger costs, then no recovery of the acquisition adjustment should be allowed by the Commission and customers will still receive the guarantee of a $1.6 million merger revenue requirement benefit. This scenario assumes that the Commission will have access to clear cut, indisputable evidence in future rate cases concerning the level of net merger savings embedded within a test year, and, therefore, will be able to determine whether the imputation of $1.6 million in merger savings protects customers. Since clear-cut, indisputable evidence of merger savings will not be available to the Commission, the Commission, in actuality in future rate proceedings, will be invited by SJLP – UtiliCorp to make guesses about the level of net merger savings, and/or make assumptions that certain calculations will produce actual net merger savings amounts, even if there is no empirical evidence justifying the assumptions. These are not hypothetical scenarios; both the recent UtiliCorp rate proceeding in Kansas for its West Plains division, and the tracking "example" offered by UtiliCorp witness Jerry D. Myers in his surrebuttal testimony, Ex. 19, Sched. JDM-1, indicate it is UtiliCorp's intent to offer, at best, completely speculative evidence concerning the existence of alleged merger savings in an attempt to recover the acquisition adjustment. Both the West Plains case in Kansas and Mr. Myers' surrebuttal testimony, Ex. 19, Sched. JDM-1, are addressed in detail in the Savings Tracking/Benchmarking section of this reply brief.

Real, tangible detriment will occur to SJLP customers from the proposed regulatory plan. The Commission will not have the benefit of an accurate quantification of actual merger savings in future SJLP rate cases. In the event that the Commission attempts to make what it believes to be reasonable assumptions as to the merger savings achieved, then the quantification resulting from those assumptions will be greater or less than actual merger savings achieved, which is an amount that essentially is unknowable. If the Commission assumes a level of merger savings that exceeds actual savings, then the $1.6 million revenue requirement guarantee will not work the way that SJLP – UtiliCorp purport that it will work. Customers will receive the benefit in rates of less than the amount of merger savings assumed and customers conceivably could experience a detriment, i.e., net merger costs passed on in rates to them. If the assumed level of merger savings exceeds actual merger savings by more than $1.6 million, then there is a merger detriment even with SJLP – UtiliCorp's merger savings guarantee. This is the potential for customer detriment under the proposed regulatory plan.

It is also possible that the Commission may assume the existence of merger savings in an amount less than actual merger savings achieved, which conceptually would negatively impact UtiliCorp's earnings. Since SJLP – UtiliCorp is proposing under the regulatory plan to reserve for itself upfront 96-97% of the total merger savings during the first ten years of the merger, the Staff believes that the risk of misidentifying the amount of actual net merger savings achieved will fall on customers much more heavily than it might fall on SJLP – UtiliCorp shareholders.

There is another way in which real, tangible detriment will likely fall on SJLP customers, if the proposed regulatory plan is adopted. UtiliCorp touts the minimum $1.6 million revenue requirement guarantee as protecting customers from harm related to its proposal to directly recover the acquisition premium in rates. In fact, on page 22 of its initial brief, UCU states: "If the worst case scenario develops and none of UtiliCorp's projected merger synergies result, customers will not be asked to pay for any of the premium costs or costs to achieve the transaction. These same customers would, however, receive a benefit because the Regulatory Plan guarantees an annual $1.6 million cost of service reduction in years 6-10 after the merger is closed." Unfortunately, this alleged protection from the detriment, when savings are not adequate, of paying for the acquisition adjustment and costs to achieve in rates, does not protect SJLP customers from the detrimental impact of being included in the UtiliCorp corporate allocations scheme.

This detriment can be easily demonstrated by referring to Schedule VJS-1, attached to UCU witness Vern J. Siemek's direct testimony. (Ex. 7, Sched. VJS-I). Schedule VJS-1 is a summary of regulated costs and savings estimated by UtiliCorp to result from the SJLP transaction over the first ten years following the merger. The average amount of estimated operating expense savings for Years 6-10 following the merger is shown to be $20.576 million annually (Section I, Line 6). This amount is offset by net capital costs associated with the transactions (including an amortization of transaction costs and transition costs) of $2.383 million annually (Section II, Line 5), net allocated corporate costs of $10.512 million annually (Section IV, Line 4), and the cost associated with 50% of the premium of $6.104 million annually (Section VII). (All of these cost numbers are estimated averages for Years 6-10.) Taking the average estimated savings amount for Years 6-10 and deducting these various merger costs derives the oft-discussed net annual $1.6 million merger benefit allegedly guaranteed to customers.

The number that the Commissioners should focus on is the net annual cost that is to be charged SJLP customers as a result of their inclusion in the UtiliCorp corporate cost allocation scheme. The allocated UtiliCorp corporate costs amounts to $10.512 million annually in additional costs for Years 6-10, per Ex. 7, Sched. VJS-1, Section IV, Line 4 (and amounts to $9.368 million annually for Years 1-5 of the merger). No party has argued that SJLP customers would be exposed to these additional costs absent the merger. Therefore, these allocated UtiliCorp corporate costs clearly should be considered incremental to the merger. This amount (Ex. 7, Sched. VJS-1, Section IV, Line 4) is considerably larger than the amount related to direct recovery of half of the acquisition adjustment (Ex. 7, Sched. VJS-1, Section VII; Oligschlaeger Rebuttal, Ex. 713, p. 32). Yet the Joint Applicants' alleged commitment to impute additional savings in future rate case test years in order to offset the impact of the merger premium and costs to achieve clearly is not intended by SJLP – UtiliCorp to apply to, nor does it in fact offset the increased revenue requirement that the allocation of UtiliCorp corporate costs will put on SJLP customers. Note again the wording in UtiliCorp's initial brief at page 22 concerning the "worst case scenario": "...customers will not be asked to pay for any of the <u>premium costs or costs to achieve the transaction.</u>"[1] (Emphasis added). Then compare that statement to the numbers set out in Ex. 7, Sched. VJS-1, in which both premium costs and costs to achieve are

[1] Cost to achieve", as the term is used by UtiliCorp in Schedule VJS-1, Ex. 7, includes both what the Staff considers to be true "costs to achieve" and what the Staff calls "transaction costs." The term "costs to achieve" in Schedule VJS-1, Ex. 7, in this section of the reply brief does not constitute agreement by the Staff with UCU's definition of "costs to achieve." See Hyneman Rebuttal, Ex. 707, pp. 29-33 for an explanation of how the Staff defines "costs to achieve" and "transaction costs".

clearly distinguished from the allocated UtiliCorp corporate costs shown in Section IV of Ex. 7, Sched. VJS-1.

There is other evidence that UtiliCorp's regulatory plan does not protect SJLP customers from detriment associated with increases in revenue requirement relating to allocations of UtiliCorp corporate costs. The direct testimony of UtiliCorp witness John McKinney contains the following questions and answers:

> Q. How do you address the concern about the need to exactly track the synergies?
>
> A. <u>Synergies need only to be proved to reach the proposed hurdle level in each subsequent rate proceeding. Only if the synergies fall short is there an adjustment.</u> That adjustment would result in a lower percentage of premium being included in the SJLP unit's rate base for recovery. Any synergies above that level are used to reduce rates during the normal course of the rate proceeding and result in even lower costs to customers.
>
> Q. What do you mean by "hurdle level"?
>
> A. <u>The hurdle level is the cost impact resulting from the premium.</u>

(McKinney Direct, Ex. 4, pp. 9-10; Emphasis added).

This quote from Mr. McKinney's testimony makes it very clear that UCU's alleged commitment to track merger savings so as to ensure customers are not detrimentally harmed by the merger through rates <u>only applies</u> to the merger premium, not to corporate cost allocation impacts on SJLP customers. This is shown by Mr. McKinney's statement that UtiliCorp only intends to track sufficient savings to reach the so-called "hurdle level", and that the "hurdle level" equals the cost impact of the premium. Further, Mr. McKinney's statements also make clear that UCU only intends to impute additional savings into a rate case test year through an adjustment if there is a shortfall between "proved" merger savings and the acquisition adjustment, not if there is a shortfall between "proved" merger savings and total merger costs, including additional corporate overheads charged to SJLP customers.

Based upon the above testimony respecting the operation of UtiliCorp's proposed regulatory plan, a truer picture of the "worst case scenario" for SJLP's customers can be brought into view from the merger. Again, based entirely on the SJLP – UtiliCorp's own estimates contained within Ex. 7, Sched. VJS-1, and assuming that UtiliCorp could not prove up any merger savings to the Commission's satisfaction, the following impact on SJLP ratepayers will result. UtiliCorp would impute an amount of merger savings in a rate proceeding necessary to offset the amount of 50% premium recovery, the amortization of costs to achieve, and the guaranteed $1.6 million customer benefit. However, as previously indicated, SJLP customers also will encounter an average increase of approximately $9.4 million annually in the allocation of UtiliCorp corporate costs to SJLP, solely as a result of the merger. This allocations impact amount is shown to be representative of Years 1-5 on Schedule VJS-1, and would be captured in the SJLP – UtiliCorp planned Year 5 post-moratorium SJLP rate case, since that rate proceeding will probably utilize a Year 4 test year.

The guaranteed revenue requirement offset would only cover $1.6 million of the $9.4 million allocation of UtiliCorp corporate costs, leaving SJLP customers with $7.8 million in increased costs and rates. Such an event is an undisputed detriment, based entirely on the Joint Applicants' own estimates of merger costs, and is a detriment for which the proposed regulatory plan offers no solution whatsoever. Furthermore, the numbers used above to estimate the impact of the allocation of UtiliCorp corporate costs on SJLP customers are conservative and likely understated because UtiliCorp has underestimated the appropriate escalation rate to apply to the allocation of UtiliCorp corporate costs, based upon the historical levels of these costs allocated to MPS. (Traxler Rebuttal, Ex. 718, pp. 28-31).

To further focus on the issue whether the proposed regulatory plan protects customers from detriment relating to the recovery of the merger premium, the operation of the Joint Applicants' "frozen" capital structure proposal needs to be considered and the question of the effect of the proposed regulatory plan on MPS' customers must be considered. The Joint Applicants contend that under their proposed regulatory plan, the merged company will not seek direct recovery of the acquisition premium to the extent that it cannot prove the existence of merger related savings. However, the Joint Applicants expect to receive a significant amount of recovery of the acquisition premium indirectly through setting SJLP's rates at an artificially high level through the "frozen" SJLP capital structure mechanism and through setting MPS' rates at an artificially high level through the "frozen" allocation of UtiliCorp corporate costs to MPS. (Tr. 685-86). These elements of the Joint Applicants' proposed regulatory plan are not tied in any way to the demonstration of the existence of merger savings. Thus, UtiliCorp could fail to prove up even so little as a penny in actual merger savings and still achieve a significant level of recovery of the acquisition adjustment through its regulatory plan rate proposals respecting the SJLP capital structure and the allocation of UtiliCorp corporate costs to MPS.

