Exhibit No.: Issues: Merger Savings Witness: Thomas J. Flaherty Type of Exhibit: Surrebuttal Testimony Sponsoring Party: Union Electric Company

Case: EM-96-149

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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EM-96-149

SURREBUTTAL TESTIMONY

OF

THOMAS J. FLAHERTY

** Denotes Highly Confidential Information**

June 3, 1996

1 2 3 4		Surrebuttal Testimony of Thomas J. Flaherty National Partner - Utilities Consulting Deloitte & Touche Consulting Group
5		Missouri Public Service Commission Case # EM-96-149
6	Q.	WOULD YOU PLEASE STATE YOUR NAME AND BY WHOM YOU ARE
7		EMPLOYED?
8	Α.	My name is Thomas J. Flaherty, and I am the National Partner - Utilities
9		Consulting and a partner in the Deloitte & Touche Consulting Group, a
10		division of Deloitte & Touche LLP. My business address is 2200 Ross
11		Avenue, Suite 1600, Dallas, Texas 75201.
12	Q.	MR. FLAHERTY, ARE YOU THE SAME WITNESS THAT PREVIOUSLY
13		FILED TESTIMONY DESCRIBING ESTIMATED COST SAVINGS THAT
14		WILL RESULT FROM THE COMBINATION OF UE AND CIPS?
15	А.	Yes. I previously submitted testimony regarding cost savings that are
16		estimated to be achieved through the combination of UE and CIPS.
17	Q.	MR. FLAHERTY, WHAT IS THE PURPOSE OF YOUR SURREBUTTAL
18		TESTIMONY?
19	Α.	My surrebuttal testimony responds to the direct testimony filed by several
20		witnesses in this proceeding. First, Mr. Maurice Brubaker has filed direct
21		testimony on behalf of the Missouri Industrial Energy Consumers. His
22		testimony demonstrates a misunderstanding of the methodology,

procedures and assumptions underlying the development of the UE and
CIPS cost savings estimates. To address these misunderstandings, I am
providing further clarification of the nature of synergies created from the
combination of UE and CIPS. I also will elaborate on descriptions of the
bases for quantifying the estimated savings and the process by which
savings were derived, reviewed and finalized in conjunction with executive
management.

In addition, my surrebuttal testimony responds to testimony filed by Mr.
Mark Oligschlaeger, regulatory auditor with the Missouri Public Service
Commission. Specifically, I will discuss the rationale behind using the
synergies study to estimate future benefits that will result from the merger of
UE and CIPS.

13 Q. MR. FLAHERTY, PLEASE SUMMARIZE YOUR TESTIMONY.

A. The merger of UE and CIPS will generate significant cost savings that will benefit all interested stakeholders. Using previously tested and accepted methodologies, the Companies have developed reasonable and justifiable estimates of the size of those benefits. The Companies have judiciously undertaken to identify opportunities for merger cost savings, and subsequently provided detailed and comprehensive support for those cost savings estimates. In addition to confirming that the estimated cost savings

areas are consistent with those in previously approved utility mergers, the

estimates have been through extensive internal review by management both
prior to and after the announcement. This review was undertaken to
specifically provide for rigorous challenge by management and to improve
the quality of the estimate. The reviews have been conducted by those with
the most intimate knowledge of respective operations, presumably those
best able to judge the achievability of estimates.

7 The savings estimates provide an accurate depiction of benefits that will 8 accrue to all stakeholders. Utilizing savings estimates to determine the 9 beneficial impact of utility mergers is a recognized common practice in 10 numerous jurisdictions, as the events giving rise to cost savings realization 11 have not yet occurred. Based on comparison to preceding transactions 12 included in analyses previously conducted and supplemented by extensive internal analyses, I believe the risk associated with achieving the projected 13 14 cost savings for this merger is minimal.

