BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

INITIAL BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

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** **
Denotes Highly Confidential material has been redacted

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I. INTRODUCTION

While this case has at times seemed to be a life-and-death struggle, it is not. If the Commission decides not to approve the proposed transaction, Aquila will go on providing safe and adequate service at just and reasonable rates, and KCPL will go on providing safe and adequate service at just and reasonable rates. In just two or three years, assuming no other merger or acquisition occurs, Aquila's highest cost debt will mature, and Aquila will succeed in working itself back to investment grade. In that same period, KCPL will be able to return its attention to the Comprehensive Energy Plan (CEP) projects that are slipping so badly out of control.

The Commission should not see this case as the last opportunity to address energy suppliers in the western part of Missouri. As the Staff discusses at length in its brief, this case is just another chapter in a long story about different proposed combinations. It is far from the first chapter, and it will not be the last. In fact, it is not even the first chapter that deals with a combination of Aquila[1] and KCPL. Other chapters deal with KCPL and Western Resources, UCU and Empire, UCU and St. Joseph Light and Power, KCPL and Empire, just to name a few. In each of those cases, the applicants argued strenuously that the particular combination put forth was a great deal for the companies involved and for affected ratepayers. Yet almost none of the various combinations were ever consummated. Some failed to get regulatory approval; some participants got cold feet despite regulatory approval; some turned out to just not make business sense despite the participants' initial enthusiasm. The particular combination in this particular chapter does not warrant approval because the price is too high and the timing is wrong. If the Commission declines to approve this transaction, no doubt another combination – or this combination at a different time and at a different price – will come along in the next few years.

The remainder of this brief is organized very simply. It begins with a discussion of the standard for approval or disapproval. Then there is a discussion of the detriments, a discussion of the benefits, and finally a short conclusion. The Commission's task in this case is to decide if the detriments outweigh the benefits. Although the Joint Applicants have already spent tens of millions of dollars in their attempt to prove up benefits, the evidence of record overwhelmingly supports

[1] Aquila was then UtiliCorp United, Inc. (UCU).

a conclusion that approval would likely be detrimental to the public interest, and very possibly disastrous to the public interest.

II. STANDARD FOR APPROVAL

There should be no disagreement among the parties or the Commission on the appropriate standard. The standard in Missouri has long been this: the Commission should only approve the merger if it finds that there is not a significant possibility of a detriment to the public interest.

Citing to a Maryland case, the Missouri Supreme Court, almost 75 years ago, established the standard for review of mergers:

> To prevent injury to the public, in the clashing of private interest with public good in the operation of public utilities, is one of the most important functions of Public Service Commissions. It is not their province to insist that the public shall be benefited, as a condition to change of ownership, but their duty is to see that no such change shall be made as would work to the public detriment. 'In the public interest,' in such cases, can reasonably mean no more than 'not detrimental to the public.'
> State ex rel. St. Louis v. Public Service Com., 335 Mo. 448, 459-460 (Mo. 1934)

In reviewing the Commission's approval of a merger, a court will defer to the Commission's expertise, because the Commission has the benefit of a staff of experts to advise it:

> 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.
>
> This case is very different from one in which we review a civil judgment for damages, to make sure that each element is supported by substantial evidence. The problems presented to the Commission involve subjective evaluations of economic factors. There is no sure method for predicting whether a project will succeed. Questions of analysis and judgment are committed by law to the decision of the Commission, **which has the assistance of a technically trained staff** and is better equipped to make decisions of this kind than we are. The users are asking us to substitute our judgment for its judgment. We decline to do this because we are persuaded that the Commission's decision is a permissible one under the record. There are times when the courts must step in to protect the public against arbitrary or unauthorized administrative action, but the users do not persuade us that such intervention is necessary or proper in this case.
>
> Love 1979 Partners v. Public Service Com., 715 S.W.2d 482, 490 (Mo. 1986); [emphasis added].

The Commission should heed its Staff. One of the main reasons in the case cited above that the court deferred to the Commission is its "technically trained staff." In a recent merger case, the Commission failed to heed the advice of the "technically trained staff" and has been suffering the consequences ever since. The MPC and MGC merger has been a constant battle (see Exhibit 100, Staff Report; also TR 1884-1885: "there's been a lot of difficulties with them."). Staff told the Commission in that case that the merger was going to be detrimental to the public interest.

Recently, the Missouri Supreme Court decided the AGP case:

The fact that the acquisition premium recoupment issue could be addressed in a subsequent ratemaking case did not relieve the PSC of the duty of deciding it as a relevant and critical issue when ruling on the proposed merger. While PSC may be unable to speculate about future merger-related rate increases, it can determine whether the acquisition premium was reasonable, and it should have considered it as part of the cost analysis when evaluating whether the proposed merger would be detrimental to the public. n15 The PSC's refusal to consider this issue in conjunction with the other issues raised by the PSC staff may have substantially impacted the weight of the evidence evaluated to approve the merger. n16 **The PSC erred when determining whether to approve the merger because it failed to consider and decide all the necessary and essential issues**, primarily the issue of UtiliCorp's being allowed to recoup the acquisition premium.

[15] See State ex rel. Martigney Creek Sewer Co. v. Pub. Serv. Comm'n, 537 S.W.2d 388, 399 (Mo. banc 1976) (stating that, for ratemaking purposes, recovery of the cost of an asset acquired from another utility depends on the reasonableness of the acquisition, considering the factors of whether the transaction was at arm's length, if it resulted in operating efficiencies, and if it made possible a desirable integration of facilities).

[16] PSC staff had also testified that their analysis of the merger demonstrated that the expected rate impact on SJLP and MPS customers would be negative. Merger costs potentially assignable to the ratepayers included transaction costs, transition costs and administrative costs. Ninety-three percent of the projected merger savings could have been achieved on a "stand alone" basis without the merger, and there was no plan to assign these savings to the customers. Projected merger savings were, in fact, illusory and PSC staff calculated costs exceeding savings by $ 68.9 million during the ten-year period following the merger.

…

Addressing the second part of this point, UtiliCorp's credit rating of BBB, while lower than SJLP's current rating, is still considered to be investment grade. No evidence was presented that would quantify how the cost of debt attributable to SJLP would increase, and even if it is assumed that the merger will increase the cost of debt for SJLP's ratepayers, that fact alone does not require the Commission to reject the merger. The risk of an increased cost of debt is just one factor for the Commission to weigh when deciding whether or not to approve the merger, and based on the evidence in the record, the PSC's findings and conclusions were not unreasonable concerning this issue.

The judgment is reversed, and the case is remanded. The circuit court shall remand the case to the PSC to consider and decide the issue of recoupment of the acquisition premium in conjunction with the other issues raised by PSC staff and the intervenors in making its determination of whether the merger is detrimental to the public. Upon remand the Commission will have the opportunity to reconsider the totality of all of the necessary evidence to evaluate the reasonableness of a decision to approve a merger between UtiliCorp and SJLP.
State ex rel. AG Processing, Inc. v. PSC, 120 S.W.3d 732, at 736, 737 (Mo. 2003); emphasis added.

The Commission set out its understanding of how to analyze a pending merger application in a 2001 case involving Gateway Pipeline:

Pursuant to Commission Rule 4 CSR 240-2.060(7) and/or (12), the applicants must show why the proposed transaction is not detrimental to the public interest. The right to sell property is an important incident of the ownership thereof and "[a] property owner should be allowed to sell his property unless it would be detrimental to the public." State ex rel. City of St. Louis v. Public Service Commission, 335 Mo. 448, 459, 73 S.W.2d 393, 400 (Mo. banc 1934). "The obvious purpose of [Section 393.190] is to ensure the continuation of adequate service to the public served by the utility." State ex rel. Fee Fee Trunk Sewer, Inc. v. Litz, 596 S.W.2d 466, 468 (Mo. App., E.D. 1980). To that end, the Commission has previously considered such factors as the applicant's experience in the utility industry; the applicant's history of service difficulties; the applicant's general financial health and ability to absorb the proposed transaction; and the applicant's ability to operate the asset safely and efficiently. See, In the Matter of the Joint Application of Missouri Gas Energy et al., Case No. GM-94-252 (Report and Order, issued October 12, 1994) 3 Mo.P.S.C.3d 216, 220.