UtiliCorp claims at page 14 of its initial brief that it is only seeking that the Commission continue a policy of considering the issue of acquisition adjustment recovery, as it claims was pronounced by the Commission in several past cases. However, UCU does request "one additional consideration" that being that "the Commission, in the context of this merger case, . . . explicitly state the method under which any premium recovery in the future Post-Moratorium rate case will occur." First, it should be noted that SJLP – UtiliCorp has not in its regulatory plan limited itself to only one SJLP post-moratorium rate case. UtiliCorp is seeking that the Commission make ratemaking commitments now that would apply to any SJLP rate proceeding in the five years following the post-moratorium rate case.

The Staff disagrees that the cases cited by UtiliCorp in its initial brief at page 14 mean what UtiliCorp claims that they mean in regard to the regulatory plan proposed by SJLP – UtiliCorp. Further, what UtiliCorp is asking that the Commission order concerning rate treatment of merger costs in this case goes well beyond what other utilities have requested in past merger cases, and certainly goes well beyond any past acts of this Commission regarding the treatment of merger savings and costs. Put simply, what UtiliCorp is seeking from the Commission in the instant merger case is unprecedented, besides being unwarranted.

The two cases cited by the Joint Applicants as precedent for the requested treatment of merger costs in this proceeding do not support the SJLP – UtiliCorp position in the instant case. *Re Kansas Power & Light Company,* Case No. EM-91-213, Report And Order, 1 Mo.P.S.C.3d 150 (1991), the Kansas Power & Light Company (KPL) – Kansas Gas & Electric Company (KGE) merger case, involved a request for a mechanism by which sharing of alleged merger savings between shareholders and customers could be accomplished. KPL did not request from the Missouri Commission direct recovery of the acquisition premium associated with its purchase of KGE, much less try to bind the Commission to specific recovery of the acquisition premium in future KPL rate proceedings. *Re Missouri-American Water Company,* Case Nos. WR-95-205 and SR-95-206, Report And Order, 4 Mo.P.S.C.3d 205 (1995) involved, in a rate increase case, a request by Missouri-American Water Company (MAWC) for rate recovery of an acquisition adjustment associated with MAWC's acquisition of Missouri Cities Water Company (MCWC). MAWC did not request upfront recovery of the acquisition adjustment in its preceding purchase and merger cases pertaining to the MCWC acquisition, nor did MAWC they ask the Commission to set the ground rules or make any upfront commitments regarding the method of recovery of the acquisition adjustment prior to Case Nos. WR-95-205 and SR-95-206. (Neither did MAWC make any such ratemaking requests in its recent purchase application before the Commission regarding United Water Missouri in Case No. WM-2000-222.) In the instant case, UtiliCorp is not seeking to follow past precedent, it is instead seeking to go well beyond, in a radical and unjustified way, what the Missouri Commission has previously indicated.

On its face, UtiliCorp's request that the Commission merely commit to recovery of the acquisition adjustment if UtiliCorp can "prove" the existence of merger savings may not seem to be unreasonable. The Staff would disagree that direct recovery of the acquisition adjustment is warranted even if merger savings could be satisfactorily proven. (Oligschlaeger Rebuttal, Ex. 713, p. 20). However, in actuality the Joint Applicants are seeking far more from the Commission in this merger case than a simple commitment to consider future direct recovery of an acquisition adjustment. SJLP – UtiliCorp are asking that the Commission fix, upfront, the SJLP capital structure to be used in future SJLP rate proceedings for a period of ten years. SJLP – UtiliCorp are asking that the Commission fix, upfront, the treatment of UtiliCorp corporate allocations in MPS rate proceedings for a period of ten years. SJLP – UtiliCorp are asking that the Commission agree, upfront, that recovery of and on 50% of the unamortized acquisition adjustment is an appropriate direct recovery of the acquisition adjustment in future SJLP rate proceedings, in addition to UtiliCorp's indirect recovery of the acquisition adjustment.

To support its request for direct recovery of 50% of the unamortized acquisition adjustment, UtiliCorp has provided absolutely no evidence as to what percentage of the acquisition premium it would be appropriate to allocate to the regulated operations of SJLP and what percentage of the acquisition premium it would be appropriate to allocate to the non-regulated operations of SJLP. UtiliCorp has acknowledged that estimated regulated operations synergies (cost savings) are not sufficient to allow UtiliCorp to recover the acquisition adjustment in entirety over the ten-year period covered by the proposed regulatory plan. (Tr. 445-46). Some level of non-regulated benefits must be assumed by UtiliCorp to justify the acquisition premium paid for the merger. (Tr. 591-92). Nonetheless, UtiliCorp has failed to present any evidence at all of what it estimates potential non-regulated synergies from this merger to be, including benefits associated with a possible sale of SJLP's generating assets in the future. Notwithstanding this failure, UtiliCorp seeks that this Commission pre-approve direct recovery of 50% of the unamortized SJLP premium of $92 million now, and far more than 50% of the unamortized acquisition premium when the indirect recovery mechanisms of the frozen capital structure and the frozen corporate allocator are taken into account. (Tr. 432). If for no other reason, the Commission, at a minimum, should reserve any determination regarding the treatment of merger costs to future rate proceedings because there is no evidence in this proceeding as to what an appropriate allocation of the acquisition adjustment to SJLP – UtiliCorp non-regulated operations should be.

Addressing this point in his surrebuttal testimony, UtiliCorp witness John McKinney stated the following:

> Q. At page 14 of his rebuttal testimony, Mr. Oligschlaeger says that UtiliCorp and SJLP have presented no evidence concerning an appropriate assignment of the acquisition adjustment to non-regulated operations. He also questions why more than 50% of the premium should not be assigned to non-regulated operations. How do you respond?
>
> A. These claims are really not relevant to this proceeding. I say this because the standard is "no public detriment." So long as SJLP's customers experience the status

> quo or better in terms of service and rates, the fact that any or all of the acquisition premium might be recovered by UtiliCorp through rates should not really matter.

(McKinney Surrebuttal, Ex. 5, pp. 7-8).

Never mind the breathtaking, but implicit assertion by Mr. McKinney that it does not matter if captive regulated SJLP customers pay in rates a portion of an acquisition premium based on UtiliCorp's expectation of non-regulated benefits, if customers' rates do not increase. As long as UtiliCorp is seeking authorization to include 50% of the unamortized acquisition adjustment directly in rates in the next SJLP rate proceeding, and this is what SJLP – UtiliCorp is seeking to do, it is indeed highly relevant what are the future expected benefits to UtiliCorp on the non-regulated side of the proposed transactions.

B. SJLP Rate Cases in 2002 and 2004

In its initial brief at page 14, SJLP alleges as a major merger benefit to SJLP customers its contention that as a result of the Commission's adoption of the SJLP – UtiliCorp proposed regulatory plan, it will be able to avoid two planned rate cases during the proposed five-year rate moratorium period for SJLP. The two avoided rate cases are both alleged to be in the amount of $2 million and are applicable to the years 2002 and 2004.

The Staff disagrees that SJLP's current assumptions about future rate relief in the next five years present meaningful evidence of possible merger/regulatory plan benefit to customers. This is because of the sheer speculation engaged in by SJLP in trying to guess what future cost levels a stand-alone SJLP would incur two to four years out (Tr. 714), as well SJLP's use of inappropriate and excessive financial targets to drive the alleged need for future rate relief.

An example of unreasonable assumptions driving SJLP's perceived need for future rate relief is in return on equity (ROE). SJLP's purported revenue requirement deficiency is premised upon a target ROE assumption used by SJLP (Pullen Surrebuttal, Ex. 24, p. 3; HC Vol. 5, Tr. 503-04). SJLP's assumed target ROE is higher than the ROE recommended by Staff witness Broadwater in this case, based upon current financial conditions. If the Commission were to assume that Mr. Broadwater's ROE findings should be substituted for SJLP's target ROE, most of SJLP's alleged revenue deficiency amounts would disappear, and with it the need for future rate increases by SJLP. To demonstrate this point, the Staff prepared HC Exhibit 28. SJLP offered and moved into evidence at the hearing HC Exhibit 28. Staff witness Traxler explained at the hearing that HC Exhibit 28 shows that SJLP's purported revenue deficiencies of $2 million in 2002 and 2004 would be reduced by $645,519 if the Staff's recommended high-end ROE were used in place of SJLP's target ROE, and that SJLP's purported revenue deficiencies of $2 million in 2002 and 2004 would be reduced by $1,445,962 if the Staff's recommended mid-range ROE were used in place of SJLP's target ROE. (Tr. 1015).

The SJLP initial brief at pages 15-16 references some concerns with the Staff's recommended ROE numbers in this case, but does not explain therein to what the concerns relate. Regardless, the Staff supports the ROE findings contained in Mr. Broadwater's testimony, and believes that they provide the most appropriate ROE assumption if the Commission is inclined to inquire into SJLP's alleged need for future rate relief. The Staff's explanations of why SJLP's criticisms of the Staff's ROE findings are incorrect follow below in this section of the Staff's reply brief.

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SJLP's claims that it will be able to avoid future rate increases if the merger is approved are ironic, in one sense. The Staff has submitted evidence that UtiliCorp's current Missouri electric rates for its MPS division are considerably higher than the current electric rates of SJLP (Williams Rebuttal, Ex. 719, pp. 6-12). For this reason, the Staff fears that one consequence of the merger may be a long-term trend in which SJLP rates gradually increase to MPS rate levels. One reason for this fear is the much greater amount of corporate overhead costs currently incurred by UtiliCorp compared to a stand-alone SJLP. A portion of the UtiliCorp corporate overhead costs would be allocated to SJLP after the merger is completed. (*Id.* at 12-13). Schedule VJS-1, attached to the direct testimony of UtiliCorp witness Vern J. Siemek (Ex. 7), clearly shows that UtiliCorp acknowledges that the SJLP division of UtiliCorp will experience substantial increased costs in the area of corporate overheads as a result of the merger.

The Staff also is compelled to correct some misinformation contained within SJLP's initial brief on several points. First, the SJLP initial brief states at page 14 that SJLP "had been granted rate increases in 1994 and 1995." SJLP was not granted a rate increase as a result of a filed rate case in 1995; instead, in the context of a revenue-neutral rate design proceeding, SJLP's electric rates were increased, while SJLP's natural gas and industrial steam rates were decreased. (Tr. 495). Second, SJLP's initial brief at page 16 claims that "Staff's revised Accounting Schedule 1-1 shows that SJLP is entitled to rate increases designed to collect revenue of $233,686 at a rate of return of 9.43%." This statement is misleading. Exhibit 730, from which the referenced Accounting Schedule 1-1 was taken, shows that at the Staff's recommended mid-range ROE of 9.89% (Staff's recommended mid-range Rate of Return is 9.09%), SJLP's rates are excessive in the amount of, approximately, $566,000; i.e., based upon this cost of service analysis, SJLP's rates need to be reduced. Absent unusual circumstances, the Staff normally recommends that its mid-range ROE be used for ratemaking purposes.

The rebuttal testimony of Staff witness Phillip K. Williams, Ex. 719 at page 4, shows that SJLP's rates have decreased more than they have increased since the 1980s. SJLP's efforts to show that rate increases are imminent in the near future on a stand-alone basis is based upon use of forecasts for which the underlying assumptions cannot withstand reasonable scrutiny. For this reason, the Commission should not accept SJLP's abject speculation regarding future rate cases and should reject the promised avoidance of these bogus rate cases as a tangible benefit to customers if the merger is approved as filed by the Joint Applicants.