15 DEVELOPMENT OF MERGER COST SAVINGS ESTIMATES

- 16 Q. HAVE YOU REVIEWED MR. BRUBAKER'S AND MR.
- 17 OLIGSCHLAEGER'S COMMENTS REGARDING THE COMPANIES'
- 18 SUPPORT FOR THEIR ESTIMATES OF MERGER SAVINGS?
- A. Yes. In general, Mr. Brubaker claims that the Companies lack an adequate
 basis for the estimated merger cost savings related to the following

1 categories: labor, professional services, contract services, procurement and 2 inventory. Likewise, Mr. Oligschlaeger claims in general that the savings 3 estimates are not detailed or supported. However, to the contrary, the estimates of merger cost savings in these areas (as in all areas) were based 4 5 on substantial, detailed financial and operational data from UE and CIPS. 6 and on sound business assumptions. Deloitte & Touche Consulting Group 7 has been involved in over 70 actual or contemplated mergers. Based on 8 that experience, it is my professional opinion that the merger cost savings 9 estimates set forth by the Companies are sound, achievable, and if 10 anything, conservative.

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Q. BEFORE DISCUSSING THE SPECIFIC AREAS ADDRESSED BY MR.
 BRUBAKER, PLEASE GENERALLY DISCUSS THE DEVELOPMENT OF
 THE SAVINGS ESTIMATES.

A UE and CIPS working group, composed of management personnel from 14 Α. 15 various functions of both companies, exchanged actual financial and operational data, which was then provided to me, to determine the relative 16 17 expenditure profiles and opportunities available for savings in each cost 18 savings area. Each specific savings category was analyzed independently 19 through a comprehensive process to determine cost savings that will be created due to the combined operations of UE and CIPS. The quantification 20 of savings was an iterative process in which the UE and CIPS working 21

1group spent significant hours collecting data, refining assumptions and2formulating conclusions about specific cost areas. The assumptions3underlying the savings percentages are reasonable, and based on a4combination of management's extensive operational experience, and the5collective experience of Deloitte & Touche Consulting Group's involvement6in previous similar transactions. The savings were then reviewed by7executive management to confirm that they are attainable.

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8 Q. MR. BRUBAKER AND MR. OLIGSCHLAEGER SEEM TO SUGGEST

9 THAT MANAGEMENT JUDGMENT AND RELATED EXPERIENCE ARE

10 NOT ADEQUATE AS BASES FOR THE DEVELOPMENT OF ESTIMATES.

11 DO YOU AGREE?

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No. The determination of benefits from a merger is an inherently forward-12 Α. looking process as it must deal with events which are yet to occur. 13 14 Management's conclusions are developed from the facts surrounding a particular area, such as opportunities for reduction of purchasing levels, and 15 supplemented by other factors that can influence management's judgment. 16 Mr. Brubaker also seems to suggest that the same level of documentation 17 18 that he is used to obtaining to evaluate rate case adjustments is available 19 for estimating merger savings. This is incorrect and unrealistic.

Q. AS A PART OF THE INTEGRATION PLANNING PROCESS, TRANSITION
 TEAMS FROM UE AND CIPS HAVE COMPLETED A MORE DETAILED
 STUDY FROM WHICH NEW MERGER COST SAVINGS ESTIMATES
 WERE PROVIDED. MR. OLIGSCHLAEGER SEEMS TO SUGGEST THAT
 THE RESULTS FROM THIS STUDY MAY UNDERMINE THE VALIDITY OF
 THE INITIAL COST SAVINGS STUDY. HAVE YOU HAD A CHANCE TO
 REVIEW THOSE RESULTS?

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8 Α. Yes. The results of the transition teams' studies confirm the initial estimates and further identify additional areas of opportunity for generating an even 9 10 greater level of merger cost savings. As I previously stated, I am fully 11 confident that the initial estimates will be at least achieved, and most likely surpassed. The transition teams' conclusions support this statement. 12 Their studies, in which the most experienced personnel from both 13 companies comprehensively examined every operation within the utilities 14 organization, support the conclusion that the merger of UE and CIPS will, at 15 16 the very least, generate the level of savings initially proposed. The extent of effort put forth during this analysis phase ensures that cost savings 17 18 estimates have been based on sound business and operational judgment.