> Under the pleading presenting the transaction between Gateway and UtiliCorp for the Commission's approval, the moving parties assert that the transaction presented will not be detrimental to the public. Therefore, they have the burden of proving that assertion. Anchor Centre Partners, Ltd. v. Mercantile Bank, N.A., 803 S.W.2d 23, 30 (Mo. banc 1991); see also Dycus v. Cross, 869 S.W.2d 745 (Mo. banc 1994).
>
> Case No. GM-2001-585; In the Matter of the Joint Application of Gateway Pipeline Company, Inc., Missouri Gas Company and Missouri Pipeline Company and the Acquisition by Gateway Pipeline Company of the Outstanding Shares of UtiliCorp Pipeline Systems, Inc. 10 Mo. P.S.C. 3d 520; 2001 Mo. PSC LEXIS 1371, 5-7; Report and Order issued October 9, 2001.

In a merger case, as in all of its actions, the Commission must bear in mind that its primary purpose is to protect the public from the monopoly power of the utilities it regulates:

> The act establishing the Public Service Commission . . . is indicative of a policy designed, in every proper case, to substitute regulated monopoly for destructive competition. The spirit of this policy is the protection of the public. The protection given the utility is incidental. State ex rel. Sikeston v. Public Service Com., 336 Mo. 985, 999 (Mo. 1935)

III. DETRIMENTS

A. The risk of a debt rating downgrade.

All of the top officers of KCPL/GPE refused to voluntarily accept the risk of a downgrade. Ratepayers have no say in this matter, although the statutorily-appointed representative of the public has steadfastly and vehemently opposed this merger from the beginning. It is KCPL/GPE management and shareholders that want this merger. If the KCPL/GPE officers were truly convinced that the risk of a downgrade was so small, why would they not be willing to put that risk on shareholders? There are at least two possible answers: 1) the KCPL/GPE officers do not truly believe that the risk is small; or 2) they believe the Commission is as willing as they are to put the risk on ratepayers and so there is no need to volunteer to take the risk on shareholders.

KCPL/GPE witness Bassham stated:

> Q. Would KCPL be willing in this case to accept a similar condition, that is that the Commission approves the merger on the condition that KCPL -- that the Great Plains shareholders rather than KCPL ratepayers pay any increased cost of debt if a downgrade occurs shortly after approval of the merger or the acquisition?
>
> A. I wouldn't do that, and I don't think it's necessary mainly because we'll be able to come back -- we won't be able to. We are coming back to the Commission in the future with rate increases, and the Commission will be able to look at what has occurred and why it's occurred and how it's occurred, and if at that time they determine we had done something imprudently, I'm sure we'll have to answer for that. Making a blanket promise at this point is not something that I think's necessary.
>
> TR. 2320-2321

This passage (and a very similar answer Mr. Chesser gave at TR. 2540-2541) illustrates the "Catch 22" that the Joint Applicants are setting up for the Commission: if the Commission approves the merger and a downgrade results, how can the Commission say that consummating the very transaction that it just approved was imprudent? If the Commission approves the merger, it will have essentially said that it is not imprudent to consummate the transaction, and the Commission will have assigned all risk to ratepayers.

Mr. Downey, although he tried to avoid the question for eight pages in the transcript (TR. 2496-2504), finally confessed that he "would not accept the risk" on behalf of the company of increased costs if a downgrade resulted from approval of the merger. Mr. Chesser, perhaps learning from Mr. Downey's experience, quickly stated that he did not know whether he would be willing to commit the company and not the ratepayers to bearing that risk. (TR. 2539).

Mr. Bassham conceded that approval of the merger by itself could lead to a downgrade by either S&P or Moody's:

> [Q.] Do you concede that there is some risk that, all else being equal, a Commission approval of this merger could lead to a downgrade by either S&P or Moody's?
>
> A. I believe I would agree with that. I would say, all other things being equal, approval of the merger would cause us to absorb some additional dollars, risk that we don't currently have. That's certainly true.
>
> TR.2324

So did Mr. Downey:

> Q. Okay. So is it your testimony that there is zero risk that the rating may go down as a result of approval of this transaction?
> A. That's not my testimony.
> Q. Okay. So you concede that there is some risk?
> A. Yes.
> TR. 2496.

Mr. Chesser opined that the risk was small, but nonetheless agreed that there is "a very minimal risk" that a downgrade will result from the merger. (TR. 2540). And Public Counsel witness Dittmer also expressed grave concern that a downgrade could result:

> Q. All right. Now, the revised plan that has been submitted, do you think that the revised plan will result in a downgrade to KCP&L?
>
> A. I can't state that with certainty. What I can state is that the calculations and assumptions that the rating agencies used to give the opinion letter to Great Plains that there would not be a downgrading are not in total sync with what they're proposing in this case or what they've agreed to in Kansas.
>
> And I also state that it assumes that all of the synergies that they've projected are absolutely correct and will occur, and if they don't occur, then they are exposed to a downgrade. I cannot state that they will or won't, but they are definitely more exposed with those parameters.
>
> TR. 1681

Mr. Bassham explained that the ratings agencies' advisory letters (such as Exhibits 124HC and 125HC) are only as good as the information on which they are based. (TR. 2331).[2] In other words, if the ratings agencies are provided with information that proves to have been inaccurate, or with projections/estimates that do not pan out, the actual rating may turn out to be different than the advisory letter predicted.

Mr. Bassham stated of the way that Moody's and S&P operate:

> they can only operate off what we are able to provide them. Obviously they're not -- they don't know our company independently. And to the extent that ultimately things change, which obviously they do on an ongoing basis, the results could change. And so ultimately this is a service which provides you with an idea based upon assumption you give them what would happen, but once it actually happens, their job as S&P or Moody's would be to make an independent evaluation, and this says that that could change at the time they actually do that.
>
> TR. 2331

[2] The citation is to a portion of Highly Confidential Volume 18 of the transcript, but the description herein is extremely general and does not reveal information that KCPL/GPE consider to be Highly Confidential.

The only evidence in the whole record that gives any assurance that consummation of this transaction will not result in a downgrade are the two letters identified as Exhibits 124HC and 125HC. With respect to Exhibit 125HC, Mr. Bassham readily admitted that quite a few of the assumptions on which S&P based its assessment are not accurate or have changed since the opinion letter was created. (TR. 2335-2342). Although the cross-examination was not as detailed with respect to Exhibit 124HC, Mr. Bassham also admitted that things had changed since the letter was issued. (TR. 2358).

And those letters were based on Schedules MWC-18 and MWC-19 attached to the February 25, 2008 testimony of KCPL/GPE witness Michael Cline. Although Public Counsel challenged[3] the designation of those schedules as Highly Confidential, and KCPL/GPE admitted that some of the information in them is only Proprietary, the Commission decided to keep as Highly Confidential all portions other than those that KCPL/GPE grudgingly admitted were historic, public information.[4] As a result, the discussion herein of Mr. Cline's April 29, 2008 cross-examination respecting Schedules MWC-18 and MWC-19 will necessarily contain some rather cryptic references to Highly Confidential Volume 20 of the transcript. Although Mr. Cline submitted the schedules, he did not prepare them himself. With respect to much of the information in the schedules,

[3] Motion to Make Certain Documents Public and Request for Waiver, filed March 21, 2008.
[4] Order Granting, in Part, Motion to Make Certain Documents Public, issued April 8, 2008.

he was unable to explain what the schedules were meant to convey or how they were prepared. (See, *e.g.*, TR. 2548, 2554, 2555, 2556, 2557, 2558, 2559, 2562, 2566, 2569, etc.). Mr. Cline has a unique way of expressing himself – both "I don't have the detail" and "I don't have any visibility into what was there" mean "I don't know" – but he quite candidly admitted over and over that he didn't really understand MWC-18 and MWC-19, and had no basis for stating that they represent reasonable assumptions on which the rating agencies could base their "opinion letters." In fact, so unfamiliar was Mr. Cline with Exhibits MWC-18 and MWC-19, that it was at least debatable whether Mr. Cline was unable to lay an adequate foundation for the admission of these exhibits. The strongest defense that KCPL/GPE was able to offer was that "Mr. Cline actually did respond to a number of questions knowledgeably." (TR. 2608). The only way that the Commission can judge the accuracy and reliability of the exhibits is by looking at the testimony on the record of the witness who sponsored them (in this case, no other witness offered any testimony to support these exhibits). And the witness could not attest to the accuracy. He could not even attest to the fact that he understood some of the material. In fact, there were some numbers that he testified were inconsistent throughout the document and he was unable to say which were -- which were accurate and which were inaccurate. For example, in summing up a series of questions about Schedule MWC-18, Mr. Cline stated:

> Q. Now, with respect to … all four of those operating assumption bullets, [on page 9 of Cline schedule MWC-18] on what basis did you yourself evaluate their reasonableness?