SJLP argues, at pages 15-16 of its initial brief, that after properly "correcting Staff's cost of capital," the record reveals that SJLP would require a rate increase of $250,000 to $1,850,000 for its electric operations, a rate increase of ($23,000) to $27,000 for its gas operations, and a rate increase of $57,000 to $105,000 for its steam operations. These "corrections" result from changing the rate of return from a range of 8.62% to 9.29%, as recommended by the Staff, to a range of 9.42% to 10.10%, as recommended by SJLP witness Stoll. This "correction" to the rate of return range results, in turn, from changes to the return on equity and to SJLP's capital structure. These "corrections" are shown on Schedule LJS-7, which was attached to the surrebuttal testimony of SJLP witness Stoll. (Ex. 21).

Staff witness Broadwater recommended a return on equity in the range of 9.27% to 10.51%, whereas SJLP witness Stoll recommended a return on equity in the range of 10.39% to 11.63%. (Stoll Surrebuttal, Ex.21, Sch. LJS-7). The difference in these two recommendations for return on equity accounts for virtually all of Mr. Stoll's "corrections." It therefore follows that if Mr. Broadwater's recommended return on equity is appropriate, and Mr. Stoll's recommended return on equity is not appropriate, the "corrections" are not necessary.

The critical question therefore becomes: Should the return on equity range be 9.27% to 10.51%, as Staff witness Broadwater recommends, or 10.39% to 11.63%, as SJLP witness Stoll recommends?

Mr. Stoll recommended increasing Staff's entire return on equity range by 1.12%. This resulted from two adjustments that he wanted to make. They were: (1) an increase of 12 basis points, which became necessary, he said, because the Staff should not have used SJLP's March 1999 stock prices, because the price of SJLP's stock had increased, due to the proposed merger with UtiliCorp; and (2) an increase of 100 basis points, which became necessary because the discounted cash flow ("DCF") for companies that are comparable to SJLP had increased by 100 basis points between 1999 and 2000.

Neither of these adjustments should be made to the ROE, for the reasons that are discussed below.

The Staff's determination of a proper ROE is described in Mr. Broadwater's Rebuttal Testimony, at pages 17-24. The basic approach was to use the ROE that was developed in SJLP's last rate case (ER-99-274) as the starting point for a return on equity range, and to then compare this range with the range that is determined by applying the DCF method and the capital asset pricing method (CAPM) to a group of companies that is comparable to SJLP. (Broadwater Rebuttal, Ex. 703, p. 19, lines 16-22).

The 12 basis point adjustment resulting from adjustment of dividend yields.

SJLP witness Stoll testified that the Staff's calculation of the ROE using the DCF in Case No. ER-99-274 was flawed, because it used stock price data from March 1999, which was affected by the announcement of the proposed merger. He said the Staff's calculation of SJLP's dividend yield, and the ROE as calculated by the DCF method, was therefore 12 basis points too low. The Staff concedes this point, and agrees that the ROE range as calculated by the DCF method in Case No. ER-99-274 was 12 basis points too low.

However, Mr. Stoll then goes on to conclude that the ROE that the Staff recommended in that case was also 12 basis points too low. The Staff disagrees with that conclusion, because Staff did not base its ROE recommendation in Case No. ER-99-274 solely on the DCF method. In fact, the DCF model produced an ROE of 9.04% to 10.28% in Case No. ER-99-274. If 12 basis points are added to the ROEs, the recommended ROE would be in the range of 9.16% to 10.40%.

The range that the Staff is recommending in the present case is 9.27% to 10.51%, which is higher than the DCF method produced in the prior case, even after making the 12 basis point adjustment that Mr. Stoll recommended. Mr. Stoll's error lies in assuming that the Staff's ROE recommendation should increase by 12 basis points, simply because the ROE calculated by the DCF method should increase by 12 basis points, even though the Staff did not rely solely on the DCF method in making it ROE recommendation in Case No. ER-99-274.

The 100 basis point adjustment related to an increase in ROE using DCF method.

Mr. Stoll also recommends a second adjustment to the Staff's recommended ROE. He claims a 100 basis point adjustment is needed because the average ROE calculated for a group of comparable companies in 2000 was 10.41%, whereas the average ROE calculated for a different group of comparable companies in 1999 was only 9.41%. The error in this analysis by Mr. Stoll is that it relies entirely upon the DCF method of determining an appropriate return on equity, and gives no consideration, whatsoever, to the CAPM method, which Mr. Broadwater also used.

As stated above, Staff witness Broadwater used the ROE from SJLP's last rate case (9.27% to 10.51%) as a starting point, and then used two separate checks on the reasonableness of this number. He determined the average ROE (in 2000) for five comparable companies, using the DCF method. The result was 10.41%, which supports the high end of Mr. Broadwater's recommended ROE range. He also determined the average ROE (in 2000) for five comparable companies using the CAPM method. The result was 9.39%, which supports the low end of his recommended ROE range.

Thus, both the DCF method and the CAPM method support Mr. Broadwater's ROE recommendation. SJLP chose to rely solely upon the DCF data, ignoring the CAPM method entirely. The Staff's analysis is more detailed, it is reasonable, and it should be followed.

Because it is not necessary to adjust the Staff's recommended ROE range, there is no need to "correct" the Staff's calculation of the cost of capital. Consequently, it is not correct to conclude that SJLP would require increases in its electric, gas and steam rates in 2002 and 2004.

IV. MERGER COSTS/BENEFITS

On page 6 of its initial brief, UtiliCorp states that "the Staff's argument that the costs of the transaction exceed the benefits, and thus, approval of the merger will necessarily result in higher rates for customers of the SJLP unit, was in essence abandoned by the candid admission of the Staff's own witness, Mark Oligschlaeger, who testified that if the merger were approved [sic] any effort to show that SJLP rates would have been lower if the merger had not occurred would involve 'an exercise in speculation.' (Tr. 594)." UtiliCorp is mischaracterizing the Staff's position on this point.

Consistent with the Staff's position on tracking, it is the Staff's position that the Commission in any future SJLP rate proceeding will not be presented with clear-cut, indisputable evidence that merger savings have exceeded merger costs. This will be because of the inherent difficulty in identifying and quantifying in those future cases savings specifically attributable to the merger. However, because this will also be the case relative to measuring merger costs for comparison to merger savings, the Staff strongly disagrees that this means that any allegation that merger costs will exceed merger savings is irrelevant or has been abandoned by the Staff in this proceeding. Rather, the fact that the Commission will not have clear-cut, indisputable evidence presented to it at the time of a later rate proceeding makes it vital that the Commission examine and seriously consider the evidence on this point now. It is for this reason that if the

Commission believes that the Staff's evidence is persuasive that reasonably estimated merger costs will exceed reasonably estimated merger savings, the Commission should deny the Joint Applicants' request for merger approval. (Tr. 716-17).

If merging utilities cannot demonstrate a reasonable expectation that savings caused by the merger will exceed merger costs, then such a transaction should be denied approval because of the ultimate, very high likelihood of a detrimental rate impact on customers. (Oligschlaeger Rebuttal, Ex. 713, pp. 40-41). That fact that the means do not now exist to make an accurate comparison of merger costs to merger savings for future rate cases means that the Commission should not take the heavy risk that in some way in the intervening five (5) years developments will occur that will permit the Staff and UtiliCorp to solve the tracking problems. Since the KPL-KGE merger case in 1990-1991, the tracking problem has not been solved. Therefore, it is not reasonable to assume that the tracking problem will be solved during the course of the SJLP moratorium. If the merger is approved by the Commission, the risk of increased rates will be placed squarely on the customers' shoulders, with no reliable means of protecting customers in future rate proceedings by accurately tracking the relationship of merger savings to merger costs.

V. ACQUISITION ADJUSTMENTS / ACQUISITION PREMIUMS

A. SJLP – UtiliCorp Proposal

On pages 26-27 of its initial brief, UtiliCorp claims that its investment in purchasing SJLP should be looked at in the same light as other utility expenditures and "include those expenditures which are alleged to bring about cost efficiencies in cost of service for ratemaking purposes." Of course, this assumes that the main purpose motivating UtiliCorp in its acquisition of SJLP was the creation of regulated operations savings that could be used to benefit customers.

As discussed in the rebuttal testimony of Staff witness Cary G. Featherstone, the Staff does not believe that customer interests drove this merger transaction in any material way for UtiliCorp and SJLP. (Featherstone Rebuttal, Ex. 704, pp. 12-14). Furthermore, the Commission must take into account the consideration that potential non-regulated benefits related to this merger were significant to UtiliCorp's perception of the desirability of entering into this merger. (Tr. 591-92). The analysis suggested by UtiliCorp in its initial brief to justify recovery of the premium (i.e., comparison of merger savings to the costs asserted to be necessary to create the savings, including the acquisition adjustment) misses the basis of the need for regulatory oversight. If an appropriate portion of the acquisition adjustment is not allocated to non-regulated operations, UtiliCorp customers will cross-subsidize in rates the non-regulated ventures of UtiliCorp.

At page 30 of its initial brief, UtiliCorp cites two past merger cases, Case No. EM-96-149, Union Electric Company (UE) and CIPSCO, Inc., and Case No EM-97-515, Western Resources, Inc. (Western Resources) and Kansas City Power and Light Company (KCPL), as implicit support for adoption of its proposed regulatory plan. Neither case provides Commission precedent for UtiliCorp's radical requests of the Commission in this merger proceeding.

Respecting Case No. EM-96-149, UtiliCorp states that "an earnings sharing grid was approved with target returns set high enough to allow for full or partial recovery of the premium or acquisition adjustment." (UtiliCorp Initial Brief, p. 30). The "target return" referred to was actually set by the Commission in Case No. ER-95-411 in July 1995, a full month before UE even announced the proposed merger with CIPSCO, Inc. In its Report And Order in the merger docket, Case No. EM-96-149, the Commission did approve a settlement calling for a second three-year earnings sharing plan for UE using a similar "target return" to that set in Case No. ER-95-411. There is no reference whatsoever in either the Stipulation And Agreement or the Report

And Order in Case No. EM-96-149, directly or indirectly, tying the second "target return" mechanism to allowing a direct or indirect recovery of the merger premium for that transaction.

For Case No. EM-97-515, UtiliCorp states that "a rate freeze was established for a period of time that allowed for a full or partial recovery of the acquisition adjustment" (UtiliCorp Initial Brief, p. 30). The Stipulation And Agreement in Case No. EM-97-515 did call for a rate moratorium of approximately three-years duration following the merger closing, an approach the Staff had indicated it finds is acceptable under some circumstances as a means to allow merging utilities to retain the benefit of merger savings for some period. (Oligschlaeger Rebuttal, Ex. 713, p. 51; Tr. 609). In addition, the Western Resources – KCPL settlement called for below-the-line treatment of the acquisition adjustment resulting from that transaction. Under cross-examination, Mr. McKinney stated explicitly that the Western Resources - KCPL moratorium approach would not be acceptable to UtiliCorp if applied to the UCU – SJLP transaction (Tr. 655).