1Q.THE RESULTS OF THE TRANSITION TEAMS' STUDY EXCEED THE2INITIAL ESTIMATES FOR MERGER COST SAVINGS. HOW DO YOU3ACCOUNT FOR THE DIFFERENTIALS?

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4 Α. The most substantive differential appears in estimates regarding labor 5 related savings. First, the transition teams' study identified an additional 13 positions, which represent a 4% increase in labor savings. The teams 6 7 identified these positions after gaining a better understanding of respective 8 activities conducted in support of day to day operations. The transition teams concluded that the joint operations could be supported at an 9 equivalent level of service after elimination of these redundant efforts. 10 Additional labor savings will also result from enacting a more accelerated 11 12 plan to displace redundant positions. Consequently, savings accrue to the 13 new company at an earlier date, therefore increasing the cost savings impact. This change in position reduction achievement accounts for a 25% 14 increase in the initial estimate of labor related savings. 15

Additional, modest cost savings differentials resulted from more detailed analyses in the areas of corporate and administrative programs, purchasing economies, facilities and electric and gas production. These revised savings estimates were relatively close to the initial estimates particularly on an annual basis.



Finally, new cost savings opportunities were identified in several areas that were not considered in the initial savings study including load management systems and improved outage control. As expected from a more intimate and detailed study, new opportunities for merger cost savings were uncovered.

To reiterate, the results of this study confirm that the merger of UE and
CIPS will generate significant benefits for all stakeholders, including
customers and shareholders.

9 Q. MR. OLIGSCHLAEGER GOES ON TO CLAIM THAT A PREFERRED

10 POLICY WOULD BE "TO BASE FUTURE RATE LEVELS ON ACTUAL

12 SAVINGS ESTIMATES." [OLIGSCHLAEGER REBUTTAL TESTIMONY,

SAVINGS RESULTS FROM THE MERGER RATHER THAN RELY ON

13 Page 17] DO YOU AGREE?

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A. No. Suggesting the use of actual savings results rather than relying on
estimates overlooks a simple point. Regardless of whether you are looking
forward or backward, you have to develop an estimate. Utilizing "actual"
results would provide a different result, but not necessarily a result that is
more reliable than a detailed, forward looking estimate. Using "actual"
results requires a comparison of historical data to <u>expected</u>, stand-alone
operational data. Regardless of the approach taken - expected results or

actual results - a comparison to an estimate of stand-alone results is
 required, nonetheless. In addition, actual results potentially will be
 influenced by other factors unrelated to the merger, making complete and
 accurate separation of impacts difficult to achieve.

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MR. BRUBAKER ASSERTS THAT THE UE/CIPS MERGER RELATED LABOR SAVINGS ARE OVERSTATED. IS HE CORRECT?

7 Α. No. Mr. Brubaker suggests that the labor reductions attributed by UE and 8 CIPS to the merger include positions that could be eliminated without the 9 merger. Mr. Brubaker's comments regarding labor savings mischaracterize 10 the nature of the analysis and rationale underlying the identification of estimated position reductions. The position reductions identified through a 11 12 comprehensive analysis represent those labor resources, and only those 13 labor resources, that become duplicative due to the merger of UE and CIPS's operations. 14

The labor analysis combined the UE and CIPS working group's intimate
knowledge of the respective organizations, and Deloitte & Touche
Consulting Group's extensive experience related to numerous merger
analyses and operational studies to accurately estimate the merger related
position reductions.

The detailed analysis aligned all positions within the respective organizations according to job functions, specifications and defined responsibilities. Following the detailed alignment of positions, the UE and CIPS working group, together with Deloitte & Touche Consulting Group, identified duplicate efforts and redundant positions. The identified position reductions were provided to UE and CIPS executive management for their review and concurrence. These positions represent the merger related labor savings. ** The labor analysis focused solely on identifying redundant positions and did not identify or include in the savings estimates any labor savings opportunities that would be associated with internal, nonmerger related . .

