Exhibit No.:
Issues: Merger Premium
Merger Tacking
Frozen Capital Structure
Witness: Cary G. Featherstone
Sponsoring Party: MoPSC Staff
Type of Exhibit: Rebuttal Testimony
Case No.: EM-2000-369

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

CARY G. FEATHERSTONE

UTILICORP UNITED INC.

AND

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Jefferson City, Missouri
June 2000

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CARY G. FEATHERSTONE

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UTITICORP UNITED INC.

AND

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM–2000–369

Q. Please state your name and business address.

A. Cary G. Featherstone, 3675 Noland Road, Independence, Missouri.

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

A. I am a Regulatory Auditor with the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. I graduated from the University of Missouri at Kansas City in December 1978 with a Bachelor of Arts degree in Economics. My course work included significant study in the field of Accounting.

Q. What has been the nature of your duties while in the employ of this Commission?

A. I have assisted, conducted and supervised audits and examinations of the books and records of public utility companies operating within the state of Missouri. I have participated in examinations of electric, industrial steam, natural gas, water and sewer and telecommunication companies. I have been involved in cases concerning proposed rate

increases, earnings investigations and complaint cases, as well as cases relating to mergers and acquisitions and certification cases.

Q. Have you previously filed testimony before this Commission?

A. Yes, I have. Schedule 1 to this testimony is a summary of rate cases in which I have submitted testimony. In addition, Schedule 1 identifies other cases I have directly supervised and assisted.

Q. With reference to Case No. EM–2000-369, have you made an examination and study of the books and records of UtiliCorp United Inc. and The Empire District Electric Company relating to the proposed merger application?

A. Yes, with the assistance of other members of the Commission Staff (Staff).

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of UtiliCorp United Inc. (UtiliCorp or UCU) and The Empire District Electric Company (Empire or EDE), together referred to as the "Joint Applicants" or "Companies," regarding their proposal to merge. I will provide testimony setting out a general review of the regulation of utility merger and acquisition activity in the state of Missouri. I will present testimony relating to what is commonly referred to as the "acquisition adjustment" (or "merger premium" or "acquisition premium") resulting from the proposed merger. I will also address the issue of rate recovery of this "merger premium" along with Staff Accounting witnesses Mark L. Oligschlaeger, Charles R. Hyneman and Janis E. Fischer. Staff witnesses David Broadwater of the Financial Analysis Department and Michael S. Proctor of the Electric Department also address the acquisition adjustment issue.

Q. How does your testimony filed in this Merger Application compare to the testimony you filed earlier concerning the same issues in the UtiliCorp/St. Joseph Light & Power merger application, Case No. EM-2000-292?

A. The testimony is very similar to that which I filed in Case No. EM-2000-292, and in many sections, is identical. I have not added any new sections except a section on summary and conclusions..

Q. How is your testimony organized?

A. The following represents the structure of the testimony by areas:

1. Mergers and Acquisition Background
2. Background of the Empire District Electric Merger with UtiliCorp United Inc.
3. Standard of Public Detriment
4. Acquisition Adjustment
5. UtiliCorp's Regulatory Plan
6. Historical Perspective Relating to Acquisition Adjustments
7. Gains on Sale of Utility Property
8. Disallowance of Merger Premiums in Rates does not Affect Mergers being Completed in Missouri
9. Termination of the KCPL Merger with Western Resources
10. Merger Tracking
11. Customers are Entitled to Savings Generated by Utilities for either Merger or Nonmerger Events
12. Commitments Made/Promises Kept
13. Capital Structure
14. Summary and Conclusions

MERGERS AND ACQUISITIONS BACKGROUND

Q. What has been your past experience relating to other mergers and acquisitions?

A. I have been involved in Staff's review of several merger and acquisition applications filed with the Commission.

UtiliCorp United Inc. Merger with St. Joseph Light & Power Company—Case No. EM-2000-292

On May 2, 2000, I filed rebuttal testimony on the proposed merger between St. Joseph Light & Power Company (St. Joseph or SJLP) and UtiliCorp.

Kansas City Power & Light Company Merger with Western Resources, Inc.—Case No. EM-97-515

I was project coordinator for Staff's review of Kansas City Power & Light Company's (KCPL) proposed merger with Western Resources, Inc. (Western Resources). On May 30, 1997, KCPL and Western Resources filed their initial application with the Commission requesting approval of a merger between KCPL and Western Resources. This application was designated as Case No. EM–97-515. A Stipulation and Agreement was filed with the Commission on July 20, 1999 and on September 2, 1999, the Commission issued an Order Approving the Stipulation and Agreement.