At pages 18 and 28 of its initial brief, UtiliCorp claims that it needs a Commission determination in this proceeding that the full amount of the acquisition adjustment of approximately $92 million will be the basis for future decisions concerning recovery of the acquisition premium. If the Commission reserves all ratemaking decisions regarding this merger to subsequent rate proceedings, then all questions regarding rate treatment of the acquisition adjustment should be reserved for those proceedings, including the appropriate quantification of the acquisition adjustment for rate purposes. Various Staff witnesses filed testimony on different aspects of the acquisition adjustment and raised and addressed questions concerning whether rate recovery should be given to all (or 50% of the unamortized amount) of the acquisition premium, if the Commission were to decide that any rate recovery is warranted. For example, Staff witness David P. Broadwater quantified the impact of the additional $.50 incremental bid per share for SJLP stock, which was allegedly necessary to obtain agreement on the merger and which is not tied to any customer benefit or perception of customer benefit. The $.50 per share increase in the price per share of SJLP stock (from $22.50 per share to $23.00 per share), which was paid by UtiliCorp at SJLP's suggestion, increased the acquisition premium by approximately $4.1 million. (Broadwater Rebuttal, Ex. 703, pp. 45-48). Staff witness Michael S. Proctor separated the acquisition adjustment into components (one part measured by the difference between the net book value of SJLP assets and the pre-merger value of SJLP stock, and a second part measured by the difference between the pre-merger value of SJLP stock and UtiliCorp's offer price for the stock), and identified why neither component should receive rate recovery. (Proctor Rebuttal, Ex. 714, pp. 7-12).

For these reasons, if the Commission rejects the Staff's recommendation that any approval of the merger be conditioned on below-the-line treatment of the acquisition adjustment, the Commission should not make any findings concerning future recovery of the acquisition adjustment that would impair parties' ability to argue that all or some of the acquisition adjustment should be excluded from rates in future rate proceedings.

On page 29 of its initial brief, UtiliCorp states that a Commission decision to exclude the acquisition premium from rate recovery would "likely discourage beneficial mergers from occurring." The Staff disagrees with this unsupported assertion. The record in this case is uncontroverted that the Commission has never allowed direct recovery of an acquisition adjustment in past cases. (Featherstone Rebuttal, Ex. 704, p. 47). Notwithstanding this fact, there has not been a dearth of proposed merger and acquisition transactions in this state in the last several years. Most all of these transactions have closed, even with the involved utilities agreeing to forego direct recovery of acquisition adjustments, presumably because the companies believed the economics of the transactions were still favorable overall to the combined utility (Featherstone Rebuttal, Ex. 704, pp. 46-54).

The Staff would remind the Commission that its decision on the acquisition adjustment issue in this proceeding will have ramifications on other positions that the Commission has taken on other issues. One such issue is the rate treatment of "gains on sales" when a utility sells and disposes of assets previously used in the provision of service. The Commission has traditionally held that gains on sales (the excess of the sale proceeds over the net book value of the assets sold) should be kept by utility shareholders, and not used to reduce revenue requirement for ratepayers. (Hyneman Rebuttal, Ex. 707, p. 45). The connection of this issue to this case is that gains on sales are the "flip-side" of acquisition adjustments, i.e., SJLP's gain on sale equals UtiliCorp's acquisition adjustment. If the Commission adopts the Joint Applicants' position on acquisition adjustments, then SJLP's shareholders will receive the benefit of the gain on sale of the SJLP assets, while SJLP's – UtiliCorp's customers get charged for the monies paid by UtiliCorp to enrich SJLP's shareholders through the acquisition premium. (*Id.* at pp.47-48). This would be a "lose / lose" situation for ratepayers.

The Commission should maintain a neutral stance towards merger and acquisition transactions, and not open itself up to the strategy of trying to "incent" mergers through the granting of rate treatment that "incents" mergers and acquisitions. (Oligschlaeger Rebuttal, Ex. 13, pp. 49-50). The "incenting" of mergers will only serve to encourage utilities to engage in mergers and acquisitions less economic than previously under the Commission's merger and acquisition actions.

On page 31 of its initial brief, UtiliCorp states: "A large number of states have permitted rate recovery of a portion or all of the cost of acquisitions." The support for this assertion is Figure 2, the chart of the National Association of Water Companies, which appears in the direct testimony of UtiliCorp witness John W. McKinney. The information in Figure 2 pertains only to water utilities, and water utilities are in a significantly different economic situation than electric utilities respecting the issue of the recovery of acquisition adjustments. (Fischer Rebuttal, Ex. 705, pp. 59-62). The Staff's research regarding other jurisdictions' treatment of acquisition adjustments indicates that many utilities do not seek direct recovery of acquisition premiums at all, and that those utilities that do seek rate recovery of acquisition premiums, they do not necessarily seek such rate recovery or are authorized such rate recovery concurrently in the merger and acquisition proceeding in which approval of the merger or acquisition is being sought and is authorized.

B. Purchase vs. Pooling Accounting

On page 8 of its Initial Brief, UtiliCorp explains that the regulatory plan is necessary to allow its shareholders to recover the estimated $92 million acquisition premium. UtiliCorp states that "[w]ere it not for the agreement to pay the acquisition premium, the merger agreement would not have been agreed to and the transaction would not take place." (UtiliCorp Initial Brief, p. 8). These comments do not address that UtiliCorp would not have had to reflect the acquisition adjustment on its books but for conscious choices it made to reflect the UCU/SJLP transaction as a "purchase" transaction. If UtiliCorp had taken reasonable actions to retain the pooling of interests method of accounting for the merger, there would be no need for the regulatory plan because an acquisition adjustment would not exist. UtiliCorp recognized this fact in its proposed merger with Kansas City Power & Light Company in 1996. (Hyneman Rebuttal, Ex. 707, p. 11). SJLP (and MPS) customers should not suffer the detriment of rate recovery of the acquisition adjustment due to UtiliCorp's particular decisions on accounting for the merger transaction.

The proposed SJLP – UtiliCorp merger was originally intended to be accounted for as a pooling of interests. Section 3.21, Pooling of Interests, of the Agreement And Plan Of Merger dated March 4, 1999 between UtiliCorp and SJLP states, in part, as follows:

> Neither the Company nor any of its Subsidiaries has taken any action or failed to take any action which action or failure would jeopardize the treatment of the Merger as a pooling of interests for financial accounting purposes. . . .

(Hyneman Rebuttal, Ex 707, p. 18).

There are certain conditions that must be met before a merger can be recorded as a pooling of interests. Subsequent to the announcement of the proposed SJLP merger, UtiliCorp decided that it did not meet one of these conditions - the alteration of equity condition - and changed its proposed method of accounting for the merger to the purchase method of accounting. While an acquisition adjustment or merger premium is not recorded using the pooling of interests accounting method, it is recorded using the purchase method of accounting. (Hyneman Rebuttal, Ex. 707, p. 10).

Companies are required to comply with Accounting Principles Board Opinion No. 16 (APB 16), entitled *Business Combinations*, as promulgated by the Financial Accounting Standards Board (FASB). Alterations of Equity Interests, Paragraph 47(c) of APB 16, prohibits a combining company from altering the equity interests of its shareholders "in contemplation" of effecting the proposed business combination to be accounted for as a pooling of interests. APB – Accounting Interpretations Nos. 19 and 20 of APB 16 indicate a presumption that any alteration of equity interests within two years of initiation of a business combination or between initiation and consummation is "in contemplation" of effecting the business combination, and so would preclude accounting for the proposed business combination as a pooling of interests. (Hyneman Rebuttal, Ex. 707, p. 5). UtiliCorp believes that the timing of its November 1998 issuance of employee stock options is the event which caused UtiliCorp to be non-compliant with the alteration of equity condition and lose the ability to use pooling of interests accounting. (*Id.* at 19-20).

The determination of whether or not a company is in compliance with the pooling of interests conditions is often a highly subjective task. This was explained by UtiliCorp witness Robert C. Kehm in response to a question about preclearing merger accounting issues with the Securities and Exchange Commission (SEC):

> The process for accounting for a transaction is for a company's accountants to go through the process of determining whether or not it meets the criteria of pooling accounting or whether or not it needs to be accounted for as a purchase. After they reach their conclusion, they often will consult with their independent public accountant, such as myself, and discuss the issues. Sometimes the facts are not clear as to whether or not the criteria is met. The company's accountants can conclude one way, and so can the independent public accountants. But there may be a certain amount of doubt involved or there may be some concerns. In those instances there is an informal process to clear those issues with -- to talk to the SEC staff and determine whether or not they're going to object to accounting, either pooling or purchase accounting or perhaps some other accounting issue, and that's the process loosely referred to here as preclearing.

(Tr. 1200-01; Emphasis added).

Mr. Kehm testified that in instances when there is a "certain amount of doubt" about an accounting issue an informal process exists to preclear the issue with the SEC. He also testified that subjective concepts, such as "in contemplation of," generate differences in how companies interpret pooling of interests conditions. (Kehm Surrebuttal, Ex. 26, p. 10).

UtiliCorp, however, decided not to try to preclear with the SEC this potential non-compliance with the alteration of equity pooling condition. Given that a favorable opinion from the SEC would have eliminated an estimated $92 million merger acquisition adjustment in this proposed merger, it is inexplicable that UtiliCorp would not take advantage of such an opportunity. Considering the facts below, there is a reasonable basis to believe that UtiliCorp could have secured a favorable ruling from the SEC:

(1) Mr. Kehm has been successful in preclearing pooling of interest merger issues with the SEC in the past. (Tr. 1201-02).

(2) Two UtiliCorp senior officers stated that the issuance of options in November 1998 was not done in contemplation of the SJLP merger and there was no relationship between this option issuance and the SJLP merger. (Hyneman Rebuttal, Ex. 707, p. 22).

(3) The timing of events shows that it would not have been possible for the 1998 stock option issuance to be in "contemplation of " the SJLP merger. UtiliCorp Chairman and CEO Richard Green decided to issue options under the 1998 Employee Stock Plan in July 1998, while UtiliCorp was not even contacted as a potential bidder for SJLP until November 1998. (Hyneman Rebuttal, Ex. 707, p. 25).

These facts clearly show that there was nothing preventing UtiliCorp from attempting to preclear the alteration of equity interest issue with the SEC. Also, given these facts, it is not unreasonable to conclude that UtiliCorp would have been successful and permitted to account for the SJLP merger as a pooling of interests. However, even if UtiliCorp was not successful in preclearing the alteration of equity issue with the SEC, it still had another option it could have taken for using pooling of interests accounting and avoid recognition of a $92 million acquisition adjustment.

If UtiliCorp received an unfavorable decision from the SEC on the alteration of equity issue, it could have rescinded the November 1998 stock option issuance and eliminated the issue altogether. According to a book published by the public accounting firm of Arthur Andersen entitled, *Accounting for Business Combination, Interpretations of APB Opinion No. 16, Business Combinations* once the issuance of stock options is determined to be a change in equity interests in contemplation of business combination, the change can only be "cured" by canceling or rescinding the options so long as no option holder has exercised any of the options issued. (Hyneman Rebuttal, Ex. 707, p. 25). Mr. Kehm testified that it was his belief that no stock options had yet been exercised and that UtiliCorp could have rescinded the November 1998 stock options. (Tr. 1208).