A. I would not have had any basis to evaluate.
TR. 2559

Another of the significant – and totally unsupported in the record – assumptions provided to ratings agencies has to do with **

** Although the KCPL/GPE presentations to ratings agencies assumed it would be **

**, there is nothing in the record to support **

** Mr. Cline, the only KCPL/GPE witness to provide testimony about it, stated the following:

**

**

TR. 2555-2556

The Commission must keep in mind that the only evidence in the record to support KCPL/GPE's contention that a downgrade will not occur is Exhibits 124HC and 125HC. And the only information[5] that was provided to S&P and Moody's was that contained in Exhibits MWC-18 and MWC-19. Neither the parties nor the Commission can have any faith in the accuracy or reasonableness of the information in MWC-18 and MWC-19 because KCPL/GPE did not present a witness who was able to testify to their accuracy or reasonableness. As a result, although the Commission did (over objection) admit the exhibits, it can place no real weight on them. Even the Regulatory Law Judge presiding conceded that "certainly, Mr. Cline's ability to answer questions with regard to certain items will certainly be -- go to its weight and credibility of the testimony." (TR. 2621) And without relying heavily on those exhibits, the Commission can have no faith that the opinions offered in Exhibits 124HC and 125HC offer any real assurance that a downgrade will not occur.

In fact, some of the assumptions provided to the ratings agencies were just flat out wrong. For example, Mr. Cline testified that the information provided to

[5] There was apparently some limited follow-up that did not change any of the significant assumptions in MWC-18 and MWC-19. (TR. 2553).

S&P and Moody's showed that Aquila received a rate increase in 2007 of $117 million. (TR. 2562-2564). The Commission's own press release regarding the May 17, 2007 Report and Order in Case No. ER-2007-0004 (Aquila's 2007 rate case) stated: "Under the decision, Aquila's annual electric revenues will increase by a total of approximately $45.1 million in the MPS service area and approximately $13.6 million in the L&P service area." That is a total increase of $58.7 million – only half of the increase that KCPL/GPE represented to the ratings agencies. There may be many more significant misrepresentations, but because Mr. Cline was unable to testify about the details of Exhibits MWC-18 and MWC-19, the Commission has no way to judge the accuracy or inaccuracy of the exhibits. If the Commission is even tempted to approve the transaction, which it should not be, it should at a minimum require KCPL/GPE to go back to the ratings agencies with a new set of assumptions that have been developed with and vetted by the parties. Only if the new "opinion letters" give a very strong assurance of no downgrade should the Commission consider approving the transaction. We have seen that this process can be done quickly.

As recently as April 2, 2008, S&P warned that:

> if Great Plains chooses to proceed with the Aquila acquisition without obtaining the appropriate regulatory safeguards and assuming the company makes no other compensating modifications to its plan, lower ratings on Great Plains and Kansas City Power & Light Company could result.
> TR. 2365; Exhibit 136

When asked by Commissioner Murray what "compensating modifications to its plan" means, Mr. Bassham identified just three: 1) not doing projects that it has planned to do; 2) issuing hybrid securities; and 3) selling Strategic Energy. KCPL/GPE has already made all the "compensating modifications" that it can, and it is out of good options. With respect to 1), KCPL skipped the 2008 wind, and pushed some of the planned La Cygne improvements clear past the end of the Regulatory Plan. About all it could do now is cancel all future wind investments or stop the Iatan projects. With respect to 2), KCPL/GPE tried for much of 2008 to issue hybrid securities but could get no traction at all in that market. Nothing in the record or the financial press would indicate that such an issuance would get any traction in the foreseeable future. With respect to 3), GPE has already smashed the Strategic Energy piggy bank and taken the cash; there's nothing left there.

And the only other option that S&P holds out in Exhibit 136 that may fend off a downgrade is "appropriate regulatory safeguards." Although it is not entirely clear what that phrase means, it must be the kinds of special regulatory treatment that KCPL/GPE had in its original "ask" but that are no longer in its current "ask." Mr. Cline testified that he thought it indicated a "focus by S&P on the concept of additional amortization" (TR. 2581), which the Joint Applicants strenuously argue is not now being requested. Even though it is couched in language reminiscent of Alan Greenspan, S&P has all but told the investment community that GPE and KCPL are headed for a downgrade if they get regulatory approval and consummate the transaction. Although GPE has recovered somewhat from its 5-year lows in late March and early April of this year, it is clear that the investment community has taken S&P's dire predictions to heart. The Commission should do the same.

In order to satisfy AGP, the Commission must make a finding, based upon the record in this case, that the chances of a downgrade are negligible. The Commission cannot do so on this record. If the Commission chooses to approve this merger with so little reassurance about the prospects of a disastrous downgrade, it is playing Russian roulette with consumers' welfare. The Commission's primary purpose is to protect ratepayers. The Joint Applicants properly bear the burden of proof on this issue. Opposing parties have sufficiently cast doubt on the validity of the assumptions that KCPL/GPE fed to the ratings agencies that the Joint Applicants must be required to affirmatively show that the "opinion letters" (Exhibit 124HC and Exhibit 125HC) have any meaning.

But if the Commission nonetheless approves this transaction (assuming the applicants consummate it after approval) and a downgrade occurs, the applicants and the ratepayers will bear the detrimental consequences for many years. As the Commission is well aware from its experience with Aquila in the recent past, once a utility slips below investment grade, it is a long hard road back to financial health. Aquila has been helped by being able to sell most of its non-regulated (and many regulated) assets, and is now seeing the light at the end of the tunnel. GPE already cashed out its equity in Strategic Energy; it has no other non-regulated assets to sell. If KCPL/GPE slips below investment grade, its road back would likely be longer and harder than Aquila's.

And if the Commission decides not to approve the transaction, the impact on KCPL would not be great:

> "Q. [by Commissioner Clayton] So basically if the deal closes, you're out the 20 million and that's it? I mean, I don't want to say that's it, but ...
>
> A. [by KCPL/GPE witness Bassham] Financially, that would be the monetary value of our expenses so far."
>
> …
>
> Q. [By Mr. Conrad] …[Y]ou responded to the Commissioner that $20 million was pretax write-off if the PSC were to reject this merger, you characterized it as you'd have to write off "our expense." Whose expense?
>
> A. [by KCPL/GPE witness Bassham] Those would be GPE expenses.
>
> Q. And GPE, that's the same GPE that still is not a regulated utility?
>
> A. It is not.
>
> Q. So if that were a write-off, then that's just -- that's just what it is, there's no impact on KCPL, is there?
>
> A. Shouldn't be.
>
> TR. 1317, 1320-1321.

If the Commission approves this merger, even if there is not an immediate downgrade, the Commission will be under constant pressure for many years to raise KCPL rates and Aquila rates enough to keep both companies at investment grade. The Commission will be locked in to awarding high returns on equity. It will essentially be blocked from disallowing imprudent construction costs. It will have to accept KCPL's inflated equity ratio. In short, it will be held hostage to insuring that the companies do not get downgraded, and will not be able to fulfill its duty to protect ratepayers. As Public Counsel witness Dittmer noted:

[Q. By Commissioner Clayton] I want to focus on your concern of any of the companies either falling below investment grade or not getting above investment grade. Explain to me how that is a detriment to Aquila customers and KCP&L customers.

A. Well, Aquila customers, let me think about that first. Right now they don't have -- excuse me. They -- they're exposed to the regulatory amortization that KCPL has, and you have -- I have to defer to Mr. Trippensee's testimony, but I think he explains some things that Public Counsel felt that they got when they signed on to the KCPL agreement that are not in the deal so far with Aquila. So they will end up paying regulatory amortization even though they haven't gotten some of the benefits that the KCPL customers got when they entered into the stipulation on the KCPL side.

And on the KCPL side, Great Plains Energy side, it is exposure to -- well, either, you know, from the Public Counsel's position perhaps paying for transaction costs, transition costs that weren't fully recovered by synergy savings, or if they are disallowed for ratemaking purposes and they do not get recovered in rates, it could result in the financial matrix falling below investment grade targets, and that would result in a downgrade to KCPL and Great Plains Energy.