Union Electric Company Merger with CIPSCO, Inc.—Case No. EM-96-149

Staff witnesses Oligschlaeger, Hyneman and I were involved in the Staff review of the proposed merger between Union Electric Company (Union Electric) and CIPSCO Inc. (CIPSCO). This merger was announced in August 1995 and was not completed until December 31, 1997. On November 7, 1995, Union Electric filed an application with the

Commission requesting authority to merge, designated as Case No. EM–96–149. The Commission conditionally approved this merger in a Report And Order issued on February 21, 1997.

Kansas City Power & Light Company Merger with Kansas Gas & Electric Company—Case No. EM-91-16

Along with other members of the Staff, I was involved in the review of the hostile tender offer to Kansas Gas & Electric Company (KGE) shareholders made by KCPL. On July 16, 1990, KCPL filed an application with this Commission to acquire and merge with KGE, which was docketed as Case No. EM–91–16. After KGE signed a merger agreement with Western Resources, known at the time as the Kansas Power & Light Company (KPL), KCPL withdrew its tender offer on December 13, 1990.

Kansas Power & Light Company Merger with Kansas Gas & Electric Company—Case No. EM-91-213

I was also involved in the review of KPL's merger with and acquisition of KGE. On November 21, 1990, KPL filed an application with this Commission docketed as Case No. EM–91–213, requesting authority to acquire all classes of capital stock of KGE, merge with KGE, and issue stock and incur debt obligations relating thereto. That application was a result of a definitive Agreement and Plan of Merger dated October 28, 1990, which was executed by the two companies. The Commission authorized the KPL merger with KGE in a Report And Order dated September 24, 1991. The State Corporation Commission of the State of Kansas (Kansas Commission or KCC), in Consolidated Docket Nos. 172,745-U and 174,155–U, approved that same merger on November 15, 1991. After receiving the necessary regulatory approvals, KPL completed the merger with KGE on March 31, 1992.

Southern Union Company Acquisition of Missouri Properties of Western Resources, Inc., d/b/a Gas Service—Case No. GM-94-40

I was also involved in the Staff's review of the Joint Application filed with the Commission on August 5, 1993 for the authorization to sell, transfer and assign certain assets relating to the provision of natural gas service in Missouri from Western Resources, d/b/a KPL Gas Service to Southern Union Company (Southern Union). This case was docketed as Case No. EM–94–40. The Joint Application was a result of an Agreement for Purchase of Assets dated July 9, 1993, which was executed by the two companies. The Commission approved this purchase transaction on December 29, 1993. Southern Union continues to operate this natural gas distribution system in the western part of Missouri as Missouri Gas Energy (MGE).

I was also one of the witnesses who addressed a proposal made by MGE in its 1996 rate case (Case No. GR-96-285) to share in purported savings relating to the acquisition.

Q. What other experience do you have regarding mergers and acquisitions?

A. I was involved in discussions with other Staff members reviewing the Union Electric acquisition of Arkansas Power & Light Company's (APL) Missouri properties, docketed as Case No. EM–91–29. This application was filed on August 2, 1990 and was approved in a Report And Order issued on September 19, 1991.

I have been involved in several other merger and acquisition applications filed with the Commission. Included among these applications was the application of United Cities Gas Company (United Cities) to acquire Monarch Gas Company, docketed as Case No. GM–96–180. This application was filed on November 29, 1995 and was approved by the Commission on March 22, 1996.

I presented testimony in Case No. GR–90–152 on the proper ratemaking treatment of the acquisition adjustment resulting from the acquisition of Associated Natural Gas Company by Arkansas Western Gas Company.

Also, I have been involved in examining the impacts of acquisition and merger activities of another utility operating within the state of Missouri. Specifically, I was involved in the supervision of an audit of UtiliCorp's Missouri Public Service (MPS) division in Case No. GR–88–194, wherein the Staff examined UtiliCorp's Corporate Office function, particularly the impacts on cost of service of that utility's acquisition and merger strategy, in the context of a natural gas rate increase case.

In addition, I was the principal Staff witness on the Corporate Office costs issue in UtiliCorp's 1990 electric rate increase case, Case No. ER–90–101, et al., respecting the MPS division's electric operations.

I have also reviewed several other applications filed with the Commission relating to acquisitions of utility property, primarily involving UtiliCorp.

BACKGROUND OF THE EMPIRE DISTRICT ELECTRIC COMPANY MERGER WITH UTILICORP UNITED INC.

Q. Do UtiliCorp and Empire currently provide utility services within the state of Missouri?

A. Yes. Empire provides retail and wholesale electric utility service to customers in the southwest part of the state of Missouri. It also supplies electricity to retail customers in the northwest part of Arkansas, northeast part of Oklahoma and the southeastern portion of Kansas. Empire provides electricity on a wholesale basis through tariffs approved by the

Federal Energy Regulatory Commission (FERC). Empire provides water service to several communities in the state of Missouri.