With these choices available to UtiliCorp, and the beneficial aspects of pooling accounting to shareholders and customers, why did UtiliCorp make no effort to retain the pooling of interests accounting method? APB 16 paragraph 48c precludes a company using the pooling of interests accounting method from disposing of a significant part of the assets of the combining companies within two years after the combination, other than disposals in the ordinary course of business. Under this condition, if the SJLP acquisition were completed in December 2000, UtiliCorp would not be allowed to sell a significant part of the assets of the combining companies until December 2002. The APB 16 two-year ban on the sale of a significant part of the assets of the combining companies (as well as other restrictions) could have had an effect on UtiliCorp's decision not to take its case before the SEC to retain pooling of interests accounting. (Hyneman, Ex. 707, p. 28)

C. Lake Road Fire And Outage

In the SJLP initial brief at pages 16-18, SJLP describes the situation involving the recent turbine failure and fire at SJLP's Lake Road power plant Turbine 4 and Boiler 6. The costs SJLP asserts are incremental to this incident have been the subject of an accounting authority order (AAO) application, in which SJLP is seeking permission to defer the costs so that the costs can be addressed in a future rate proceeding. This request is currently docketed as Case No. EO-2000-845.

In its initial brief at page 17, SJLP references an "agreement" with UtiliCorp that if the Commission approves the SJLP – UtiliCorp merger and the proposed regulatory plan, that any Lake Road incident costs deferred pursuant to a Commission order in the AAO case will be written off. The SJLP initial brief states at page 17 that "[t]he write-off would reduce the book value of SJLP, and, at the time of closing for the merger, would be considered in the determination of the premium. (Tr. 145)."

The relationship of the acquisition adjustment to both the booking of any deferral, and any subsequent write-off of the deferred amounts, may not be entirely clear from the rather terse explanation in SJLP's initial brief. Allowing a utility to defer costs pursuant to an AAO issued by the Commission creates a "deferred asset" on the company's books, in the amount of the deferral. Because the acquisition adjustment is measured in this case as the difference between the net book value of SJLP's assets and the purchase price of those assets, the deferral would increase the net book value of the assets on SJLP's books at the time of the closing of the merger, and accordingly, the acquisition premium amount would be reduced by the amount of the deferral. If later the deferred amount is written off, the deferred asset will be removed from SJLP's books, the net book value of SJLP's assets will be decreased by the amount of the write-off, and the acquisition adjustment will increase by the amount of the write-off. If the entire deferred amount is written off, the amount of the acquisition adjustment in effect will be re-instated to the original amount that would have been the case absent the deferral, all other things being equal. (Tr. 889-90).

As the Commission is aware, UtiliCorp is seeking direct recovery of 50% of the unamortized amount of the acquisition adjustment as part of its proposed regulatory plan in Years 6-10 following the closing of the merger. If the Commission determines that the Lake Road incident costs should be deferred, and these costs are subsequently written off by the Joint Applicants, then the regulatory plan would provide for a least a partial recovery of the written off costs from ratepayers through rate treatment of the acquisition adjustment. The Commission should not assume that a write-off of deferred Lake Road incident costs will not result in UtiliCorp customers paying any of the incremental costs of the Lake Road incident under the proposed SJLP – UtiliCorp regulatory plan.

VI. CORPORATE ALLOCATIONS

This section deals with the projected level of UCU's corporate overhead costs subject to allocation to all of UCU's divisions, including SJLP, in the event of a merger. In particular, the Staff raised the issue of the inflation factor used by the Joint Applicants in projecting UCU's total corporate overhead allocations during the 10-year period. In its Initial Brief, UCU mounts only a token defense of its use of a 2.5% inflation factor, alleging that 2.5% is reasonable and that, in any event, the inflation rate is "largely irrelevant" because in the SJLP division's post-moratorium rate case, the actual inflation rate will be used. (UCU Brief at 47).

The Staff certainly does not consider the issue of an appropriate inflation factor to be "largely irrelevant". Why should it be any less relevant than the numbers that are being inflated? Indeed, why did the Joint Applicants submit <u>any</u> of their projections of the costs and benefits associated with the subject merger?

The answer to all of these questions is that the Commission must consider now, and not five years from now, the "not detrimental to the public interest" standard on which its ruling on the proposed merger is based. That ruling can only be made on the basis of projected costs and savings. The Commission, if it is to approve the subject transaction, must satisfy itself now that the Joint Applicants have met the legal standard and that savings will, at a minimum, be sufficient to cover merger costs. That, of course, is the reason that the Staff and the other parties have spent countless hours poring over all of the Joint Applicatants' projections, which include the inflation rate applied to UCU's corporate overhead allocations.

Staff recommends a 5% inflation rate, which is twice as large as that used by the Joint Applicants. (Traxler Rebuttal, Ex. 718, p. 30, lines 4-5). The impact of the inflation rate differential is significant. By using Staff's recommended 5% inflation rate for corporate overhead allocations to SJLP, the Joint Applicants' projected total net merger savings in years 6 through 10 is reduced by approximately $18 million. (Revised Sch. SMT-3A, Ex. 729, line 15, Col. B less Col. F). As noted in Staff's Initial Brief, this represents more than 40% of the difference ($42.5 million) between the Staff's projections in years 6 through 10 (prior to any recognition of the acquisition premium) and those of the Joint Applicants. (Staff Brief at 127).

Staff is not surprised that UCU seeks to dismiss the inflation rate issue as "largely irrelevant." UCU offered no evidence to support its use of an indicator relating to the prices consumers can expect to pay for goods and services (Consumer Price Index) as a basis for projecting the growth in UCU's corporate overhead allocations to an operating division. Moreover, the Commission has in the past rejected the use of a national indicator in estimating various categories of utility costs, including corporate allocations, in favor of techniques that involve known and measurable and company-specific data. (*In the Matter of Proposals to*

Establish an Alternate Regulation Plan for Southwestern Bell Telephone Company 2 Mo. P.S.C. 3d 479, 491 (1993).

Nor did UCU offer any evidence to support its assertion that, because of the presence it of re-engineering costs in the historical UCU corporate allocations to MPS, it was inappropriate for Staff to consider these allocations in developing Staff's 5% inflation rate recommendation. Indeed, UCU's failure to make the effort show the effect of the alleged distortion invites the conclusion that the impact is not terribly significant. In addition, UCU's concern about alleged distortion was limited to the years 1998 and 1999. No similar assertion was made regarding the years 1996 and 1997. (Siemek Surrebuttal, Ex. 8, p. 5, lines 17-19).

Staff witness Traxler's Revised Schedule SMT-5 (Ex. 725, lines 12-14) shows average annual increases in UCU's corporate overhead costs to MPS since 1995, for various multi-year time frames, as follows:

4-year average increase (1996-1999): 45.7%

3-year average increase (1997-1999): 20.0%

2-year average increase (1998-1999): 6.2%.

Thus, regardless of whether one looks at a two-, a three-, or a four-year average, actual historical experience clearly suggests that a corporate allocations growth rate far in excess of UCU's proposed 2.5% rate is warranted. Accordingly, Mr. Traxler's selection of a 5% estimated inflation rate for corporate allocations is eminently reasonable. Therefore, the Commission, in deciding whether the projected costs and savings meet the "not detrimental to the public interest" standard, should rely on Mr. Traxler's projected costs for UCU's corporate cost allocations, which are based on a 5% inflation rate.

VII. "FROZEN" MPS ALLOCATION FACTOR

This section addresses the negative impacts of the Joint Applicants' proposed regulatory plan in regard to the rate treatment of allocations of corporate overhead costs to MPS, with resultant detrimental impacts on the MPS ratepayers. The Staff asserts that the Joint Applicants' regulatory plan, if approved, will negatively affect corporate overhead costs allocated to MPS, to the detriment of MPS's ratepayers, in the following respects:

1. By artificially "freezing" MPS's corporate allocation factor to exclude the impact of the SJLP acquisition, the Joint Applicants would be denying MPS and its ratepayers the normal and natural effect of the transaction, which, by the Joint Applicants' own admission, is a reduction in UCU corporate allocations to MPS. (Tr. 844, lines 16-18; 977, lines 6-9). At the same time, costs allocated to MPS, "for financial reporting purposes will reflect a lower allocation of UCU's corporate costs." (Tr. 402, lines 6-8). Staff calculates that the detrimental effect on MPS ratepayers of collecting in rates amounts in excess of MPS's actual costs will amount to an average of almost $3.5 million per year. (Traxler Replacement Pages, Ex. 721, Sch. SMT-8, line 17).

Even assuming adoption of the "frozen" allocator method, corporate overhead charges to MPS would actually <u>increase</u> under the regulatory plan, since the amount of the UCU overhead costs to be distributed will increase as a result of the UCU/SJLP merger. When an MPS allocation factor undiminished by the addition of the SJLP division to the corporate fold is applied to an increased dollar "pool," MPS and its ratepayers will automatically have to bear higher corporate overhead costs than they would in the absence of the subject merger. As a result, the MPS ratepayers can expect to be detrimentally affected to the tune of about $1 million annually from this aspect of the regulatory plan. (Tr. 403, lines 4-8).

With respect to the first effect noted above, UCU argues in its Initial Brief that the post-merger MPS allocation factor should be calculated assuming the non-existence of the then-new SJLP division, thereby preventing MPS from enjoying a normally expected reduction in allocated overhead, "because the MPS customers are not being asked to bear any of the costs, including premium costs, related to the merger. Therefore, in future rate cases, the allocation factors should not be impacted by the SJLP unit." (UCU Brief at 48). According to UCU, the regulatory plan provides for both costs and associated savings to flow to the SJLP division. (Id.). UCU states that it would be "unfair" if MPS customers were to gain the benefit of the reduced corporate allocation without also incurring its share of the costs. (Id. at 15). UCU further argues that, "under the well-established 'no detriment' merger standard, there is no requirement that MPS customers realize a benefit in order for the transaction to be approved." (Id. At 49).

In response, the Staff asserts that UCU's corporate overhead allocation contrivance amounts to an attempt to shift merger costs to MPS. The SJLP/UCU merger should be economic on its own, without indirectly requiring MPS ratepayers to pay for the acquisition premium through over-collection in rates of corporate overhead costs. The Staff does not agree that UCU's corporate allocators proposal is necessary to maintain the pre-merger "status quo" for MPS customers; instead, instead, it will lead to MPS customers paying higher rates than if the merger did not take place. (Tr. 884-885). Setting rates for MPS by using a UCU allocator that excludes SJLP results in a UCU overhead cost to MPS that does not exist in reality. UCU has never, in a previous rate case involving MPS, asked the Commission to ignore the impact of another division on its allocated costs to MPS. Presumably, in those prior cases UCU did not regard it as "unfair" to allocate to MPS its actual share of corporate overhead costs, based upon allocation factors that considered all of UCU's other divisions. Furthermore, if MPS were to receive said actual share, contrary to UCU's assertion, MPS would, in fact, also be absorbing its actual share of the costs of the merger, in the form of higher pool costs, right along with the associated savings. These additional pool costs amount to more than $39 million over 10 years. (Revised Sch. SMT-3A, Ex. 729, Col. C [or D], line 12 plus line 13). In addition, authorizing the use of such a methodology would require the Commission to deviate from "cost-based rates" for rate cases involving MPS. As noted above, MPS's rates will be increased by an average of almost $3.5 million annually for non-existent UCU corporate overhead costs to MPS.

