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January 11, 2002

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

Re: UtiliCorp United Inc., d/b/a Missouri Public Service
Case No. ER-2001-672

Dear Mr. Roberts:

On behalf of UtiliCorp United Inc. d/b/a Missouri Public Service, I deliver herewith for filing with the Missouri Public Service Commission an original and eight (8) copies of Schedule JRE-1 to the Rebuttal Testimony of UtiliCorp witness Jon R. Empson. The schedule was inadvertently omitted from the filing made by UtiliCorp on Tuesday, January 8, 2002.

Copies of the schedule will be provided to all parties of record.

Would you please bring this filing to the attention of the appropriate Commission personnel.

Thank you very much for your assistance.

Very truly yours,

James C. Swearengen

James C. Swearengen

JCS/lar
Enclosures
cc: Parties of Record

Exhibit No.: 3
Issue: Policy
Witness: Jon R. Empson
Sponsoring Party: UtiliCorp United Inc.
Case No.: EM-2000-369
Date Prepared: August 23, 2000

MISSOURI PUBLIC SERVICE COMMISSION
Case No. EM-2000-369

Surrebuttal Testimony

of

Jon R. Empson

Jefferson City, Missouri

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF JON R. EMPSON
ON BEHALF OF UTILICORP UNITED INC.

CASE NO. EM-2000-369

Q. What is your name and position?

A. Jon R. Empson. I am Senior Vice President of UtiliCorp United Inc. ("UtiliCorp"), responsible for Regulatory, Legislative and Environmental Services.

Q. What role did you have in the application which seeks approval of the merger of UtiliCorp with The Empire District Electric Company ("Empire")?

A. While having overall responsibility for UtiliCorp's regulatory filings, I specifically had the responsibility in this case for ensuring UtiliCorp's Senior Management that the merger application contained plans that would provide UtiliCorp shareholders with the opportunity to earn a fair return on investment and provide a net benefit to customers.

Q. What is the purpose of your surrebuttal testimony?

A. My primary purpose is to provide a simplified explanation of the regulatory plan that will help evaporate the cloud of confusion the Commission Staff ("Staff") and the Office of the Public Counsel ("OPC") have cast over this case through their rebuttal testimony.

Q. Please explain.

A. Having listened to the evidentiary hearing in the UtiliCorp merger case involving St. Joseph Light and Power Company ("SJLP") and having read the rebuttal testimony in this proceeding, I am frustrated by the attempts to characterize UtiliCorp's regulatory plan as unique or complex and shifting the risk to the customers to pay for the acquisition premium. Clearly, the shareholders of UtiliCorp are bearing the risk of the Empire transaction (as well as the SJLP transaction) and while the regulatory plan has several elements, it is based on simple, basic principles.

Q. Can you provide some specific references in Staff and OPC testimony that highlight your concerns?

A. Yes, I can. There are numerous references that could be cited but a few representative statements are:

① OPC witness, Ryan Kind, states on p. 36, lines 4-5: "UtiliCorp's proposed regulatory plan, which would require ratepayers to fund a large position of the acquisition premium, ..."

② Staff witness, Cary Featherstone, states on p. 113, lines 16-17 and 21-22: "UtiliCorp's regulatory plan is developed to capture all the savings for UtiliCorp and pass the costs of the merger back to its customers."

"The shareholders benefit from retaining savings while forcing customers to pay for the mergers."

③ Witness Featherstone also states on p. 114, lines 9-10: "These plans shift the risks of both of these mergers to the three UtiliCorp Missouri divisions' respective customers."

④ Witness Featherstone also states on p. 41, lines 11-12: "Allowing recovery of positive acquisition adjustments in rates does not provide sufficient incentive for the acquiring utility to negotiate the best possible price for the acquired firm."

⑤ Witness Featherstone also states on p. 32, lines 1-5: "UtiliCorp's regulatory plan includes unique regulatory proposals, such as using Empire's pre-merger capital structure in future Empire rate proceedings and excluding savings in the administrative and general (A&G) cost categories for the MPS division from inclusion in rates in future rate proceedings."

⑥ OPC witness Robertson makes comparable statements about customers bearing the costs on p. 57, lines 13-14 and p. 69, line 3-5.

Q. How would you describe the Empire transaction?

A. First, I want to state that I am not an accountant. My explanation will focus on the concepts behind the transaction.

Q. Please proceed.

A. UtiliCorp shareholders, through the actions of its Board of Directors, have agreed to invest approximately $900 million to acquire ownership of Empire. Basically, the total price consists of $620 million to acquire the assets at net book value and $280 million to create the opportunity for the transaction to occur. This latter amount has been called the "acquisition premium." It is important to understand that if UtiliCorp shareholders had not been willing to pay a premium to create the opportunity for this transaction and put their money at risk, this transaction would not occur. The payment of the premium is a <u>precondition</u> for the transaction.