UtiliCorp operates regulated retail electric utility service in the states of Missouri, Kansas and Colorado, serving approximately 349,000 customers. UtiliCorp also provides natural gas distribution service to 831,000 customers in the states of Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota.

Q. What is the history of The Empire District Electric Company?

A. According to Empire's 1999 Annual Report to Shareholders, Empire was founded in 1909 and is incorporated in the state of Kansas.

Empire's corporate headquarters are located in Joplin, Missouri. It is an independent investor-owned electric utility that is engaged in the generation, purchase, transmission, distribution and sale of electricity to approximately 145,000 electric customers in Missouri, Kansas, Oklahoma and Arkansas. According to the 1999 Form 10-K (page 3), Empire derived approximately 88% of its retail electric revenues from the Missouri customers, 6% from Kansas customers, 3% from Oklahoma customers and 3% from Arkansas customers. Empire's service territory encompasses 10,000 square miles in its four-state region. At the end of 1999, Empire had 615 employees. In 1999, electric revenues represented about 99.5% of gross operating revenues; water revenues represented the remaining 0.5% of gross operating revenues.

Q. What caused the Staff's review in this case?

A. On December 15, 1999 UtiliCorp filed an Application with the Commission requesting approval of a merger between UtiliCorp and Empire pursuant to the "Agreement and Plan of Merger" (Merger Agreement) dated May 10, 1999. Under terms of this Merger Agreement, Empire will merge with and into UtiliCorp.

Q. What regulatory approvals must UtiliCorp and Empire receive to complete the merger?

A. The Proxy Statement/Prospectus of Empire (Proxy Statement) dated July 29, 1999 (page 32) identifies the regulatory approvals the Companies must receive to complete the merger. This Commission and the Kansas State Corporation Commission (Kansas Commission) must approve the merger where both Empire and UtiliCorp provide utility services. The merger also requires regulatory approval from the Arkansas and Oklahoma Commissions where Empire provides service. Joint Applications to merge were filed with Arkansas Public Service Commission on January 28, 2000 and with the Kansas Corporation Commission and Oklahoma Corporation Commission on January 31, 2000. In addition, the merger must receive approvals from the public utility commissions in Colorado, Iowa, Minnesota, and West Virginia (UtiliCorp disposed of its West Virginia properties as of December 31, 1999 and no longer requires regulatory approval from that State's commission), where UtiliCorp has utility operations. The Companies need approval from the Federal Energy Regulatory Commission (FERC) under the Federal Power Act. In addition, the Department of Justice and Federal Trade Commission have to review the merger under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The Federal Communications Commission (FCC) must approve the transfer of FCC licenses from Empire to UtiliCorp.

Q. Did UtiliCorp approach Empire to bring about this merger proposal?

A. Yes. UtiliCorp initially approached Empire to see if there was any interest in pursuing common issues. Empire engaged Salomon Smith Barney Inc. (Salomon) as its financial advisors to provide advice and assistance throughout the discussions, and ultimately the negotiations, with UtiliCorp.

Q. What is the purchase price being offered by UtiliCorp for Empire?

A. UtiliCorp is paying Empire shareholders a value of $29.50 for each share of common stock. According to page 3 of the Merger Agreement, Empire shareholders will have the option of receiving:

- $29.50 in cash, subject to certain adjustments, or
- Shares of UtiliCorp common stock with an average trading price of $29.50, subject to certain adjustments.

The value of the merger consideration received may be more or less than $29.50 and the form of the merger consideration received may be adjusted, depending on certain factors. UtiliCorp witness Robert K. Green, UtiliCorp's President and Chief Operating Officer, indicates in his direct testimony (page 8) that the merger may be valued at approximately $850 million, depending on the number of shareholders that elect to take cash and those that elect to take UtiliCorp common stock as consideration of their Empire stock. The final value will also be affected by the average trading price of UtiliCorp stock. UtiliCorp will assume the indebtedness of Empire.

This merger consideration represents a $275 million, or approximately 39 percent, merger premium of the book value of Empire. The UtiliCorp common stock will be valued based on the average trading price for UtiliCorp's common stock during the 20 trading days ending on the third trading day prior to the closing date of the merger (Proxy Statement, pages 3 and 36). The valuation of UtiliCorp's common stock will determine the actual price that Empire's shareholders will receive as consideration for redeeming their shares. As an example, Empire's 1999 Annual Report to the Shareholders identifies the levels of consideration being received based on different stock prices of UtiliCorp, as follows:

> The Merger Agreement contains a collar provision under which the value of the merger consideration per share will decrease if UtiliCorp's common stock is below $22 per share preceding the closing and will increase if UtiliCorp's common stock is above $26 per share preceding the closing. The average trading price of UtiliCorp's common stock price will be used to determine the merger consideration and will be calculated based on the closing prices on the NYSE during the 20 trading days ending on the third trading day prior to the closing date of the Merger. If the average trading price is below $22, UtiliCorp will pay 1.342 times the average trading price for each share of Company common stock and if the average trading price is above $26, UtiliCorp will pay 1.135 times the average trading price for each share of Company common stock. For example, if the Merger had closed on March 6, 2000, the average trading price for UtiliCorp's common stock would have been $17.5656 per share, resulting in the payment of $23.5513 for each share of the Company's common stock.
>
> [source: page 26 of the 1999 Annual Report to Empire's shareholders]

While Empire's shareholders may elect to take either stock or cash in exchange for their existing Empire stock, the Merger Agreement contains a restriction that total cash paid out will be limited to no more than 50% of the total merger consideration, and the number of shares of UtiliCorp common stock that may be issued will be limited to 19.9% of the number of then outstanding shares of common stock of UtiliCorp (page 26 of the 1999 Annual Report to Shareholders).

All the operations of Empire will be merged with and into the operations of UtiliCorp, and Empire will be operated as a division of UtiliCorp. UtiliCorp will maintain The Empire District Electric name as a trade name within the existing service territory of Empire.

Q. Does the merger consideration being paid to Empire's shareholders contain a "control premium?"

A. Yes. A portion of the merger consideration of $275 million, or the approximate 39 percent merger premium, relates to what is commonly referred as "control

premium." While the actual consideration paid to Empire by UtiliCorp for control of the company is not known, it is common for consideration to be paid in a merger to the seller for relinquishing its control of the company. Mr. Myron McKinney, Empire's President and Chief Executive Officer, indicates at page 6 of his direct testimony that consideration had to be made to Empire's shareholders for giving up control when he stated the "financial parameters must be achieved in the merger for the company giving up control... ."

Q. Does the merger agreement permit the post-merger Empire to participate on UtiliCorp's board of directors?

A. No. While Empire initially requested a seat on the UtiliCorp board, it was not provided for in the merger agreement. This request was not acceptable to UtiliCorp. In addition, none of Empire's officers are being provided positions after the merger is completed.

Q. Did St. Joseph receive any membership on the UtiliCorp board?

A. No. Like Empire, St. Joseph did not obtain a seat on the UtiliCorp board, nor will any of its officers retain positions with UtiliCorp after the merger is completed.

For UtiliCorp to control all board of directors and officer level positions, an amount had to be included as merger consideration to St. Joseph's and Empire's shareholders. This control premium allows UtiliCorp to control all aspects of the post-merger entities.

For additional discussion of the control premium, see rebuttal testimony of Staff witness Hyneman.

Q. Why did Empire seek a buyer for its utility property?

A. The Proxy Statement (pages 17 through 19) identifies in detail the process that the Board of Directors of Empire engaged in to conduct a series of analyses relating to its

future operations. Also, the direct testimony of Mr. Myron W. McKinney, President and Chief Executive Officer of Empire (pages 4 through 6), provides similar detail about the merger process that Empire used to determine its future corporate structure. Some of the more important events that occurred during the period prior to 1998 through May 10, 1999, the date the Merger Agreement was executed, are as follows:

- In recent years, Empire has carefully followed developments in the electric industry that have resulted in increased competition in the markets for electricity. Empire began to develop strategic alternatives, including possible business combinations.

- During the past several years, Empire's management has had discussions with other utility companies in light of possible strategic alliances, including business combination transactions. As part of this effort, over the last two years Empire has engaged in general conversations with UtiliCorp regarding activities which might be mutually beneficial. In June 1998 Empire signed an agreement to market natural gas in its service area for UtiliCorp's subsidiary, Aquila Energy.

- Empire conferred with Salomon Smith Barney from time to time as its principal investment advisor and consulted with Cahill Gordon & Reindel as its principal legal advisor.

- In August 1998, a member of UtiliCorp's board and Empire's President met to continue to assess areas of common interest between the two companies. At this meeting the discussion centered on the possibility of UtiliCorp managing natural gas purchases for Empire, and UtiliCorp and on Empire participating in joint generation projects or other energy supply activities.

- After subsequent telephone conversations, on October 21, 1998, Empire's President and UtiliCorp's board member met to discuss the possibility of a business combination. On October 29, 1998 the companies entered into confidentiality agreements and commenced an exchange of information to determine the feasibility of a business combination.

- From October 1998 through early January 1999, UtiliCorp's board member and Empire's President held several telephone conversations to continue discussions regarding a possible business combination.

- On January 14, 1999, representatives of Empire and UtiliCorp met. UtiliCorp presented its views on the business rationale for a combination of the two companies and its views on the valuation of Empire, alternative forms of consideration, accounting and tax treatments associated with those alternative forms of consideration, social issues and advantages for both organizations. Empire agreed to discuss these issues internally and with its financial and legal advisors.