And, I mean, I think I had this discussion with Commissioner Murray. I mean, you get into -- you're trying to put ring fences around saying, well, okay, they got downgraded, but now we're going to put on our blinders, we're going to pretend that they are investment grade. We're going to only use investment grade interest, but then you're crawling out and you -- frankly, you're exposed to very aggressive rate filings at that point.

It's -- you know, it will be -- it just gets more aggressive when they fall below investment grade.

Q. You don't think the rate filings have been aggressive at this point?

A. I think they would get more aggressive. I really believe that.

Q. So KCP&L customers would face exposure to costs that are potentially not recovered, which would lead potentially to higher interest costs, higher capital costs, and would potentially lead to more -- a downgrade that would lead to additional regulatory amortizations; is that accurate?

A. Yeah. You're hitting it all. Then once they get downgraded, then you start -- potentially start cutting back your construction program and you start cutting service. So there's all those things happen when your investment grade rating falls below acceptable parameters.

Q. Okay. And do you believe that the Commission has the power, the ability to protect those customers if that scenario were to happen? Can we say no to additional regulatory amortizations if you have KCPL fall below investment grade? Can the Commission say no or is the Commission bound to grant those additional amortizations?

A. There's where you kind of go into Never-Never Land. I mean, you can say we only want to pass on prudent and reasonable costs, but then you will come in -- the company will come in with tremendous pressure on all fronts saying we've got to have more money, we've got to get investment grade back, we have to have reasonable rates, our shareholders can't bear this, we won't be able to provide quality service. So I don't know the answer. I can't state with certainty that you can box it in fully.

I don't think any Commission should knowingly take actions that will lead to a downgrade. I mean, that -- I've never heard of that being suggested and I've never heard of it happening. Sometimes unknowingly, you know, things happen and there's a downgrade, but to knowingly say we think the parameters are not good enough to allow an investment grade rating but nonetheless we're going to go forward and we're going to try and protect the ratepayers by just putting in regulatory interest, it just would be -- it would just be difficult for me to agree with that scenario. As soon as they get a downgrade, I think there's more pressure for rate relief.

TR. 1742-1745, 1749

Another significant incorrect assumption contained in the material given to ratings agencies is that KCPL will continue to be able to use a 55% equity ratio in its next rate cases. Mr. Cline testified that:

Q. Mr. Cline, did you participate in a -- in an investor conference on April 10th of 2008?

A. Yes, I did.

Q. Do you recall a question about debt and equity in which you answered specifically with respect to equity ratios that you manage towards?

A. Yes, I do.

Q. And on April 10th did you not say that, "What we have told people is that we are managing toward kind of a **55 percent**

> **equity ratio at the holding company which is what we also use for regulatory purposes at Kansas City Power & Light**"?
>
> A. Yes.
>
> Q. Okay. And is that, in fact, correct? Is that what you do manage to?
>
> A. In general that is a -- that is a very broad target.
>
> Q. Is it important to you as -- as treasurer of KCPL to behave consistently with commitments that the company made in the regulatory plan that was entered into in EO-2005-0329?
>
> A. Absolutely, yes.
>
> (TR. 1344; emphasis added).

But the Regulatory Plan calls for an equity ratio of 49%, not 55%, so something has got to give. Either KCPL will have to scale back and live under the terms of the Regulatory Plan and use approximately 49% equity instead of 55% for regulatory purposes at KCPL, or it will have to concede that it is not behaving consistently with the commitments that it made in the Regulatory Plan, and the Regulatory Plan will be terminated. These are the only options, and either one is significantly less favorable than the assumptions KCPL/GPE provided to ratings agencies which led to the conclusions in Exhibits 124HC and 125HC. If KCPL uses the 49% equity ratio that it agreed to target in the Regulatory Plan, its revenue requirement will be significantly lower in the next two rate cases than if it uses the 55% that it has been telling ratings agencies about. But if KCPL refuses, then the Regulatory Plan is no longer valid and KCPL will have to forego such benefits as regulatory amortizations and the “decisional prudence” with respect to its Comprehensive Energy Plan. Either one (a significant reduction in revenue requirement or the termination of the Regulatory Plan) would be seen by ratings agencies as much less favorable than the assumptions in Exhibits 124HC and 125HC.

If the Commission decides to approve the merger, it should at least insulate Missouri ratepayers from the effect of a downgrade. In at least one UCU case, the Commission approved the transaction subject to the following (among other) conditions:

> 6. That **any adverse financial effects of this acquisition are borne by the shareholders** of UtiliCorp United Inc.
>
> …
>
> 10. That UtiliCorp United Inc., exercise reasonable diligence and prudence to maintain its investment grade credit rating.
>
> <u>In the Matter of the Application of UtiliCorp United Inc., for Authority to Acquire the Shares of Avon Energy Partners Holdings and to Take All Other Actions Reasonably Necessary to Effectuate Said Transaction</u>; Case No. EO-2002-215; 2001 Mo. PSC LEXIS 1759; 11 Mo. P.S.C. 3d 25; issued December 18, 2001

One of the most experienced witnesses to appear in this case is Public Counsel witness Dittmer. The Commission is very familiar with his eminent qualifications, and should be aware that he is not given to hyperbole. So when Mr. Dittmer testifies about the possibility of a "death spiral," the Commission should be more than concerned – it should be scared that it might make a decision with disastrous consequences:

> Q. When you wrote your testimony that was back in October of 2007, you indicated on page 48 that you could not envision a scenario wherein enough conditions would be imposed that would adequately protect ratepayers from the detriment resulting from this merger. Now, considering the detriments that you see from the revised plan and, as I interpret what you've said, all centering around a potential downgrade of KCP&L if the synergies aren't realized, can

> you envision conditions which would protect from those potential detriments?
>
> A. I guess the short answer is no. Where I get caught or hung up is, if the synergies aren't real, let's say the Commission issues an Order and says we will initially allow you to defer transaction and transition costs and we accept that you're never going to ask for high cost in interest cost, but we expect you to prove it up in the next rate case.
>
> Next rate case comes along and ultimately parties disagree that the synergies have been realized and, therefore, you determine that synergy savings won't cover all the costs they're trying to recover in this proceeding, and now there will be -- now there will be a hit to those financial matrix which drive the credit rating, credit rating agencies' opinion. And at that point if there's a downgrade, there's high cost interest that comes through the pipeline for the next rate case.
>
> At that point, it would seem you would say, okay, we never saw this one coming up. This is really a cost of them not being able to prove up, not realizing their synergy savings. Now we've not only got high cost debt on the Aquila side that we're going to pass on to ratepayers, we now have high cost -- a little higher cost debt on the KCPL/Great Plains side, and we're not going to allow recovery of that, **and then you start moving into the so-called death spiral.**
>
> **That's the problem. You can -- the Commission can have a stated policy of we will never charge the ratepayers for costs that we don't think they should have to bear, but in this case there may not be enough cushion to prevent the downgrade if they occur.**
>
> TR. 1687-1689

Part of the problem is that, even though KCPL/GPE have dropped the explicit request to recover Aquila’s high cost of debt from ratepayers, KCPL/GPE will still have to pay it. It does not go away until about 2011, and KCPL/GPE will have to somehow come up with the cash to cover it, even with all the other ongoing expenses of the CEP projects that it is already struggling with. Public Counsel witness Dittmer discussed this problem:

> Q. As I understand your testimony there, you believe the purchase price agreed to in this case would appear to be in the range of reasonableness?
>
> A. Well, you have to read what I said after that. It is close to book value, and if you stop right there and put your blinders on, then you would say, yeah, it looks pretty reasonable. It's the added lug of the high cost debt that made what otherwise appears to be a reasonable price somewhat unreasonable.
>
> Q. And that's been withdrawn, is your understanding, correct, from the company's revised proposal?
>
> A. That has been withdrawn, but we're still exposed to the risk. The company still has to pay it even though they aren't directly asking for the ratepayers to pay for it. Presumably they're paying for it through synergy savings, which are again suspect.
>
> TR. 1664-1665

Staff witness Schallenberg also testified that the purchase price is unreasonable:

> Q. Do you agree with him that the price that has been proposed for this acquisition is a reasonable price?
>
> A. From a public interest perspective, I would not. From an Aquila shareholder, I would say it is.
>
> Q. Okay. Let's talk about public interest. Tell me why the price is not appropriate. Then give me an idea of what price would be appropriate as an example or a range.
>
> A. Why it's not appropriate right now is it transfers too much value to the Aquila shareholder that puts the combined Great Plains and KCP&L -- because there's no ring fencing there, so if Great Plains is in trouble, KCP&L's in trouble and Aquila, since it will be part of the combined entity under the transaction.
>
> It puts too much financial stress on them to have to try to absorb the excess consideration going to Aquila shareholders. That's why I would say it's not -- it's not beneficial to -- it's not in the public interest. It's not a fair price in the public interest. To an Aquila shareholder today, it's a fair -- I mean, it's a healthy premium.
>
> TR. 1841-1842

As a final thought on this issue, Public Counsel notes that it ill befits the Commission, whose primary duty is the protection of ratepayers, to so readily yield to the Joint Applicants' feeble arguments about why so much information must be kept secret. Public Counsel argued a number of times[6] that the mere fact that KCPL/GPE communicated certain information to ratings agencies does not render that information Highly Confidential under the Commission's rules, but the Commission uniformly sided with Joint Applicants on that question. Public Counsel still strongly disagrees with the Commission that this information should be kept secret, and has filed concurrently with this brief yet another motion to reconsider its previous rulings and open up information that the Commission has decided to keep secret.