UCU's Initial Brief does not address the second effect noted above. The Joint Applicants did, however, offer testimony suggesting that a tracking system would be implemented to ensure that SJLP would not receive a share of any increase in UCU's corporate overhead cost pool resulting from the merger. (Myers Surrebuttal, Ex. 19, p. 6, lines 2-5; Tr. 450, lines 7-8; Tr. 976, lines 18-21). The Staff, however, remains highly skeptical that such a system can ever be successfully developed. Furthermore, the Joint Applicants have presented no concrete proposal regarding how their tracking system will work, so as to ensure that MPS customers will not be detrimentally impacted by the increase in UCU corporate overhead costs resulting from the proposed merger. Accordingly, Staff asserts that MPS ratepayers can expect a detrimental impact amounting to an average of approximately $1 million per year in connection with the allocation of the higher UCU corporate overhead pool costs resulting from the merger even if one assumes that the allocation factor to MPS is frozen with respect to the SJLP addition. The $1 million annual increase in UCU costs allocated to MPS from higher UCU "total pool" costs can only be fairly offset by using the lower allocation factor which results by adding the SJLP division.

In total, under the proposed regulatory plan, customers of MPS will be detrimentally impacted in the amount of almost $4.5 million ($3.5 million plus $1 million) per year. For the reasons stated, the Commission should reject UCU's labored and wholly artificial and unprecedented scheme for allocating its overhead costs to MPS in the wake of the proposed UCU/SJLP merger.

VIII. "FROZEN" CAPITAL STRUCTURE

In its Initial Brief, UtiliCorp stated: "The reason for the proposal is that, absent the merger, the capital structure for SJLP as a continued stand-alone company would not have changed appreciably and as a consequence using this 47% debt 53% equity capital structure will result in no "new" cost for the SJLP customers." (Initial Brief of UtiliCorp, p. 47). This statement is based upon the false premise that UtiliCorp knows how SJLP will finance its operations in the coming years. In fact, UCU does not know, and cannot know that the capital structure for SJLP as a stand-alone company "would not have changed appreciably."

Furthermore, the 47% debt, 53% equity capital structure that UtiliCorp wishes to preserve for the next ten years was not an actual capital structure at any relevant time. It was, rather, the *hypothetical* capital structure that was utilized in SJLP's last rate case (Case No. ER-99-247). SJLP's capital structure has already changed since the last rate case, and will surely change again during the period of time for which UtiliCorp seeks to "freeze" the capital structure.

UtiliCorp is asking the Commission to allow it to use a capital structure that existed in 1999, at the time of the last rate case, but which would already be seven years old, when the "frozen" capital structure first takes effect in 2006, and would be 11 years old before the "frozen" capital structure ends in 2010.

The "frozen" capital structure that UtiliCorp seeks to use would bear little relationship to the reality of how the new SJLP Division would be financed. This new division would not be financed as a separate entity, but as a part of UtiliCorp. It would be UCU, not SJLP, that would have the obligation to repay the loans that are used to finance SJLP's operations, and it would be the shareholders of UtiliCorp, not SJLP's shareholders, that would be providing the equity capital to support the SJLP Division. The Commission should not "freeze" SJLP's capital structure, but should use the capital structure of UtiliCorp.

Even if there would be, as UCU claims, "no new or increased cost" as a result of the implementation of this part of the Regulatory Plan, that does not mean that there would be no detriment to the public interest. The Staff submits that if the financing costs that the ratepayers have to pay are greater than the financing costs that UCU incurs in support of its new St. Joseph Division, there is a detriment to the public.

IX. MERGER SAVINGS

X. JOINT DISPATCH

UtiliCorp addressed the issue of joint dispatch savings at pages 35-39 of its Initial Brief, as Issue No. 10. UtiliCorp's argument there begins with a false and unsubstantiated claim regarding the Staff's assumptions, stating, at page 35, that the Staff "wrongly assumes that there exists a perfect wholesale market and that MPS, SJLP and the merged company will participate in that market on the same basis." This statement is wrong, for several reasons.

> First, the Staff never stated that it assumed a "perfect" wholesale market. Second, UtiliCorp has not defined what it means when it uses the term "a perfect wholesale market." Third, the Staff used the same assumptions regarding the prices and economic opportunity for off-system sales as those used by the Joint Applicants.

The fundamental difference between Staff and the Joint Applicants with regard to the wholesale market for electricity is that the Staff does not agree with the Joint Applicants' assumption that without this merger, the two stand-alone Companies will face the same economic opportunities in the wholesale market as they have experienced historically. Instead, the Staff's position is that the two stand-alone Companies will face the same economic opportunities in the wholesale market as the merged company. Indeed, if this is not the case, then the merger has resulted in increased market power for the merged entity.

While the brief of the Joint Applicants contains much with which the Staff disagrees, it does in fact point out the heart of this issue, which is: *Is the historical performance of SJLP and MPS the proper basis from which to measure changes that are directly attributable to the merger?*

The following are examples of this "historical performance" criteria from the Joint Applicants' brief:

> The actual experience of UtiliCorp and SJLP in the wholesale market since 1996 is a clear indication of the different approaches taken by each on a stand-alone basis. This historical track record should be considered and given great weight. (Initial Brief of UtiliCorp, p. 36).
>
> First, it was assumed that on a stand-alone basis, both entities would continue to generate approximately the same level of normalized wholesale volumes and margins. (Initial Brief of UtiliCorp, p. 36).
>
> MPS's activity, both in terms of volumes and margins, has reached a plateau, in part due to transmission limitations. The operations of the combined company, with its enhanced transmission capabilities, will allow it to expand its efforts in the wholesale market much more efficiently than either of the companies could do separately. (Initial Brief of UtiliCorp, p. 37).

> The increase in market penetration and sales activity are primarily due to the transmission interconnects that the new combined company will have via the interconnections that SJLP has with other utilities in the Mid-Continent Area Power Pool ("MAPP"), and the increase in available capacity for sale into the wholesale market. (Initial Brief of UtiliCorp, pp. 37-38).

The Staff's position on the question of whether historical performance is the proper basis from which to measure changes that are directly attributable to the proposed merger is clear.

First, SJLP's generation position has significantly changed from its historical position. With the addition of base-load generation from the Nebraska Public Power District, SJLP is now in a much better position to take advantage of market sales opportunities in the off-system sales market than it has historically been able to do. (Proctor Rebuttal, Ex. 714, p. 34, line 17 – p. 35, line 2). Thus, the argument that historical performance should be the basis against which to measure the impact of the merger clearly has failed to account for SJLP's changed circumstances. As SJLP has significantly more excess base-load generation to sell in the wholesale market than it has had in the past, it has become more profitable for SJLP to participate in that market.

Second, the Joint Applicants acknowledge that the elimination of "transmission limitations," through SJLP's interconnections into the MAPP region, and the "increased availability of capacity for sale into the wholesale markets" are the only reasons that the Joint Applicants will enhance their market opportunities via the merger. As stated in the previous paragraph, the Staff agrees that SJLP will have increased capacity available to sell into the wholesale markets; however, this is not due to the merger. In addition, with the implementation of FERC Order No. 2000, transmission systems will become subject to Regional Transmission Organizations ("RTOs"), in order to enhance the competitiveness of the wholesale generation market. (Ex. 728, pp. 89-93). A primary enhancement from RTOs is the elimination of "pancaked" transmission rates, which will give generators of electricity open access to larger market areas. (Ex. 727, pp. 62-64). The Joint Applicants have agreed to join an RTO. (Kreul Direct, Ex. __, p. 12, line 20 – p. 13, line 11). Under cross examination, the Joint Applicants' witness on enhanced market opportunities from the merger, Frank DeBacker, was not able to testify on even the basics of the impacts of FERC Order 2000 on the enhancements to competition in wholesale markets. (Vol 7, p. 932, line 13 – p. 933, line 21). Thus, the Commission must determine whether it is the merger or the establishment of RTOs that will, in fact, expand the market opportunities of the Joint Applicants. The Staff's position is that with the elimination of pancaked transmission rates via RTOs, the merger will add little to increase economic opportunities in the wholesale electricity markets.

Third, the Joint Applicants claim that SJLP's historical lack of involvement in competitive wholesale markets can only be changed if there is a change in SJLP's management's "attitude" to be more involved in the wholesale market, and if there is an investment of approximately $1.17 million dollars per year ($3.5 million divided by 3 years). (Initial Brief of UtiliCorp, p. 38). The Staff's contends, however, that if the economic opportunity to make additional profits in the wholesale market (after paying the cost of implementing such activities) *already* exists for SJLP, then SJLP *as a stand-alone company* has the obligation to both its shareholders and its ratepayers to engage in such activities.

In their original filing, the Joint Applicants did not state how much SJLP saves by not engaging in additional wholesale activities. The Staff has therefore not been able to review the claim that this savings amounts to the $1.17 million per year figure that is mentioned above. However, assuming that this figure is correct, additional savings of $11.7 million could be added to the Staff's savings estimate of $6.8 million over a 10-year period. The resulting total savings

($18.5 million over 10 years) is still significantly less than the $104 million in "savings" that the Joint Applicants claim the merger will produce.

XI. ELECTRIC ALLOCATIONS AGREEMENT

XII. SAVINGS TRACKING

A. UtiliCorp's "Burden" on the Tracking Issue

The Staff recommends that the Commission take no steps to set up a savings tracking mechanism for the UtiliCorp - SJLP merger in this application. If the Commission adopts the Staff's recommendation to not approve the merger, or if the Commission adopts the Staff's fallback recommendation to treat the acquisition adjustment below-the-line, then the tracking issue is moot in any event. However, even if the Commission were to decide to reserve all ratemaking decisions regarding the acquisition adjustment and other merger costs and savings to subsequent rate proceedings, the Staff would still recommend that no findings should be made in this application regarding a future tracking method.

UtiliCorp claims that approval of a specific tracking system by the Commission is not critical for approval of the merger in this case (UtiliCorp Initial Brief, pp. 39-40). However, UtiliCorp is clearly seeking piecemeal approval of some aspects of a future savings tracking mechanism by the Commission at this time in the current docket, namely in the area of "benchmarks" (*Id.* at 45). The Staff disagrees with this strategy of attempting to tie down some aspects of a tracking method now while leaving other aspects undefined until a later rate proceeding. In the event the Commission does not decide future rate treatment of the acquisition adjustment in this case, UtiliCorp properly will have the burden of justifying any future rate recovery of this amount that is sought. If UtiliCorp attempts to justify rate recovery of the acquisition adjustment by citing alleged merger savings in a later rate proceeding, that burden should include UtiliCorp putting forth a proposal for identifying and quantifying alleged merger savings, a proposal which would presumably include a comparison of pre-merger and post-merger cost levels for certain expense categories or for the SJLP division in total. It should be UtiliCorp responsibility to justify the existence of purported merger savings in the future, including proposals for appropriate savings benchmarks, if applicable. It is not the job of the Staff, other parties, or ultimately the Commission to help UtiliCorp to carry this future burden by making upfront, piecemeal recommendations or determinations now as to certain aspects of the desired tracking approach.