- On January 27, 1999, Empire's President met with UtiliCorp representatives to respond to certain aspects of the issues presented at the January 14 meeting. The discussion centered on certain social issues including transition teams, continued benefit plans, continued Empire presence in Joplin and community support. Valuation issues were discussed. Empire stated that if UtiliCorp's views on possible values were within a certain range, a recommendation would be made to its board of directors that discussions concerning a possible merger of the companies should continue on an exclusive basis.

- On February 3, 1999, UtiliCorp representatives contacted Empire's President to further discuss issues raised, including valuation, at the January 27 meeting. UtiliCorp indicated it was willing to continue discussions with Empire on the terms previously discussed, with a period of exclusivity.

- On February 4, 1999, Empire's board of directors received a report from Empire management on the discussions to date with representatives of UtiliCorp. Empire management recommended to the board that discussions with UtiliCorp continue on an exclusive basis. Empire's board agreed to continue exclusive discussions with UtiliCorp.

- On February 11, 1999, Empire's President met with UtiliCorp representatives to discuss scheduling of due diligence and preparation of a merger agreement.

- On March 10, 1999, Empire's senior management and its financial advisors had a meeting with UtiliCorp representatives, in which it had an opportunity to review UtiliCorp's business. Empire discussed a wide range of topics relating to UtiliCorp's business.

- On March 15, 1999, the companies commenced negotiating a merger agreement, and during the weeks of March 16 and

March 22, 1999, legal advisors for UtiliCorp and Empire commenced legal due diligence investigations and the companies' other representatives and advisors continued due diligence investigations.

- On March 29, 1999, the Empire's board was briefed on the status of negotiations concerning the merger and the draft merger agreement.

- On April 1 and April 7, 1999, meetings continued between Empire and UtiliCorp representatives, their respective legal advisors and Empire's financial advisors.

- On April 22, 1999, Empire's board of directors was updated regarding the merger negotiations.

- After the April 22 meeting between Empire and its board of directors, discussions continued between Empire and UtiliCorp representatives. The companies continued discussions concerning the terms of the merger and related matters, to finalize the terms of the merger agreement.

- Empire's board of directors met on May 7, 1999, to consider the proposed merger. The board was informed that an offer to merge with UtiliCorp had been received. Salomon made a presentation to Empire's board concerning Salomon's evaluation of the fairness of the consideration to be received by Empire's stockholders. Empire's management and legal advisors also made presentations concerning the transaction.

- On May 10, 1999, Empire's board of directors continued its consideration of the proposed merger. Salomon made a presentation concerning, and provided the board with a signed copy of, Salomon's fairness opinion. Empire's board unanimously approved the merger agreement and the merger of Empire with UtiliCorp.

- Following the May 10, 1999 meeting of Empire's board of directors, the merger agreement was executed and delivered by both companies.

- On May 11, 1999, the merger was publicly announced.

Q. Did the Empire Board recommend approval of the merger to the shareholders of Empire?

A. Yes.

Q. Did the shareholders subsequently approve the merger?

A. Yes. At a special meeting held on September 3, 1999, Empire's shareholders approved the merger with 76.3 percent participation. Of those shareholders that participated, 93.5 percent voted to approve the merger. A simple majority of the outstanding shares of Empire's common stock was required to adopt the Merger Agreement and approve the merger. UtiliCorp is not required to seek approval of this merger from its shareholders.

Q. Why did Empire's Board recommended approval of the merger to its shareholders?

A. The Proxy Statement (page 19) identified reasons the Board approved the merger. The overwhelming majority of reasons the Board approved and recommended shareholder approval for this transaction dealt with Empire's ownership issues. Very little mention is given to Empire's customers or employees.

The reasons the Empire Board believed the shareholders should approve the merger with UtiliCorp are identified in the Proxy Statement as follows:

- the merger **consideration offers Empire shareholders an attractive premium** over the trading price of [Empire] common stock prior to the announcement of the merger;

- as the result of the merger, Empire shareholders will most likely **benefit from increased dividends**;

- **Empire shareholders will benefit by participating in the combined economic growth of the service territories** of UtiliCorp and Empire, and from the inherent increase in scale, the market diversification and the resulting increased financial stability and strength of the combined entity;

- there **will likely be cost savings from a reduction in operating and maintenance expenses** and other factors;

- the combined enterprise **can more effectively participate in the increasingly competitive market** for the generation of power; and

- UtiliCorp has significant non-utility operations and, as a larger financial entity following the merger, should be able to **manage and pursue further non-utility diversification activities** more efficiently and effectively than Empire could as a stand-alone entity.

[emphasis added]

The reasons cited by the Board in its communication to the shareholders regarding the merger illustrate that the rationale for the Empire merger, like most mergers, is about increasing the overall wealth of Companies' shareholders.