B. The estimated transaction and transition costs are very significant.

There is general agreement among the parties to this case as to how these costs are defined,[7] although disputes can certainly arise in later cases about how particular costs are categorized. In Missouri, the historical norm has generally been to allow some recovery of transition cost, but not of transaction costs. In this case, KCPL/GPE is requesting Commission authority to defer both sets of costs for later recovery. The Joint Applicants propose to recover all costs (except

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[6] See, *e.g.*, TR. 1285, 1345-1346, 1361-1362, 1479-1480, 1787.

[7] Transaction costs are costs "incurred to accomplish the merger" and transition costs are those that "pay for the subsequent post merger transition…." Union Elec. Co. v. PSC, 136 S.W.3d 146, 151 (Mo. Ct. App. 2004)

certain severance payments that they voluntarily excluded) from ratepayers, and none at all from shareholders. TR. 1380-1381.

Public Counsel witness Dittmer, in his Rebuttal Testimony (Exhibit 200, page 43), explained why transaction costs are generally not recovered through rates but rather charged to shareholders:

> First, it should be recognized that transaction costs consist of cost incurred by both the acquiring company as well as the acquired company to simply complete the transaction. Transaction costs consist of items such as legal, banking and consulting fees directly related to closing the transaction. Inasmuch as these costs are only incurred to facilitate consummation of the transaction – and not to facilitate the provision of utility service – such costs are properly considered to be a part of the purchase price of the acquisition.
>
> As stated previously, absent the specific rate and accounting treatment being requested by the joint applicants, pursuant to Generally Accepted Accounting Principles, transaction costs would be added to the value of the consideration being given by GPE for the Aquila stock being acquired to arrive at the total purchase price of the transaction. The excess of total purchase price, including transaction costs, over the fair market value of assets being acquired would be initially recorded as a goodwill asset subject to impairment testing for potential immediate write-down or write-off.

Mr. Dittmer further explained why such costs should not be recovered from ratepayers:

> Historically utility businesses have been considered a franchised monopolistic service. As such, regulated utilities have enjoyed certain privileges in exchange for accepting certain obligations which are generally not applicable to non-regulated, competitive businesses. Often referred to as the "regulatory compact," utilities are generally required to provide non-discriminatory, safe and reliable utility service at prescribed prices in exchange for receiving the right to a certificated service territory (i.e., a non-competitive market), the right of property condemnation as well as the opportunity to recover all reasonable costs and the

> opportunity to earn a fair and reasonable rate of return. Under this arrangement, utilities are shielded from certain market and operating risks which plague competitive businesses. In exchange for these privileges, utilities are generally prohibited through rate regulation from earning unreasonably high "windfall" profits.
>
> Decades ago, regulators realized that the intent of protecting ratepayers from providing unreasonable returns to utilities would be circumvented if rates were developed by considering a return on investments above net depreciated original costs. If investments above net depreciated original cost were included in rate base and allowed depreciation or amortization recovery, investors could receive windfall profits, otherwise not achievable vis-à-vis continued ownership, by simply exchanging or selling utility property. To avoid this undesirable consequence, regulators have generally limited rate recovery to return of and return on net depreciated original cost utility investment.
>
> As noted near the outset of this testimony, Aquila elected to pursue a sale of all its remaining assets to maximize value for its shareholders. It did not enter into the transaction for the benefit of its ratepayers. Accordingly, the transaction costs which are not being incurred to facilitate provision of utility service, but rather, to facilitate a transaction to maximize value to shareholders, should not be directly passed onto ratepayers as the joint applicants are proposing.
>
> (Exhibit 200, Dittmer Rebuttal, pages 44-45).

Staff witness Schallenberg also testified that transaction costs should not be recovered from ratepayers:

> Transaction costs do not meet the normal criteria for traditional expenses used to establish rates. These costs are not used or useful nor necessary for the provision of safe and adequate service. These costs are investor costs incurred in the buying and selling of their stock. These costs are the fees stockholders incurred when buying or selling stock. These are the costs of a non-regulated holding company. GPE and its Board decided to incur these costs. KCPL and its Board made no decision to be involved in this transaction as already discussed. Recovery of these transaction costs would result in regulated utilities subsidizing their non-regulated parent companies.
>
> (Exhibit 100, Staff Report, page 51).

Mr. Schallenberg elaborated on this point during the hearing:

> A. That the transaction costs should not be recovered from -- by the Applicants through their -- their rates.
>
> Q. And can you give me further explanation why you don't think that's appropriate?
>
> A. Well, generally speaking, in this case, the utility, KCP&L, is not a party to the transaction. The transaction is Great Plains Energy through a sub that it will create, and in fact, I think the sub's already created. It will acquire the ownership of Aquila. And so those -- and those costs are -- are on Great Plains' books, they are costs of Great Plains. So generally speaking, as a matter of regulatory philosophy, utilities don't pay the costs of their nonregulated parents. And so I'm opposed to the suggestion that KCP&L should in some way transfer those costs to its books and then have those deferred for recovery in a future rate case because they're not -- they're not KCP&L's costs. KCPL is not even a party to that.
>
> On the other hand, in Aquila's case which is another component of the transaction cost in -- as it exists today, there is a commitment from Aquila, or an understanding that these transaction costs from their merger and acquisition activity were not going to be included in rates. So a continuation of that philosophy today would be -- is that that still wouldn't -- that that would still be applied and customers still wouldn't pay those costs.
>
> TR. 2050

Furthermore, the total amount of projected transaction costs is much higher than the prior UCU/KCPL merger. TR. 2053

If the Commission approves the transaction, KCPL/GPE is confident that disallowing recovery of transaction costs would not change its rating. KCPL/GPE witness Bassham testified:

> Well, it would obviously have an impact on us. It would be, you know, forty -- $47.2 million we wouldn't recover. All other things being equal, only disallowing those dollars over a five-year period in and of itself would not change our rating, I don't believe.
>
> TR. 1323.

Mr. Chesser offered a similar opinion.

C. KCPL should re-focus on its construction projects, not integrating its operations with Aquila's.

The resources of any company are finite. KCPL is no exception. Many entities, including the Commission Staff, the previous Public Counsel and other customer representatives, spent a great deal of time and effort to create and seek approval of the Regulatory Plan. KCPL's performance under that plan has – by any measure – been somewhat poor, and it will certainly not be improved if the company's resources are diverted to accomplishing its so-called "integration of operations" with Aquila. Public Counsel witness Dittmer testified:

> Q. Now, you testified earlier that simply calculating the synergies is a very intensive process. Is it your understanding that achieving the synergies will also be a difficult process?
>
> A. I would -- yes, I would agree.
>
> Q. Now, are you familiar with the suite, I should say, of projects that are part of the comprehensive energy plan, the infrastructure projects?
>
> A. I read the stipulation at one point in time, not recently. I know, you know, Iatan, pollution control and wind were three big ones. There probably are some others, but those three come to mind.
>
> Q. Is that group of projects a fairly aggressive construction program for a utility?
>
> A. Yes. It was a -- it was a big number relative to KCPL's then investment.
>
> Q. Will managing that kind of projects also take a lot of attention?
>
> A. Yes, I would agree, it would.
>
> Q. Is a company's ability to take on and manage big projects unlimited?
>
> A. I guess they're unlimited to go out and get outside resources to help them, but generally, no. You can't -- you have to

> divide -- you have to allocate your limited resources between projects.
> TR. 1778-1779

Even before the recent crane collapse, KCPL's first reforecast of the Iatan projects showed them to be much more expensive than the Regulatory Plan contemplated. A second reforecast is going to be done next year. While all the KCPL witnesses refused to admit it, it is a foregone conclusion that the cost will again go up, possibly way up. KCPL has decided to put off – for a number of years – significant portions of the La Cygne upgrades that are required by the Regulatory Plan. KCPL decided not to go forward with the 2008 wind investment because it could not arrange financing. Against this backdrop of building financial pressure on KCPL and its loss of control over the CEP projects, KCPL wants to functionally integrate with Aquila. During a time that KCPL should be focused on building a power plant that is falling increasingly behind schedule and increasingly over budget (and completing its other obligations under the Regulatory Plan), KCPL's management, instead, wants to turn its attention to the integration of Aquila into KCPL.