In any case, UtiliCorp's emphasis on the Commission needing to establish tracking benchmarks upfront is misplaced. Benchmarks will serve only as a starting point for examining the question of whether actual merger savings exist and, if so, how much. (Traxler Rebuttal, Ex. 718, p. 13). They in no way will resolve the questions of how one can distinguish merger and non-merger savings and accurately quantify the savings amounts. Ordering benchmarks in this proceeding will not move the parties or the Commission at all towards establishing a workable savings tracking system. UtiliCorp's position on benchmarks in this case appears to be more related to an interest in setting up a mechanical system for identifying "presumed" merger savings than in dealing with the real conceptual issues of how actual merger savings can be identified in the first place.

B. Benchmarking Agreements

At page 45 of its Initial Brief, UtiliCorp references several agreements it claims to have reached with the Staff regarding "benchmarks" or "baselines" for various categories of costs. These "agreements" need to be placed in the proper context. Because the Staff recommends the Commission not decide savings tracking issues in this docket, the Staff likewise recommends that the Commission not establish benchmarks or baselines in this case. However, in the event that the Commission decides it is appropriate to establish savings tracking benchmarks in this application, the Staff believes use of an actual cost of service calculation for SJLP would be better than relying on the 1999 SJLP budget for that purpose, as the Joint Applicants have proposed. UtiliCorp and SJLP have now agreed with the Staff that use of the adjusted 1999 cost of service calculation for benchmark purposes is appropriate for all items except generation/joint dispatch savings, and benefits savings. The Staff agrees that the approach of comparing stand-alone MPS and SJLP dispatch model results to a combined dispatch model result is appropriate for generation related savings. However, the Staff and UtiliCorp disagree on what inputs should be used for the stand-alone MPS and SJLP dispatch models. (DeBacker Surrebuttal, Ex. 20, p. 3). For benefits savings, though, the Staff advocates use of the 1999 actual SJLP cost of service as a benchmark, instead of actuarial estimations of stand-alone SJLP benefit costs over the ten-year period of the regulatory plan, as recommended by UtiliCorp. (Traxler Rebuttal, Ex. 718, pp. 13-15).

C. UtiliCorp's Current Accounting System

On pages 40-44 of its Initial Brief, UtiliCorp engages in a lengthy discussion of its current accounting system and its alleged ability to track "incremental" costs to UtiliCorp associated with the SJLP transaction. However, all of this discussion is irrelevant to the question of whether UtiliCorp can actually identify and quantify actual merger savings allegedly resulting from the SJLP merger. Even if UtiliCorp's Peoplesoft system does have all of these characteristics, the UtiliCorp brief nowhere asserts that the accounting system has the capability of (1) ascertaining what SJLP's actual cost of service would have been on a stand-alone basis during the course of the regulatory plan; or (2) determining what impact the SJLP merger had on the financial results of UtiliCorp, when compared to the myriad of other internal and external non-merger forces affecting UtiliCorp's earnings. Without answers to these questions, no one can claim an ability to accurately track savings. (Oligschlaeger Rebuttal, Ex. 713, pp. 26-27; Featherstone Rebuttal, Ex. 704, pp. 64-67).

UtiliCorp's initial brief at page 44 states:

> Because UtiliCorp's system will track SJLP's operations separately from the rest of UtiliCorp's operations, the results can be compared to the baseline determined by the Commission in this case. The results of that comparison could represent total savings, both merger related and non-merger related. (Ex. 19, p. 4).

"Ex. 19" is the surrebuttal testimony of UtiliCorp witness Jerry E. Myers. In his surrebuttal testimony, Mr. Myers' follows up this discussion by providing an example of how such a tracking process would work, which appears in his surrebuttal testimony as Schedule JDM-1. Schedule JDM-1 is a tracking method, though the Joint Applicants are careful not to call it a formal proposal for tracking. This method does not provide any means by which merger and non-merger components of the total savings amounts can be disaggregated, which is the fundamental tracking question. Even beyond that criticism, a closer examination of Mr. Myers' Schedule JDM-1 is in order for what it seems to reveal about the Joint Applicants' attitude towards tracking.

First, it is apparent that Schedule JDM-1 represents an interest by UtiliCorp in setting up a mechanical process to derive merger savings. By agreeing on a set of calculations, and then assuming the results of those calculations represent merger "savings" or the starting point for determining merger savings, UtiliCorp would like for the Commission to believe that it will be able to avoid most of the inherent difficulties in meeting its burden for proving the existence of merger savings.

Second, Mr. Myers' surrebuttal testimony at page 5 makes clear that other parties will have, in effect, the burden of proving the existence of non-merger savings in the context of the tracking method contained in Schedule JDM-1. If non-merger savings can be proven or agreed to by the parties, then the amount of non-merger savings is to be subtracted from "total" savings, with the remainder assumed to be merger savings. Under this approach, savings are assumed to be merger related unless otherwise shown not to be.

If any tracking system is to be considered by the Commission, the Staff urges that the Commission place the burden of demonstrating the existence of merger savings clearly on the party seeking acquisition adjustment recovery. The reasons why UtiliCorp might like to avoid such a burden are demonstrated in the history of its 1999 West Plains rate proceeding in Kansas.

D. West Plains Energy Kansas Case

UtiliCorp does have some prior history in regard to making claims for merger savings in order to justify rate recovery of an acquisition adjustment that may be of interest to the Commission. In Kansas, in a 1999 rate proceeding, *Re: UtiliCorp United Inc., d/b/a West Plains Energy Kansas,* Docket No. 99-WPEE-818-RTS, No. 10 Order On Application, 198 PUR4th 397 (January 19, 2000), UtiliCorp sought recovery of an acquisition adjustment associated with its 1991 purchase of former Centel properties, now known as "West Plains Energy Kansas." To justify the requested rate recovery, UtiliCorp presented alleged evidence of merger savings in seven separate areas. These areas included savings associated with reduced coal contract costs at a power plant in which West Plains was a minority owner, and labor reductions. 198 PUR4th at 404-06. Mr. John McKinney was a witness for UtiliCorp on this issue. *Id.* at 403. As previously recounted for the Commission, the Kansas Corporation Commission (KCC) rejected most of the claimed savings amounts, noting among other things in regard to the coal contract that the majority owner of the power plant in question had sufficient incentive on its own to seek fuel cost reductions. The KCC determined that alleged merger savings purportedly related to fuel cost reductions. The KCC determined that alleged merger savings purportedly related to employee reductions appeared to be the norm in the current electric industry, and were no more than cost reductions that a prudent utility would seek to achieve, mergers or no mergers. *Id* at 404-06.

Several aspects of the KCC Order may be of particular interest to the Missouri Commission. First, the KCC made clear exactly what the test for accepting claims of merger savings was: "…the Applicant failed to carry its burden of proof with respect to these claimed savings and failed to establish that the coal cost savings would not have been created but for the Centel acquisition." 198 PUR4th at 404. The burden was clearly placed on UtiliCorp, and the test was proof of savings that would not be possible but for the merger. As shown in Schedule JDM-1 to Mr. Myers surrebuttal testimony, Ex. 19, UtiliCorp appears to be suggesting tracking methods that would put the burden of proving savings are not merger-related on other parties. The record is also clear in this proceeding that UCU is including in its estimated merger savings amounts alleged savings that in fact would be possible without the merger (i.e., off-system sales opportunities).

Second, the KCC Order indicates how speculative the entire process is of attempting to identify merger savings after the fact. The Joint Applicants will no doubt point out that the KCC did accept some of UCU's claims of merger savings, and allowed West Plains recovery of almost one-half of the claimed acquisition adjustment on that basis. 198 PUR4th 405-06. (The KCC did not allow rate base treatment of any portion of the acquisition adjustment. *Id.* at 404.) In respect to its agreement with West Plains on several categories of merger savings, the KCC stated the following:

> . . . After several rounds of testimony, the conflicting evidence concerning acquisition savings indicates that the amount of annualized savings recoverable, as stated in paragraphs 15 and 16 above, ranged from zero percent to 100% of the acquisition premium. [Citations omitted.] The Commission evaluated specific areas of claimed savings and finds that the Centel acquisition created approximately $2,350,000 of annual savings. The $2,350,000 savings falls at or near the midpoint of the range of testimony provided in this proceeding. Based on the record in this proceeding, and recognizing that a docket was not opened earlier to determine merger savings, the Commission believes that the midpoint of the range of the evidence provides a substantive basis alone to support the Commission's finding . . . .
>
> 198 PUR4th at 406.

This excerpt from the KCC Order illustrates in several respects the inherent lack of clarity in seeking to make after-the-fact quantifications of merger savings. First, the range of savings estimates offered by the parties show the inescapable subjectivity of the process, and also that parties to a rate proceeding are unlikely to come to any agreements regarding savings estimates. Further, it is striking that the KCC felt obliged to rely, at least in part, on a calculated midpoint in the savings estimates offered in coming to its determinations on merger savings. Again, this suggests that this type of process will not give this Commission a great deal of confidence that hard facts will be available in the future to make definitive determinations in future rate cases as to allegations of merger savings achieved. In this light, UtiliCorp's claims that customers will be absolutely protected from detriment under its regulatory plan should be assessed.

E. Summary

The Staff continues to assert that after-the-fact attempts to identify and quantify actual savings resulting from a merger are very difficult, and practically impossible to do. Therefore, a regulatory plan dependent upon the ability to track merger savings to protect customers should be rejected for that reason alone. The Staff recommends, in the case the Commission leaves merger savings and cost rate issues to a future rate proceeding, that the Commission make no findings at this time regarding any aspect of a future merger savings tracking method, and make clear it is UCU's sole responsibility to propose any such plan in future rate proceedings.

XIII. MPS SAVINGS ASSIGNMENT

On page 15 of UtiliCorp's initial brief, in relation to future reductions in UtiliCorp corporate allocation factors that the MPS division will experience, UtiliCorp states that "it would be unfair to have MPS customers gain this benefit without also incurring their share of the costs."

This statement is an inaccurate description of the effect of the SJLP – UtiliCorp proposed regulatory plan on MPS customers. It is very clear that the intent of the regulatory plan is to take MPS off cost-based ratemaking as it applies to UtiliCorp corporate allocation factors in order to allow UtiliCorp a means of indirectly recovering a portion of the acquisition adjustment. (Tr. 907). If MPS' rates are to be held higher than they otherwise would be, specifically to allow for acquisition adjustment recovery, then it should be evident that MPS' customers in fact will be paying part of the merger premium. This makes UtiliCorp's unwillingness to provide MPS' customers a material portion of the purported merger savings, unfair and inappropriate.