Q. Please explain.

A. It is necessary for a proposed merger to provide opportunities to shareholders in order for management to be able to pursue the merger. If the merger cannot be presented as advantageous to shareholders, they will not vote for approval. The Proxy Statement identifies several benefits to Empire's shareholders to ensure that they believe that they are being rewarded for giving up control of the company. Maximizing shareholder value is extremely important in the merger process. The board of directors has a special and unique responsibility to the shareholders and other investors of the entity to ensure that the owners of the entity are fully compensated for relinquishing their ownership interest. The payment of the merger premium to Empire's shareholders is the primary benefit to them, along with any opportunity to receive an increase in dividends. Also, typically the opportunity for a smaller company like Empire to access more potential shareholders by trading stock in a larger pool of investors such as the case for UtiliCorp's stock, is considered a benefit. This allows former Empire stockholders to trade their stock in a more liquid market than was previously available to them.

Other potential shareholder benefits resulting from mergers, include the opportunity to be an owner of a larger combined company with greater potential for economic growth, the opportunity as a shareholder to "keep" the preponderance of the purported merger savings, the opportunity to participate in the increasingly competitive market for power when reserves of generation are declining, the opportunity to engage in non-regulated and non-utility diversification and the opportunity to realize the benefits of a larger combined company for such things as access to a larger share of the capital markets, procurement of goods and services, etc.. These all relate directly to enhancing shareholder value.

Q. Will this proposed merger benefit Empire's employees?

A. It is not clear if the merger will benefit Empire's employees to the extent it will benefit shareholders. It is expected that the Empire merger will result in reductions of over 200 employees. In addition to this reduction in work force, it was announced early in the St. Joseph-UtiliCorp merger that there would be in excess of 100 employees eliminated as the result of that merger. These reductions in the levels of employees from both mergers represent significant cuts in the Empire and St. Joseph organizations. Empire will lose approximately one-third, or in excess of 200 employees, of its existing work force which totaled 626 as of December 31, 1998. St. Joseph also will lose almost one-third of its total employees, a reduction of 100 employees out of 339 employees employed as of December 31, 1998. For those employees fortunate enough to retain their jobs, there may be some benefits that result from the merger of these two entities. One of the benefits may be more career opportunities that a larger organization may provide. Also, Empire's and St. Joseph's employees may receive additional training opportunities because of the size of the merged company.

Q. Will the merger benefit Empire's customers?

A. Compared to the two stakeholders previously discussed, shareholders and employees, Empire's customers are the least likely to receive benefits from this merger. Under the regulatory plan proposed by UtiliCorp, Empire's customers may have to wait in excess of five years before they receive any merger savings through rates. Moreover, Empire's customers will not have the opportunity for any rate reductions that might result from anticipated productivity gains and technological improvements, as well as other potential non-merger events that might occur after Empire completes construction of the combined cycle generating facility it is currently building. Non-merger related savings result in cost reductions that are typically passed on to customers in the form of rate reductions. UtiliCorp's proposed regulatory plan does not make any distinction between merger and non-merger related savings and does not permit customers to benefit from non-merger related savings. The regulatory plan being proposed by UtiliCorp and Empire (which is similar to the one being proposed in the St. Joseph merger) requires customers to give up their right to reductions in rates as part of the UtiliCorp Regulatory Plan.

Q. Have there been any rate reductions in the recent past for Empire customers like there have been for St. Joseph customers?

A. No. There have not been rate reductions for Empire's customers as has occurred over the last 15 years for St. Joseph customers. While there have not been rate reductions for Empire customers, they enjoy some of the lowest electric rates in the midwest region. Mr. Myron W. McKinney states at page 8, in his direct testimony that Empire electric rates are "fully 30% below the national average." Empire's electric rates are very similar to the electric rates that St. Joseph charges. They both are the lowest electric rates in the State among the

major providers of electricity. Staff witness Phillip K. Williams addresses, in his rebuttal testimony, Empire's, St. Joseph's and Missouri Public Service's electric rates over an historical time frame as well as the history of rate increases and rate reductions since the mid-1980's.

Q. Will there be rate reductions in the future if the merger with UtiliCorp is completed?

A. Not if UtiliCorp's proposed regulatory plan is adopted. UtilCorp's proposal precludes any rate reduction for at least five years. Under this regulatory plan, Empire's electric rates will be "frozen" for at least five years after the merger closes. At the close of the five-year moratorium period, UtiliCorp plans a rate increase case which will address the recovery of the acquisition adjustment and other rate matters. The acquisition adjustment is a very significant cost that would contribute significantly to any need to increase rates, not reduce them. If that is the case, no merger or non-merger related savings will be available to customers.