D. Additional (regulatory) amortizations for Aquila will be detrimental to the public interest.

Even KCPL/GPE admits that it has every intention (if this transaction is approved) of seeking regulatory amortizations for Aquila at the very first opportunity:

> Q. Does that indicate that there will be a request for additional amortizations in a future regulatory plan for Aquila?
>
> A. Yes, sir. Consistent with what I just told you, which was **we will ask for a amortization provision in a regulatory plan** which we want to work with the parties on, and if we're not able to come to an agreement on that plan, then as I sit here today, I would anticipate asking for that in a future case.
>
> But because we're not asking for it here, there's no binding request to the Commission, so it may or may not ever be granted, or asked, for that matter.
>
> TR. 1272; emphasis added.

Similar evidence is in Exhibit 125HC:

**

** Exhibit 125HC

And in Exhibit 124HC:

**

** Exhibit 124HC

And Public Counsel witness Dittmer explained how the regulatory amortization issue has been presented to ratings agencies:

> Q. And the request for an additional amortization provision for Aquila in future rate cases?
>
> A. Well, my understanding is that they withdrew it as a condition of approval of this case, but they very much intend to come right back and ask for it in the next rate case.

Q. They've indicated they would like to visit with the Public Counsel and other interested parties about that kind of a provision in a regulatory plan; is that your understanding?

A. Well, they definitely said that they would like to visit, but they've also -- my understanding is **they've basically represented to the rating agencies that it would occur.**

TR. 1661; emphasis added.

Under the AGP ruling, supra, the Commission cannot simply ignore the additional amortization issue; it is very much a part of this transaction. Furthermore, it is also a factor in the question of the reliability of the assurances provided in Exhibits 124HC and 125HC. If the ratings agencies have been told that it would occur, how reliable are their reassurances?

Public Counsel witness Dittmer had a significant discussion of the amortization issue with Commissioner Clayton:

21 Q. Okay. Now, what is your understanding of the current proposal as it relates to interest cost? How -- if we were to approve the merger, according to the current proposal, who pays that extra interest cost that is not built in to Aquila's rates right now?

A. Great Plains Energy shareholders.

Q. So the shareholders would pay -- in theory would pay that extra cost unless at some point they're included back in rates?

A. Pay it in the terms of reduced actual earned return below targeted authorized return.

Q. Okay. Now, you mentioned right before we left, I asked about the interest cost, and you responded to me with a -- with an answer that related to regulatory amortizations or additional amortizations. I want you to explain how you were answering my question, if you recall.

A. If I'm remembering the question and scenario correctly, what I was trying to relay is part of the company's proposal in this case is were -- they're saying we're not asking for a guarantee of regulatory amortization but it's coming. We're going to ask for it in the next rate case, and at the very time that you're trying to calculate extra expense, amortization expense, the company will be incurring interest costs that it was not collecting from ratepayers.

> So you get into a real odd situation where I guess you're trying to calculate theoretical investment grade interest and the lug that you would have to pay on that, on the amortization expense at the very time that the company's eating some interest costs, and whether the two would balance out to where they could actually keep their investment rating.
>
> Well, No. 1, you'd have to make the decision because I know the Public Counsel at this point is opposed to approval of regulatory amortization for Aquila for specific reasons stated in Mr. Trippensee's testimony. But even beyond that, if the Commission disagreed and gave that to them, you could -- you could have a scenario where you're giving the company more in revenues than can be justified under traditional rate of return with the intent of keeping investment grade rating, and because of the interest cost recovery that's not occurring, you could still have a downgrade. And I think that would be an ironic and unfortunate situation, but it's something that this Commission certainly needs to grapple with.
>
> TR.1734-1736

<u>E. KCPL/GPE have not requested authority to merge (directly or indirectly) Aquila with KCPL.</u>

Public Counsel anticipates that the Staff will persuasively present this issue in its brief, so Public Counsel will not devote a great deal of attention to it here. This is, however, a critical issue. The Joint Applicants have provided absolutely no information about they intend to operate the “functionally integrated” companies, and indeed that information does not exist:

> Q. The synergies are based upon the integration and centralization of the operations of Aquila and KCPL, are they not?
>
> A. They are.
>
> Q. If Aquila and KCPL were not permitted to integrate or centralize their operations, would GPE close or consummate the transaction?
>
> A. The definition of close is difficult. If -- if you're asking would -- would we be -- would we be able to generate the savings that we've projected here and we anticipate would benefit ratepayers

> if we're not allowed to operate as a joint entity, the answer is no, we wouldn't be able to.
>
> Q. Are there presently any contracts or agreements between KCPL and Aquila to integrate or centralize their operations?
>
> A. We've not executed operating agreements of any sort yet. There may be agreements between the companies of some sort on a day-to-day basis, but in terms of our operating agreements to combine centralization, we've not yet. If that were something the Commission felt important, we certainly could do that.
>
> We're working very hard on a cost allocation manual which would be used to allocate costs between the two entities to be sure that costs are allocated appropriately between the two companies based upon appropriate need and usage.
>
> TR. 1382-1383

In the entire record in the case, the most detailed explanation of what the Joint Applicants want the Commission to approve came very late in the process:

> what we would like reflected in the Order is an acquisition or a merger of Aquila into Gregory Corporation, which then would be Aquila as a separate subsidiary of Great Plains Energy. What we would like included in the Order is the ability to operate non-generation, operate the two utilities in an integrated fashion.
>
> In other words, the way we plan to operate, and this is where it gets a little confusing when we talk about operating agreements, is Bill Downey will be president and CEO of both companies, and to the extent we can use KCPL as essentially a service company to Aquila and track those costs, track all the interplay between the two, that's where we can generate the synergies.
>
> So what we would like the Commission to do is authorize us to operate on an integrated basis, except for any generation production and any -- we're not selling or transferring assets, simply services.
>
> TR. 1486-1487

Staff witness Schallenberg explained why the lack of any concrete information about how the "functionally integrated" companies will operate is so detrimental:

> [W]ouldn't a cost allocation manual identify potential savings and how costs would be divvied up for common costs, common

services, common portions of the business, like HR, personnel, customer relations, that sort of thing? And can't that be done in the way this merger application was filed?

A. The cost allocation manual would handle standard corporate governance, you know, common board, that kind of thing. Now, when you start talking about trying to commingle service centers, call centers, employee groups and stuff like that, you're going to need -- to keep -- to know where the cost and all that stuff goes and who the responsibility is, you're going to need a defined operating or ownership agreement to define who's going to be responsible for what before you can do any kind of cost assignment or allocations.

Q. Through some sort of operating agreement?

A. Right.

Q. And those -- you're saying that there is no -- none of that exists right now?

A. No. I mean, not -- I know we've -- we've done discovery and tried to find it, and they do not exist, unless they've been drafted since the last time we asked the question.

Q. And you absolutely need documents such as that to measure potential savings, synergy savings?

12 A. I would say so, because that actually is the foundation that defines the transaction, how you're going to operate, of which then you look at and say, okay, if we do that versus what we're doing now, what is going to be the result? And usually in the process of forming those operating agreements, you sit down and define the specific obligations for KCP&L and for Aquila, and from that, in fact, a lot of times when you actually do that, you're actually putting numbers together to look at what impact that has on us because that dictates what you put in as how you're going to share costs.

...

Q. Now, what kind of transaction would have to be before us before we could look at the savings between that would be created by the combination of operations that is proposed here between KCP&L and Aquila?

A. You would need at a minimum the operating agreements and ownership agreements that would be the basis of the combination and integration, merger, whatever is really being proposed between KCP&L and Aquila. So you would have an understanding of the respective legal entities' obligations, responsibilities.