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operational improvements. Because the labor analysis only identified
 overlapping labor resources associated with redundant efforts, none of the
 identified position reductions could be achieved absent the merger of UE
 and CIPS operations.

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MR. BRUBAKER ASSERTS THAT INDUSTRY BENCHMARKS INDICATE THAT THE IDENTIFIED POSITION REDUCTIONS COULD BE ACHIEVED ABSENT THE MERGER. PLEASE RESPOND.

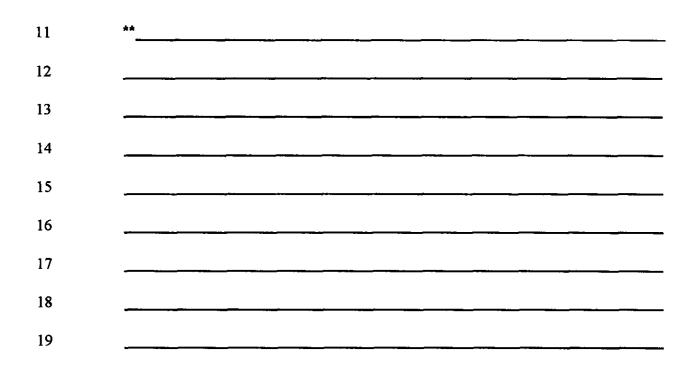
Mr. Brubaker's contention indicates a misunderstanding surrounding the 8 Α. 9 industry benchmarks and methodology used to identify position reductions. The information regarding the industry benchmarks was not used to any 10 extent in determination of potential position reductions. The industry 11 benchmarks provide nothing more than a directional indication of where the 12 13 combined company might rank relative to peers given various operational and financial metrics. Due to the multitude of factors underlying various 14 companies' operational and financial statistics, the type of conclusions 15 regarding staffing levels reached by Mr. Brubaker cannot reasonably be 16 drawn from the benchmarking data. Without appropriate normalization of 17 the raw data, the relative size of customer bases or density of service 18 territories, and other numerous like factors, skew the results of 19 20 benchmarking analyses. The benchmarking information by itself does not suggest that a single position could be eliminated. The industry 21

benchmarks connote no information related to the impact of consolidating
 UE and CIPS operations.

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Q. MR. BRUBAKER CONTENDS THAT ESTIMATED SAVINGS IN THE
 AREAS OF PROCUREMENT AND INVENTORY WERE NOT BASED ON
 ANY DETAILED ANALYSIS. PLEASE RESPOND.

A. Procurement savings will be achieved via the new company's ability to
increase bulk commodity orders, secure volume discounts and bring about
purchasing efficiencies from suppliers and vendors. Some examples will
illustrate the type of savings that can be generated from changes in
purchasing and inventory management practices.