To the extent this merger results in the elimination of the opportunity for rate reductions for Empire's customers, the merger is detrimental to the public interest. If that happens, the consequences of the merger are as follows:

- benefits go to Empire's shareholders who will receive the merger premium;

- benefits go to UtiliCorp's and Empire's shareholders for having a strategically larger company which will be better positioned to compete in the changing electric utility industry;

- detriments go to Empire's employees who lose their jobs because of the merger;

- detriments go to the City of Joplin, which will lose one of the community's larger employers, and suffer adverse impacts to the local economy, with loss of the corporate offices of Empire District Electric and loss of more than 200 jobs; and

- detriments go to Empire's customers in (1) the loss of possible future rate reductions, and (2) the potential of increased rates as a result of rising costs from merger transaction and transition (costs to achieve), recovery of the merger premium, the frozen capital structure and the shifting from lower administrative and general (A&G) costs of the stand-alone Empire operations to the substantially higher A&G costs of UtiliCorp.

- detriments go to Missouri Public Service's customers for the frozen A&G cost allocations and frozen joint dispatch for the fuel areas.

Q. If there have been no rate reductions for Empire customers in the recent past, then how will the failure to provide rate reductions in the future be detrimental to Empire customers?

A. Since Empire customers will have experienced several rate increases as a result of capacity expansion, it is only fair and appropriate that once the construction is completed and reflected in rates, customers should be able to benefit from the possibility of lower rates, even though they already enjoy some of the lowest rates in the midwest region. Once the new State Line combined cycle unit is completed, which is expected to occur May 2001, Empire anticipates the need for rate relief with this addition to rate base. Once this current construction cycle is completed, opportunities may exist to reduce rates as the result of efficiencies that may take place or as result of a declining rate base. "Freezing" rates as provided for in the proposed regulatory plan will prevent these opportunities from being available to Empire's customers.

It is noteworthy that UtiliCorp does not propose to "freeze" rates for Empire's customers in the same fashion that it proposes to do for St. Joseph's customers. In the case of the regulatory plan being proposed in the St. Joseph merger (Case No. EM-2000-292), UtiliCorp proposes to "freeze" rates immediately. However, in the instant Empire case, UtiliCorp proposes to "freeze" rates after the State Line combined cycle unit rate increase

takes effect. At the same time UtiliCorp is citing the virtues of the merger by indicating that there will be substantial merger savings, the Joint Applicants propose to increase rates because the capacity addition (which is non-merger related) must be added to rate base. Once the subsequent five-year moratorium expires, UtiliCorp will file yet another rate case, this time to reflect the revenue requirement impacts of the Empire acquisition adjustment. It is unlikely that Empire customers will ever see the benefits of purported merger savings or any rate reductions reflected in their electric rates.

STANDARD OF PUBLIC DETRIMENT

Q. What standard did Staff utilize to develop its recommendation regarding the proposed merger between UtiliCorp and Empire?

A. Staff utilized the standard of "detriment to the public interest," as it has in the other merger cases in which I have participated. If the Joint Applicants fail to show that the proposed merger of UtiliCorp and Empire is not detrimental to the public interest in Missouri, i.e., if it is not demonstrated that the Missouri public will not be harmed by the proposed merger, then the Commission should reject this Application and not approve the proposed merger. Staff counsel has advised that the "not detrimental to the public interest" standard is based on case law generally cited in Commission Orders as State ex rel. City of St. Louis v. Public Serv. Comm'n, 73 S.W.2d 393 (Mo.banc 1934); State ex rel. Fee Fee Trunk Sewer Co., Inc. v. Litz, 596 S.W.2d 466 (Mo.App. 1980). Staff counsel also advises that the Commission has incorporated the "not detrimental to the public interest" standard in its rules requesting applications for 4 CSR 240-2.060(8)(D).

Q. How is Staff defining the term "public?"

A. Consistent with Staff's position in other merger cases, Staff views the members of the "public" that are to be protected as those consumers taking and receiving utility service from Empire's electric and water operations in the state of Missouri.

In this case, Staff would define "public interest" as referring to the nature and level of the impact or effect that Empire's merger action will have on its Missouri customers. This includes Empire's electric and water customers. There is a fundamental concern in the regulation of public utilities that the public being served must not be impacted adversely or harmed by those responsible for providing monopoly services. Public utilities in Missouri are charged with providing safe and adequate service at nondiscriminatory, just and reasonable rates. If this merger results in adverse or negative impacts to Empire's Missouri electric customers and water customers, then the Commission should not approve the Joint Applicants' Merger Application or, in the alternative, should impose conditions sufficient to overcome the detriments of the merger.