> Q. Now, earlier there was talk, I believe it was in one of the opening statements, about a cost allocation model being the -- the cost allocation manual, I mean, being the -- the document or the method by which we would determine that each entity was allocating costs and responsibilities appropriately. It's your position that a cost allocation manual is not -- would not accomplish the same thing as an operations agreement presented at the time of the merger proposal; is that accurate?
>
> A. The cost allocation manual is not a -- it uses the operating agreements to know how to assign what transactions it's assigning costs for. So it's -- it's designed, unless you're doing it just inner-division or just within the same entity, but when you're crossing between legal entities, the cost allocation manual would need to know the nature and the scope of the transaction so it knew what costs to capture and then, based on the nature of the activities, what's the appropriate way to assign those costs, because you have to give instruction to employees and to the cash management group to know how to code expenditures or to assign time.
>
> TR. 1856-1857, 1876-1877

In short, without operating agreements and/or other detail, there is no way the Joint Applicants or the Commission can have any faith in the synergy savings estimates.

<u>F. Once approved and consummated, there will be no turning back.</u>

As noted above, if the Commission approves the Joint Application and allows this transaction, it will be playing Russian roulette. And just like Russian roulette, once the trigger is pulled, there is no way to take it back. The Joint Applicants frequently refer to savings that they believe will be achieved on “Day

One." One of the things they mean by this is that on "Day One,"[8] Aquila will cease to exist as anything but a legal artifice. It will have no employees, it will have no management, and in short order it will not even have its name. As KCPL/GPE witness Cheatum put it: "Once the merger is finalized, there will no longer be an Aquila. It will be Kansas City Power & Light…." (TR. 1503). All of this will happen so quickly that if the Commission has second thoughts, or if a reviewing court decides that the Commission did not consider all the factors it should have or came to the wrong conclusion, it will be too late.

III. BENEFITS

A. The estimated savings are exaggerated.

1. "Enabled savings" should not be included.

Perhaps the most significant of the many problems with KCPL/GPE's estimates of expected synergy savings is that much of the savings are not really attributable to the merger. Public Counsel witness Dittmer described the process that KCPL/GPE went through to develop its savings estimates:

> GPE/KCPL have undertaken studies in an attempt to estimate the incremental costs that GPE/KCPL will incur to construct, operate and maintain the Aquila Missouri electric properties following the merger. Such studies have attempted to determine staffing and other resource requirements that GPE/KCPL will experience following the merger. According to GPE/KCPL witness Mr. Robert Zabors, this process was undertaken by integration planning teams consisting of

[8] It is possible that "Day One" is not literally the first day after the Commission's approval is effective, but it is quite clear that the Joint Applicants intend to move very, very quickly.

> KCPL and Aquila management and employees. It is my understanding that the integration planning teams have basically attempted to develop a budget for the merged entity "from the bottom up" with obviously no historic data to employ as a test for achievability.
>
> Further, and importantly, the integration teams have incorporated within such "bottom up" budgets anticipated efficiencies that are expected as KCPL and Aquila exchange "best practices" in various functional areas. Or in other words, the integration teams have concluded that KCPL is more efficient in certain functional areas than Aquila and vice versa. Selecting the "best practices" from each stand alone entity, GPE/KCPL includes in its "bottom up" estimation process efficiency gains and attendant savings that are not directly and exclusively related to the merger.
> (Exhibit 200, Dittmer Rebuttal, page 27)

KCPL/GPE witness Zabors explained the two types of savings that he and his integration teams identified:

> Two primary types of synergies result from mergers. The first type of synergies occurs as a direct result of combining the entities. That is, "but for" the merger, these synergies would not exist. These are commonly called "created savings. These include overlapping positions and functions as well as savings that result from economies of scale. The second type of synergy is "enabled" by a merger. The merger enables the company to apply improved practices, processes and skills from either party. Synergy estimates in this analysis include both types of synergies. (Zabors Supplemental Direct, page 6)

Mr. Dittmer explained the problems with including "enabled savings" as part of the synergy savings attributable to the merger:

> In some instances it is possible to identify and quantify "enabled" savings. For instance, in the production area, virtually all of the claimed savings are clearly identified as resulting from the exchange of generating plant operating procedures and maintenance programs or from installing new equipment on existing production facilities. Mr. F. Dana Crawford discusses the various production equipment expected to be installed as well as the various processes anticipated

> to be implemented to achieve savings. In the case of the production function, "enabled" savings are clearly identified and quantified.
>
> However, with regard to other synergy savings claimed, it would likely be impossible to distinguish and quantify "created" versus "enabled" savings. This conclusion is further confirmed by the joint applicants' response to OPC Data Request No. 5031 wherein the joint applicants were requested to provide a breakdown of "created synergies" versus "enabled synergies." The response stated in relevant part that "[n]either Mr. Kemp nor other KCPL witnesses attempted to develop a quantitative breakdown between these types of synergies."
> (Exhibit 200, Dittmer Rebuttal, page 29).

Moreover, because of the way KCPL/GPE did its analysis, there are some "enabled synergies" that cannot be broken out from the quantification of total estimated synergies. Mr. Dittmer testified that many of these are simply embedded in the analysis as best practices:

> There are several references to exchanging "best practices" between the joint applicants that have in some fashion been considered in the development of synergy savings, including the following:
>
> - Mr. Wallace Buran discusses anticipated operation and maintenance savings in the amount of $78 and $31 million of avoided capital cost savings for the first five years following the merger resulting from "implementing 'best practices' spend management[9]." Some of the elements contributing to the expected savings, such as eliminating duplicate expenditures and achieving higher volume leverage, can be correctly characterized as "but for" savings only achievable with the merger. However, other elements, such as increasing strategic sourcing effectiveness, improved supplier contract compliance, and application of best sourcing knowledge from both organizations, could be achieved absent the merger. It is not possible to assign the total claimed $109 million (i.e., $78 million of O&M savings and $31 million of avoided capital

[9] The term "spend management" is not defined in Mr. Buran's testimony, but appears to be a term of art he utilizes to refer to the efficient sizing, ordering and acquiring of goods and services needed for both utility operations and construction.

cost savings) of spend management savings between "created" versus "enabled" savings, but clearly a portion of the $109 million of spend management savings has been predicted to occur as a result of simply implementing improved programs and procedures.

- Mr. Buran also describes anticipated savings of approximately $6.7 million during the first five years following the merger in warehouse and inventory costs. Included within such estimated savings are cost reductions stemming from reducing warehouses, storerooms and inventory that result from adjoining service territories, eliminating duplicate inventories, and negotiating larger volume discounts that can only be achieved with the proposed merger. However, in arriving at claimed savings for this category the joint applicants also considered potential savings from applying KCPL's vendor-managed inventory programs to Aquila's warehouses and building upon purportedly superior supplier relationships that KCPL has fostered with certain suppliers. Thus, a portion of the claimed $6.7 million of warehouse and inventory savings is estimated to occur as a result of simply implementing process and program changes that could be implemented absent the merger.
- Mr. Buran discusses anticipated savings of $1.5 million resulting from Asset Recovery and Reclamation processes. A portion of the claimed $1.5 million savings is expected to occur as a result of negotiating better terms and conditions with vendors buying scrap and recycled materials from the larger merged entity. However, clearly a portion of such savings was estimated by assuming an exchange of best practices between KCPL and Aquila regarding recycling, replacing and refurbishing equipment.

(Exhibit 200, Dittmer Rebuttal, pages 31-32).

Mr. Dittmer summarized the reasons that enabled savings should not be considered merger savings for the purposes of the "not detrimental to the public interest" analysis:

> [A]ny savings attributable to an acquisition or merger should be limited to savings that are quantifiable and clearly related to structural differences in ownership or operations. By "structural differences" I am referring to unique and definite considerations such as economies of scale, geographic synergies, geographic advantage related to interconnections with other utilities, preferential

tax or preferential financing treatment which simply would not be available to the former owners of the stand alone entities no matter what level of effort was put forth by the previous management. I do not believe that savings generated simply by greater efficiencies of new management which could have or should have been implemented by former owners/managers of the stand alone entities should be utilized to offset the various incremental costs being incurred exclusively to facilitate the transaction (i.e., transaction costs and incremental interest costs).