Q. Why do you say that the UtiliCorp shareholders have assumed the risk?

A. UtiliCorp's shareholders have invested this money based upon the belief that UtiliCorp's management will be able to create incremental value by consolidating operations and creating a more efficient utility and therefore earn a reasonable return on its investment. Conceptually, this incremental value created by UtiliCorp management funds the acquisition premium. If UtiliCorp's management does not create the required incremental value to fund the acquisition premium, UtiliCorp's shareholders absorb the risk and will not receive an adequate return on the invested capital. It is important to emphasize that if the UtiliCorp shareholders had not assumed this risk by paying the premium, the incremental values could not be created. The payment of the premium triggers the chain of events.

Q. Have the Staff and OPC claimed that the proposed regulatory plan has the customers assuming the risks and paying the premium?

A. Yes, but both the Staff and OPC are decoupling the enabling action – payment of premium which creates the risk – from the results – creation of incremental value which funds the risk. On the one hand, they want the shareholders to absorb the premium cost, the transaction costs, and even some of the transition costs; while on the other hand they want the customers to receive the incremental value created by the transaction.

Q. Staff Witness Featherstone (p. 41, lines 20-23) has stated that the adoption of positive acquisition adjustments … removes from purchasing utilities … incentive to negotiate a lower price …". If the concept of recovering the acquisition premium as proposed by UtiliCorp is adopted, what constrains the price utilities will pay for utility properties?

A. Basic economics. If any acquiring utility can only recover premium that is funded by the incremental values created, they will limit the premium paid to make these economics work. That is the simple concept that UtiliCorp has used in developing the regulatory plan in this case.

Q. How does this concept apply to the regulatory plan in this case?

A. UtiliCorp has proposed a five-year rate moratorium, which will initially enable it to fund some of the costs to create the incremental values. By retaining the incremental values created during years 1-5, and essentially charging the shareholders all of the costs and holding the customers unharmed through frozen rates, UtiliCorp is attempting to make the economics of the transaction work through the values created. But again, the risk resides with the shareholders since rates to the customers are frozen.

Q. You've explained that the created value has to fund the costs. How does that occur in year 6 when cost recovery is directly requested for a portion of the premium and other costs?

A. Again, the proposed regulatory plan places all of the risk on UtiliCorp shareholders. In year 6, UtiliCorp asks to recover up to 50% of the costs (i.e. premium) but only if the created value at least equals that cost. If, based upon the guidelines developed in this proceeding, UtiliCorp cannot document that the incremental values created and realized from this transaction are at least equal to 50% of the cost of premium, the shareholders will bear the difference – not the customers. The incremental values created by the initial premium payment by the shareholders and invested transaction costs are what fund the recovery of these costs. Even if UtiliCorp falls short in creating incremental value to fund the premium, the Empire customers are guaranteed at least a $3 million reduction in cost of service and the financial risk for this transaction again rests with the shareholders.

Q. What do you mean by the phrase "guidelines developed in this proceeding"?

A. UtiliCorp management must have guidelines established by the Commission in its order approving the merger in this case which validate the starting point for synergy categories. For example, the starting point for determining electric off-system sales, joint dispatch, number of employees, operating costs and normal cost increases are critical. Then, there must be a recognition in the order that synergies will be measured against these starting points. Any attempt to speculate on what Empire might have, could have, or should have achieved during the five-year rate freeze relating to these synergy categories is irrelevant and a nonproductive exercise. It would be inappropriate to hold UtiliCorp to a standard of proving a negative, i.e., Empire could not have achieved these synergies as a stand-alone entity.

Q. As you read Staff rebuttal testimony in this case, what general, overall observation would you make?

A. It would appear that the Staff has attempted to create a great deal of confusion but in the final consideration I am hopeful that the Commission will be able to sort things out. The regulatory plan is clearly designed and does in fact place the risk of recovering the premium on the UtiliCorp shareholders. I cannot think of a reasonable scenario where the customers of either Empire or UtiliCorp are placed at risk or detrimentally impacted. The regulatory plan is designed to provide UtiliCorp shareholders with the <u>opportunity</u> to recover some of its investment over a period of time. On the other hand, the Staff apparently does not want to recognize the upfront investment made by UtiliCorp shareholders that creates the opportunity for Empire customers to receive a $3 million reduction in the cost of service in year 6.