XIV. TRANSACTION COSTS AND COSTS TO ACHIEVE

A. The Regulatory Treatment of Transaction Costs

Among the issues in this case is the question of the appropriate regulatory treatment of certain costs that the Staff labels "Transaction Costs." These are costs directly associated with the completion of the merger transaction, including, for example, "fees paid for legal, banking and consulting services necessary to close the transaction." (Russo Rebuttal, Ex. 717, p. 2, lines 13-15). In proposing the regulatory treatment of transaction costs, UCU groups them with "costs to achieve," which the Staff defines as costs that the Joint Applicants would incur in order to combine the systems and processes following an approval and execution of the merger. In its Initial Brief, UCU states that transaction costs should be recoverable in rates, arguing that "[f]ailure to deduct these costs from resulting merger synergies would result in overstating synergies that could not otherwise be achieved absent the merger" and that transaction costs "should be given rate recognition by allowing UtiliCorp to retain merger benefits equal to these costs." (UCU Brief at 50).

B. The Regulatory Treatment Of Transaction Costs

Staff's position is that transaction costs are separate and distinct from costs to achieve (Russo Rebuttal, Ex. 717, p. 7, lines 20-21). Transaction costs are <u>directly</u> related to the actual acquisition transaction, and for the most part, occur during the time leading up to and including the execution of the transaction, while costs to achieve are normally incurred after the transaction is completed.(Russo Rebuttal, Ex. 717, p. 10, lines 14-18). Transaction costs, which are more standardized, less discretionary, and often more easily quantified than costs to achieve, result directly from the decision of the shareholders to enter into a merger and are therefore closely tied to the acquisition (or merger) premium (*i.e.*, the amount by which the acquisition price exceeds the net book value of the acquired assets). In fact, "[t]ransaction costs are referred to as 'direct costs of the merger' and are coupled with the merger premium to make up the amount of the acquisition adjustment to be recorded on the utility company's balance sheet." (Hyneman Rebuttal, Ex. 707, p. 29). Thus, like the acquisition premium, transaction costs are "ownership" costs. (Id.). As such, they are a matter of concern strictly to UCU's shareholders, and not its customers, who, in their capacity as ratepayers, have no ownership interest in the Company. The shareholders elect to incur both the acquisition premium and the costs directly associated with the merger transaction as a way to increase the value of their investment. (Russo Rebuttal, Ex. 717, p. 2, lines 9-11). "Both the USOA and GAAP (APB 16) require that transaction costs be treated the same as the merger premium." (Hyneman Rebuttal, Ex. 707, pp. 29-30). Ratepayers, on the other hand, are neither considered nor involved in the decision whether to merge. (Id. at 31). In light of the foregoing, it follows that transaction costs should receive the same regulatory treatment as the acquisition premium; namely, they should be excluded from rate recovery. Ownership issues are strictly a shareholder concern; therefore, costs associated with ownership should be borne by the shareholders.

However, in the event the Commission decides that recovery of transaction costs in rates should be permitted, Staff would recommend that they be amortized over a period of 40 years (Russo Rebuttal, Ex. 717, p. 6, line 21), as opposed to the 10-year period proposed by the Joint Applicants. As noted in Staff's Initial Brief, transaction costs are closely tied to the transaction itself, and the Joint Applicants are already recommending a 40-year time frame for amortization of the merger premium. (Staff Brief at 172). Since transaction costs are conceptually very similar to the premium, there is no reason to give transaction costs more favorable treatment than the Joint Applicants themselves are proposing for the premium (*i.e.*, 40-year amortization).

Moreover, in the event the Commission decides, notwithstanding the Staff's recommendation, to permit recovery of transaction costs, Staff would recommend that 50% of such costs be allocated to UtiliCorp's non-regulated operations, on the basis that the Joint Applicants failed to provide Staff with any information concerning a reasonable allocation of the acquisition adjustment to such operations. (Russo Rebuttal, Ex. 717, p. 7, lines 12-15). In support of its recommendation, the Staff offered considerable evidence that a significant portion of the benefits the Joint Applicants expect to realize from this merger pertain to non-regulated operations. (Hyneman Rebuttal, Ex. 707, pp. 51-69). Based on that evidence, some portion of merger transaction costs should be assigned below the line to non-regulated operations. UCU argues that the assignment of a portion of the transaction costs is assigned implicitly to non-regulated operations, asserting that under UCU's proposed 10-year amortization of yields only a 60% payback of the transaction costs. According to UCU, the result is actually an under-allocation of transaction costs to non-regulated operations, "[s]ince the regulated operations of SJLP are significantly more than 60% of total operations…". (UCU Brief at 51).

The question, however, is not what percentage of SJLP's operations are regulated; rather, it is what percentage of the benefits flowing from the merger can be expected to accrue to UCU's non-regulated operations. Again, based on the evidence indicating that the relevant percentage is substantial, Staff continues to recommend that at least 50% of the transaction costs associated with the subject merger be assigned below the line to UCU's non-regulated operations. The recommended 50% allocation is conservative because UCU has provided no evidence to the Commission to indicate that even 50% of the total benefits from this transaction would apply to regulated operations.

C. The Regulatory Treatment of Costs to Achieve

As suggested earlier, "costs to achieve," as distinguished from transaction costs, are costs that will arise in the merged utilities as they take advantage of opportunities for potential savings presented in the post-acquisition environment. Such costs are typically associated with consolidating and integrating various operations, systems, practices, and procedures. The Staff believes reasonable and prudent levels of costs to achieve should be considered for recovery because of their direct relationship to potential merger-related customer savings. (Russo Rebuttal, Ex. 717, p. 10, lines 18-21).

The Joint Applicants propose that costs to achieve be amortized over 10 years. (Siemek Direct, Ex. 7, p. 8, line 4). The Staff, however, recommends that these costs be expensed in the period in which they occur, as a means of offsetting any merger savings actually realized during the same time period. (Russo Rebuttal, Ex. 717, p. 10, lines 4-6). This treatment would allow the Joint Applicants to seek recovery of costs to achieve incurred within a test year set for a future rate proceeding.

Although the Staff generally supports consideration of costs to achieve for recovery in rate cases, if the Commission is inclined to make rate determinations in this proceeding, Staff is opposed to the inclusion in cost of service of some of the specific items proposed by the Joint Applicants; in particular, the amounts estimated for the "Officers Severance/Retention" ($3,232,913) packages, the "Supplemental Executive Retirement Plan," or "SERP" ($1,620,000), and the "Paid Advisory Board" ($432,000). (Russo Rebuttal, Ex. 717, pp. 9, 11).

With respect to "Officers Severance/Retention," and the "Paid Advisory Board," UCU argues respectively that: a) these costs are the price for eliminating the salaries of the then-former SJLP executives, and b) the establishment of the Paid Advisory Board is necessary to accomplish the merger. (UCU Brief at 51-52). In so arguing, UCU is, in effect, raising an "umbrella" by purporting to show that overall the proposal is economically justified and then seeking to include under that umbrella various implicated costs, regardless of whether they are prudent and benefit the ratepayer.

The Staff, however, is hardly inclined to abandon its normal practice of scrutinizing the various cost elements as to their prudence and their connection to the ratepayers, and instead to "open the gates" and agree to inclusion in cost of service simply because some allegedly associated synergies of greater value can be identified. The fact is that executive severance amounts are not expended for the purpose of creating merger savings. They are paid to ensure management "neutrality" in merger transactions, so that the interests of the shareholders are represented fairly. (Russo Rebuttal, Ex. 717, p. 14, lines 10-11). Moreover, these payments are made pursuant to contracts with SJLP executives by SJLP itself. UCU, the party with an interest in fostering merger savings, had no role in establishing these payments. Accordingly, the Officers' Severance/Retention program is strictly an ownership issue, and the costs associated with these "golden parachutes," which amount to approximately three times the executive's salary (Russo Rebuttal, p. 13, line 10), should legitimately be borne by the shareholders, and not by the ratepayers. Similarly, the cost of the Paid Advisory Board, which will be involved in charitable activities and possibly economic development, and which is merely advisory in nature, constitutes an inappropriate and unnecessarily duplicative cost, and should therefore be excluded from recovery in rates. (Staff Brief at 176).

With regard to the funding of the Supplemental Executive Retirement Plan, which is another plan akin to a golden parachute (Russo Rebuttal, p. 12, line 24), UCU argues that rate recognition of this cost item is justified, given that the funding is currently part of SJLP's current cost of service and "because the full funding to be paid at closing will eliminate the annual funding requirement." (UCU Brief at 52). In the opinion of the Staff, UCU seeks to use the occasion of the subject merger in order to cure a considerable underfunding of SERP at the expense of the ratepayers. It is not clear why the merger should trigger full funding if SJLP did not fully fund the SERP on a stand-alone basis. As in the case of the Officers' Severance/Retention program, funding of such golden parachute-type plans should be the responsibility of a utility's shareholders and not the ratepayers.

XV. CUSTOMER SERVICE INDICATORS

UtiliCorp argues that Staff can get the customer service standard information in question any time it requests it, or by way of audits, so there is no reason to institute a reporting requirement for the information. However, given the uncertainty regarding the continuation of service quality following a merger, Staff believes that a regular reporting of information is the most efficient and effective method to monitor service quality. A regular reporting system specified in advance would provide the Company with exact information on the type, the format and the frequency of such information. Therefore, Staff desires that this information to be provided to it on a monthly basis should the Commission approve the merger (Bernsen Rebuttal, Ex. 702, p. 10, lines 4-6). It would only make good sense for the Commission to order such a formal reporting requirement, so that all parties are aware of the information to be provided, the format of the information and the timing of the reports.

The Company further argues that it is unfair to single it out for customer service reporting requirements when they do not apply to all other Missouri utilities. However, the Company's response implicitly assumes that there are not differences between merging utilities and non-merging utilities in terms of customer service concerns. However, as Staff witness Bernsen points out, this is not the case. (Bernsen Rebuttal, Ex. 702, p. 2, line 13 through p. 3, line 2.) As Staff asserts that merging companies may face greater incentives to cut back on expenditures pertaining to customer service in order to pay for acquisition adjustments (Bernsen Rebuttal, Ex. 702, p. 2, lines 14-16), Staff believes that there is good reason to demand greater information in this area from merging utilities than is currently requested from non-merging utilities. Other companies requesting mergers before this Commission have agreed to reporting requirements similar to those being requested of UtiliCorp. These companies include: Western Resources, Inc. and Kansas City Power & Light Company, Case No. EM-97-515; Southern Union and Pennsylvania Enterprises, Inc., Case No. GM-2000-49; and Atmos Energy Corporation and Arkansas Western Gas Company, Case No. GM-2000-312 (Bernsen Rebuttal, Ex. 702, p. 3, line 13 through p. 4, line 3).

XVI. LOAD RESEARCH CONDITION

XVII. STRANDED COSTS

XVIII. MARKET POWER AND TRANSMISSION ACCESS AND RELIABILITY

XIX. FERC ORDER CONDITIONALLY AUTHORIZING MERGERS OF SJLP AND UTILICORP AND EMPIRE AND UTILICORP

XX. CONCLUSION

Wherefore for the above stated reasons and the reasons stated in the Staff's initial brief, the Staff requests that the Commission adopt the Staff position on each and every issue presented in the instant proceeding.

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 3rd day of October 2000.

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