…

First of all, savings from any new-found or recently-implemented efficiencies will inure to the benefit of the merged entity prior to the first rate case and, thereafter, in between rate cases until all efficiencies are fully implemented and reflected in rates. Therefore, to a certain extent – due to the phenomena of regulatory lag – the merged entity will benefit from implementation of efficiency gains indirectly resulting from the transaction even if such efficiency savings are ultimately incorporated in the ratemaking formula at the time of rate case proceedings.

Second, it is generally agreed that regulation is intended to be a surrogate for competition. In a non-regulated environment, companies not operating efficiently would be forced to become efficient if they are to survive and prosper. If a merged regulated utility company implements efficiencies which could have been implemented under prior stand-alone ownership, the conclusion drawn is that the previous owners were not providing reliable service at the lowest cost possible consistent with prudent safety standards and that regulation, perhaps temporarily, had failed in its role as a surrogate for competition. Arguably, ratepayers are no worse off if the merged entity retains the savings from efficiencies gained from the exchange of ideas, processes and procedures between the previous two stand alone entities to "offset" or "pay for" transaction costs or merger premiums related to the merger. However, under such scenario ratepayers will never benefit from the merger – or will not benefit from the merger for an extended period of time. Further, if as in the instant case, all of the incremental cost associated with the transaction proposed by the joint applicants exceed the sum of "created" as well as "enabled" savings, ratepayers will clearly be harmed as a result of the merger.

(Exhibit 200, Dittmer Rebuttal, pages 33, 34).

> He elaborated on this point about enabled synergies at the hearing:
>
> Q. And is it your understanding that KCPL will be hiring Aquila's customer service operation expert Jim Albers to lead KCPL and Aquila's customer service operations after the transaction closes?
>
> A. I don't recall that specifically.
>
> Q. Okay. Let's assume for a minute that that's in the testimony. Would you expect someone to come over from KCPL or to be able to give his expertise to the KCPL customer service operations if the transaction was not approved and he remained at Aquila?
>
> A. Perhaps not that individual, but, I mean, we now have public records of what can be done. I would be -- I think Aquila or KCPL would be remiss not to look at where the management consultants have found supposed areas for improvement and go forward now. The question is why they didn't do it sooner. We don't know the answer to that, but clearly they should move forward on their own, maybe not with those specific individuals crossing from the two companies.
>
> TR. 1673-1674

Some of the questions by Commissioner Murray appeared to indicate a concern that Aquila might not be able to achieve the full range of "enabled" synergies absent the merger because the process of realizing some of them might be somewhat capital intensive. Unlike KCPL, Aquila has not made any filings with the Commission stating that it has opted not to proceed with a capital project because of trouble arranging financing, but KCPL has. In Case No. EO-2008-0224, KCPL recently filed a notice that, because it was unable to arrange financing under favorable terms, it had decided to not go forward with the wind projects that it had only a few months before been planning to complete in 2008. Aquila has not had similar problems. Furthermore, of the enabled savings that Mr. Dittmer identified, most are not capital intensive. TR. 1769-1770.

The Commission should not require other parties to conduct an entire "bottom-up" analysis of synergy savings in order to discredit KCPL/GPE's savings estimates. Public Counsel witness Dittmer pointed out that the Joint Applicants have literally spent millions of dollars to get to their estimates, and it would take at least a couple of million – and maybe more – to do a similar analysis. For a point of reference, Public Counsel's annual budget for all cases for all utilities is less than a million dollars. The Commission should not accept Joint Applicants' synergy savings estimates as gospel just because they've spent a lot more money than any other party can afford to do its own estimates.

<u>2. The value of some of the "created savings" is inflated.</u>

Furthermore, in addition to the problems with including "enabled savings," many of the claimed "created savings" are exaggerated. Although Public Counsel witness Dittmer did not do an exhaustive review of the synergy savings estimates, he was able to clearly identify some claimed "created savings" that were inflated:

> The joint applicants have identified a number of Aquila management positions that will be eliminated if the merger is consummated that should result in savings. This is typically an expected result as typically mergers can achieve economies of scale when the combined entity can accomplish certain tasks with fewer personnel than is occurring with two stand alone entities. This occurs most frequently with regard to corporate overhead functions such as treasury, information technology, accounting, human resources, and corporate governance functions. In this case, Aquila's Missouri electric operations are already part of a larger Aquila organization owning and operating utilities in five states. As a result of already being part of a larger utility organization wherein one would expect economies of scale for corporate overhead functions to already exist,

> the typical overhead savings expected from mergers are not as certain to result.
>
> While the joint applicants have estimated savings in personnel expected from consolidating duplicate activities, they have not considered that as a result of merged entity being larger, that GPE and KCPL executives and upper management will likely demand higher compensation packages. Compensation for corporate executives and top management is typically established by considering the compensation being paid other corporate officers/top management in comparably sized corporations. GPE/KCPL's synergy studies have incorporated the savings anticipated from eliminating Aquila officers and management, but have not added an allowance for increased pay for GPE/KCPL executives and managers that will likely result as compensation studies present higher pay packages of larger "comparables." In response to a question regarding compensation studies for GPE/KCPL officers and employees, GPE/KCPL indicated that it was unlikely that the larger size of the merged company would have an impact on the "comparables" employed in future compensation studies. That stated, they indicated that they would not be agreeable to limiting compensation for officers, executives and employees above that which would reasonably be expected if the merger were not consummated. Further, they agreed that the assumption of not increasing compensation for the increased size of the merged entity was not a "conservative assumption."
> (Exhibit 200, Dittmer Rebuttal, pages 36-37).

Staff witness Schallenberg also agrees that the estimates of synergy savings are overstated:

> Q. Are you aware that Mr. Dittmer also testified that he believes the estimated synergy savings in this transaction have been overstated?
> A. Yes.
> Q. Do you agree or disagree with that testimony?
> 5 A. I agree they're overstated.
> TR. 1901-1902

3. The "escalation" factor is inappropriate.

Public Counsel witness Dittmer disagreed that the way that KCPL/GPE calculated an escalation factor to use in estimating synergy savings is either appropriate or "conservative." KCPL/GPE witnesses repeatedly characterized their estimates of synergy savings as conservative; the other witnesses, including Mr. Dittmer, disagreed. One of the facets of the KCPL/GPE analysis that does not qualify as "conservative" is the way in which KCPL/GPE escalated costs. The "bottom up" incremental cost estimates that the integration teams developed were compared to Aquila's actual 2006 "base line" costs. Both the incremental costs and the base line costs were then escalated by a factor of 3.1% per year to arrive at estimated synergy savings for each year 2008 through 2012. The process of escalating the estimated incremental costs and Aquila's stand alone 2006 base line costs for inflation had the effect of escalating merger savings for the 2008 through 2012 period. Such an adjustment is not appropriate, and it is certainly not consistent with a "conservative" estimate of savings. Mr. Dittmer explained why not:

> I would simply observe that I do not view the application of a CPI-inflation factor to calculated synergy savings as "conservative." It is reasonable to expect that gains in productivity would offset some of the impact of price inflation experienced with wages, goods and services being purchased by GPE/KCPL. Accordingly, I do not view the application of an inflation factor to calculated merger savings to be "conservative."
> (Exhibit 200, Dittmer Rebuttal, pages 41-42).

4. Adopting KCPL/GPE's "spend management" best practices may do more harm than good.

KCPL/GPE readily admits that best practices spend management is the largest single piece of the estimated $131 million savings from supply chain synergies. (TR. 1527). The parties were prohibited from exploring – even by way of an offer of proof – whether KCPL's spend management practices can be considered "best practices," but that is a critical assumption underlying the estimate of these synergy savings. As Public Counsel explained – to no avail – at the hearing:

> But I think it's of paramount importance that the Commission fully investigate all of the issues that may pertain to whether or not this transaction is detrimental to the public interest.
>
> …
>
> And with respect to purchasing practices and supply chain savings, I think the company has made that a -- certainly one of the strong parts of their arguments in favor of approval of the merger, that supply chain savings and purchasing practices at KCPL are very good and superior to those at Aquila, and I think the Staff certainly has the right and the Commission has the obligation to hear issues concerning GPE and KCPL's purchasing practices.
>
> TR. 2084

Because the Commission refused to allow, even as an offer of proof, the Staff's case about the problems with KCPL/GPE's purchasing practices, the record is incomplete and lopsided. The Commission has the completely unrealistic KCPL/GPE $131 million estimate of savings in this area, but refused to entertain any evidence about why it is inflated and unrealistic.

CONCLUSION

For all the reasons stated herein, the Commission should decline to approve the proposed transaction.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to all parties this 2nd day of June 2008.

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