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5	Merged requirements also will allow the combined company to contract for
6	increased production runs at substantial unit cost savings. These savings
7	result from spreading the fixed cost associated with design, pilots and setup
8	across a larger base of units, thereby reducing the total cost per unit.
9	Furthermore, merged purchasing will increase the ability of the combined
10	organization to strengthen relationships with the best manufacturers and
11	distributors, and subsequently influence improved joint purchasing
12	practices. For example, the increased purchasing activity of the combined
13	company may entice a supplier to invest in EDI technology in support of
14	improved transaction processing, which subsequently will lead to decreased
15	transaction costs. ³
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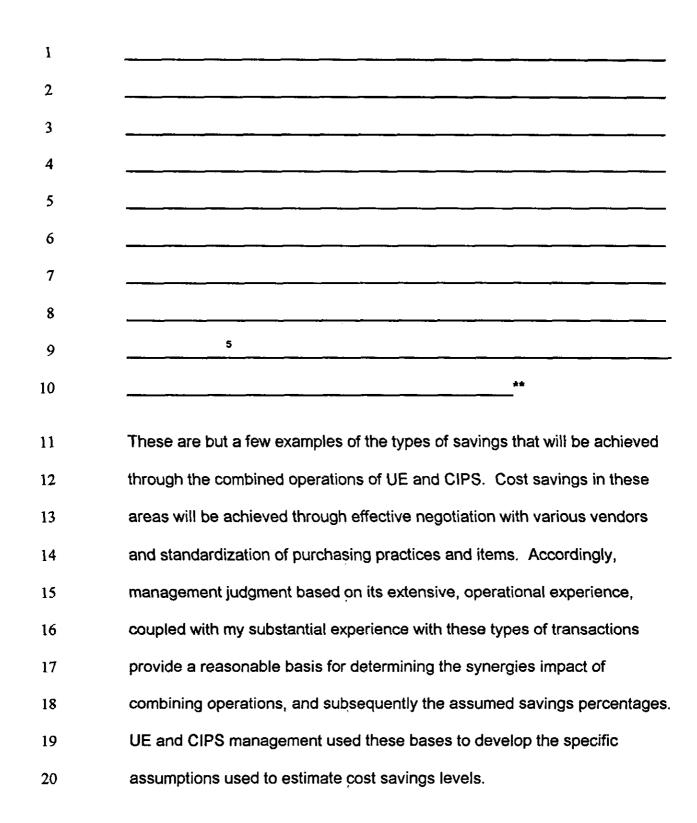
³ Electronic Data Interchange is a company-to-company mechanism for electronically transmitting electronic transactions.

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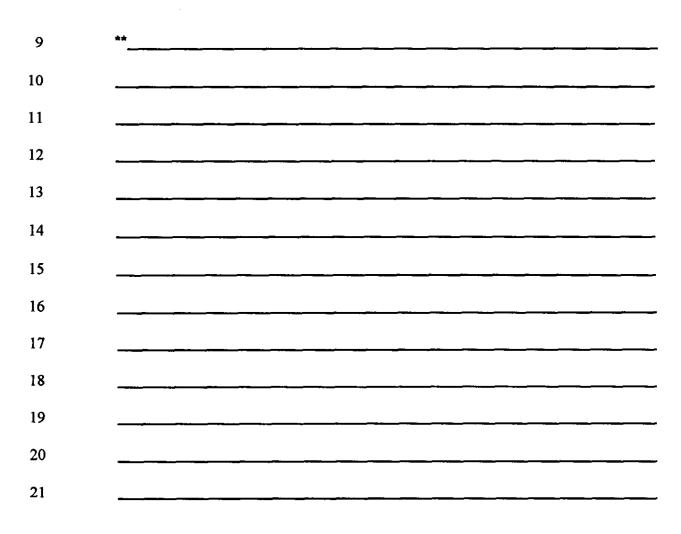


Q. CAN YOU PROVIDE FURTHER INFORMATION REGARDING
 ESTIMATED SAVINGS IN THE AREA OF CONTRACT AND
 PROFESSIONAL SERVICES?

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A. Savings for contract and professional services will be achieved through
improved buying power due to the consolidation of common service
providers, and increased scope of services of other providers. Some
examples will illustrate the type of savings generated from changes in
procuring contracts for services.

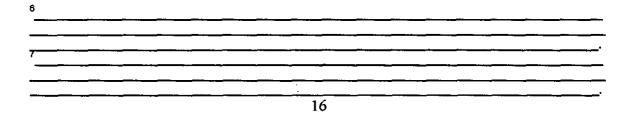


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16	The assumed savings percentages represent reasonable estimates based
17	on sound business judgment and experience from previous transactions.
18	The underlying assumptions for all savings areas were developed through

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the combined efforts of the UE and CIPS management group, the members
 of which have extensive operational experience, with the assistance of
 Deloitte & Touche Consulting Group. I am fully confident that the cited
 savings are attainable.

5 Q. IN SUPPORT OF HIS CONTENTION THAT THE PREPARED

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6 WORKPAPERS DO NOT SUPPORT THE PROJECTED SAVINGS, DOES 7 MR. BRUBAKER OFFER ANY ALTERNATIVES FOR ESTIMATING 8 SAVINGS?