Q. Is there an analogy you might offer that represents your understanding of the Staff's position?

A. Yes. Conceptually, I can see two utilities merging that have two offices, but both offices are too small to hold the combined staffs. However, one of the offices has additional space available that could be leased. The decision is made to "buy-out" the other utility's lease (i.e., pay a premium to enable consolidation) so that the merged utility can consolidate into a single office and gain operational efficiencies. The analysis developed by the merged utilities shows that the cost for the "buy-out" is more than offset by the gains in operational efficiencies. In other words, the premium paid (i.e. buy-out) was necessary for the operational efficiencies (i.e. synergies) to be achieved.

Q. Please continue with your analogy.

A. From the utility perspective, the cost of the lease buy-out should be amortized over the term of the lease and included in rates knowing that the related efficiencies or cost reductions gained from the consolidation more than offset this cost so the customer is a net winner. Simply stated, the costs should be matched with the savings. The merged utility should be held accountable to document these savings as at least equal to the cost of the "buy-out." It would appear that the Staff position would be to disallow including the lease buy-out in rates but to retain the benefits for the customers or use a show cause to "claw" back the benefits before the buy-out is repaid by the operational efficiencies. In my mind, both costs – the premium and the lease buy-out – were incurred to create an opportunity to develop incremental value that benefits customers and both would be legitimate, reasonable utility expenses.

Q. Why has UtiliCorp recommended freezing the Empire capital structure as part of the merger regulatory plan?

A. There are two reasons. First, there is no detriment to the Empire customers by maintaining Empire's or a comparable company approach in setting rates. That is the basis for rates today and how UtiliCorp itself will assign capital requirements to Empire in the future. Staff has taken a comparable company approach in testimony in other cases involving companies like SJLP so the concept is not foreign to the Staff.

Second, UtiliCorp has always managed and funded its operations on a comparable company approach. As UtiliCorp grew its business portfolio and changed its risk profile from a utility to a more diversified energy company, it was important to internally maintain books and records that reflected the proper business profiles. The proposal to adopt Empire's capital structure is consistent with UtiliCorp's current operational and regulatory practice.

Q. Why does the regulatory plan exclude the impact of Empire in determining corporate allocations to UtiliCorp's Missouri Public Service ("MPS") operating division?

A. Staff and OPC have consistently challenged UtiliCorp's growth strategy. Even in this proceeding, Staff goes back almost 20 years to quote UtiliCorp Chairman, Rick Green about the implementation of the growth strategy.

Bob Green explains in his surrebuttal testimony in this case the intent of Rick Green's comments from the 1980's. UtiliCorp has not sought to recover from its Missouri customers merger and acquisition expenses or premiums associated with its non-Missouri acquisitions. As we designed the regulatory plan in this case, we felt it was important to maintain this "independent" approach. That is, MPS customers should not bear the costs of the merger transaction. Therefore, all of the premium was assigned to Empire and the allocation factors were neutralized so that the benefits of reduced factors also did not go to MPS customers. An option would have been to assign prorata costs of the transaction to MPS that create the benefit (lower allocations).

Q. Why didn't UtiliCorp choose this alternative?

A. The alternative raised a new policy issue for the Commission that was better addressed directly by our proposal. The new issue was whether we should be adding costs to MPS customers in all acquisitions that reduce corporate allocations to MPS customers. We concluded it was best for this merger to isolate the premium and benefits as much as practical with Empire. This was also consistent with Rick Green's commitment that MPS customers would be protected from downside risks associated with UtiliCorp's M&A strategy.

Q. Do you have any concluding comments?

A. Yes. The regulatory plan was specifically designed to ensure that Missouri customers of both Empire and MPS would not be exposed to any downside risk. The UtiliCorp shareholders are taking the risk in this merger by making the initial investment, developing the required synergies, guaranteeing a reduction in the cost of service for Empire customers in year 6, and funding costs only if the incremental values can be proven. The regulatory plan virtually and explicitly guarantees that Empire customers will not be detrimentally impacted by this transaction.

The Staff and OPC want the Commission to ignore what is known today about the operations of both Empire and MPS, ignore that reasonable synergies can be estimated and created, and engage in speculative scenarios of what might happen if the two companies continued to operate independently for the next five years. This merger is not detrimental to either the Empire or MPS customers and the proposed regulatory plan should be approved to enable UtiliCorp to create the guaranteed benefits.

Q. Does that conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of UtiliCorp United Inc. and The Empire District Electric Company for Authority to Merge The Empire District Electric Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions.	)	Case No. EM-2000-369

County of Douglas)
)
State of Nebraska)

AFFIDAVIT OF JON R. EMPSON

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

Jon R. Empson

Jon R. Empson

Subscribed and sworn before me this 16th day of August, 2000.

GENERAL NOTARY-State of Nebraska
SHEILA A. NELSON
My Comm. Exp. March 3, 2001

Sheila A Nelson

Notary Public