9 Α. No. Mr. Brubaker simply argues that the workpapers for the identified 10 savings areas do not provide the type of support which he believes is necessary to establish the estimated savings. He failed to offer any 11 12 suggested alternative or adjustment to these estimated merger related 13 savings, although he acknowledged in response to a data request that 14 "some savings should be achievable." However, the detailed workpapers and related testimony prepared by the Companies fully support the 15 16 estimated savings and provide reasonable estimates based on the specific facts of this business combination, and establish that these savings 17 18 estimates are consistent with other merger and acquisition experience. Furthermore, the basic cost savings rationale is consistent with the 19

approach applied before, and accepted by, numerous other jurisdictions in
 connection with other business combinations.

3 USE OF MERGER COST SAVINGS

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4 Q. MR. OLIGSCHLAEGER CONTENDS THAT THE MERGER COST

SAVINGS ESTIMATES FAIL TO OFFER ADEQUATE SUPPORT FOR
 DETERMINING THE LEVEL OF BENEFITS THAT WILL RESULT FROM
 THE MERGER OF UE AND CIPS. DO YOU AGREE?

No. The synergies study was conducted by the Companies for the primary 8 purpose of determining reasonable estimates of the total benefits that will 9 accrue to stakeholders as a result of the merger between UE and CIPS. 10 11 The resulting conclusions conservatively indicated that the merger between 12 UE and CIPS will generate at least \$590 million in cost savings over the first ten years of operations. Based on my experience, these estimates provide 13 14 reasonable determinations of the size of benefits that will accrue to 15 stakeholders in the future.

In a similar manner, traditional rate setting, even through the use of an
historical test year implicitly accepts assumptions and expectations
regarding future events to establish fair rates for customers and fair returns
for shareholders. These rates are not reexamined every year, but carried
over a period of time, therefore relying on reasonable estimates about future

cost of service. The proposed treatment of merger cost savings by UE and
CIPS supports this conceptual framework. Ultimately, actual data for the
combined operations can, and will, be influenced by any number of factors
unrelated to the merger. The same holds true for conclusions drawn in
traditional rate setting cases. The level of data present in a merger filing
compared to a rate case does not inherently suggest that merger cost
savings estimates will be less accurate.

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8 Q. MR. OLIGSCHLAEGER GOES ON TO DISCUSS THE INORDINATE

9 **RISKS THAT RATEPAYERS WOULD ASSUME UNDER THE PROPOSED**

10 SAVINGS SHARING PLAN. PLEASE COMMENT.

A. Based on a combination of my experience related to previous transactions,
the risk associated with achieving the Companies' projected savings levels
is minimal.

14 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

15 A. Yes, it does.

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BEFORE THE PUBLIC SERVICE COMMISSION STATE OF MISSOURI

In the matter of the Application of Union Electric Company for an order authorizing: (1) certain merger transactions involving Union Electric Company; (2) the transfer of certain Assets, Real Estate, Leased Property, Easements and Contractual Agreements to Central Illinois Public Service Company; and (3) in connection therewith, certain other related transactions.

Case No. EM-96-149

FILED JUN 1 9 1996

MISSOURI PUBLIC SERVICE COMMISSION

AFFIDAVIT OF THOMAS J. FLAHERTY

STATE OF	<u>Texas</u>)	
)	SS
CITY OF	<u>Dallas</u>)	

Thomas J. Flaherty, being first duly sworn on his oath, states:

1. My name is Thomas J. Flaherty. I work in the City of Dallas, Texas, and I am the National Partner - Utilities Consulting and a partner in Deloitte & Touche Consulting Group a division of Deloitte & Touche LLP.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony consisting of pages 1 through <u>19</u>, inclusive, all of which testimony has been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Thomas J. Flaker A

Subscribed and sworn to before me this 31st day of May, 1996.



Notary Public