In the merger case involving KPL and KGE in 1991, the Commission identified the "public" as Missouri ratepayers. At pages 12 to 13 of its Report and Order (Case No. EM–91–213), the Commission stated the following:

> The Commission has found no evidence in this record that KPL would be unable to render safe and adequate service to its Missouri ratepayers as a consequence of the proposed merger. However, the Commission has found that the savings sharing plan proposed by KPL as part of its merger application has the potential of exposing Missouri ratepayers to higher rates than would be the case without the merger which would be **detrimental to the public interest** . . . .
>
> The Commission has also found that there is potential for a **detrimental effect on Missouri ratepayers** from the merger through increased A & G and capital costs . . . .
>
> Based upon these findings and determinations, the Commission concludes that Missouri ratepayers will be shielded from any

> potential ill effects from the proposed merger and will suffer **no detriment** as a result. Therefore, the Commission concludes that, in the absence of a finding of **detriment to the public interest,** it may not withhold its approval of the proposed merger and will authorize KPL to acquire and merge with KGE.
>
> [emphasis added]

Clearly, the Commission was identifying the Missouri ratepayers as the relevant "public" in its Report and Order. This is the standard that is being applied by the Staff to the proposed merger between UtiliCorp and Empire.

Q. Is Staff defining "not detrimental to the public interest" differently in this case than it has in previous merger cases?

A. No. Although this merger is being evaluated based on the **no detriment standard** for all of Empire's Missouri customers in the two utility operations for which it supplies utility service, another equally important group of customers must be considered. Unlike other mergers that have typically occurred in this State where only one of the two utilities has a Missouri service territory, this merger involves the application of the standard to the customers of both merging companies. UtiliCorp provides electric and natural gas service to Missouri customers through its Missouri Public Service division. Thus, the Commission should also evaluate this merger using the **no detriment standard** as it relates to UtiliCorp's Missouri customers.

ACQUISITION ADJUSTMENT

Q. Will this merger transaction result in an acquisition adjustment?

A. Yes. UtiliCorp will have to record on its books, for a period of 40 years, the acquisition adjustment which results from the merger premium being paid to Empire's shareholders.

Q. Are the Joint Applicants proposing to recover the acquisition adjustment in rates?

A. Yes. The Joint Applicants are, in effect, requesting to fully recover the acquisition adjustment through the proposed regulatory plan identified in the direct testimony of UtiliCorp witness John W. McKinney. The regulatory plan is a proposal that allows UtiliCorp to retain a substantial portion of the purported merger savings and future non-merger savings in order to recover the merger premium being paid to Empire's shareholders. UtiliCorp assumed it would retain 100% of the merger savings in its financial evaluation of the merger with Empire. Staff witness Oligschlaeger addresses the Joint Applicants' regulatory plan in his rebuttal testimony.

Q. What is the expected amount of the acquisition adjustment related to the proposed merger between UtiliCorp and Empire?

A. UtiliCorp identifies the acquisition adjustment as approximately $275 million (UtiliCorp witness Jerry D. Myers' direct testimony, page 4). UtiliCorp will incur additional costs relating to closing or completing the merger, commonly known as transaction costs; i.e., legal, engineering, investment banking (the separate financial advisors used by Empire) and other consultants' fees. Transaction costs are typically incurred prior to the completion of the merger since they are incurred in reaching the agreement to merge and in closing the merger.

UtiliCorp also will incur costs referred to as transition costs, commonly referred to as "costs to achieve" the merger; i.e., costs typically incurred after the merger is completed to integrate and implement systems and processes of the two combining companies. Transaction costs and "costs to achieve" the mergers are discussed in the rebuttal testimony

of Staff witness James M. Russo. UtiliCorp has identified what it believes these costs are expected to be as follows:

Merger premium	$ 275.000 million
Transaction costs (Costs of the merger)	19.274 million
Total value of acquisition adjustment	$ 294.274 million
Transition Costs (Costs to achieve)	$ 13.886 million

[Source: UtiliCorp witnesses Myers, page 4, and Vern J. Siemek—Schedule VJS-2]

The merger premium calculation is based on the agreed upon price per share paid to Empire shareholders of $29.50 if UtiliCorp's price per common share is between $22.00 and $26.00 at the time of the merger closing.

Q. What is a "merger premium?"

A. The "merger premium" represents, in general, any portion of the purchase price for a company which reflects a valuation above the current net book value of the acquired company's assets, or market value of the acquired company's stock.

For UtiliCorp specifically, the merger premium represents the transfer of shareholder wealth from UtiliCorp to Empire to consummate the merger, measured by the gain in stock price and increase in the number of shares of UtiliCorp stock to be held by Empire shareholders, compared to the market value and the number of shares of pre-merger Empire stock.

Q. What is an acquisition adjustment?

A. An acquisition adjustment results when utility property is purchased or acquired for an amount either in excess of or below net book value. Net book value relates to the value placed on utility property and recorded on the Company's books and records at the time the utility property is first placed in public service, adjusted for depreciation and amortization. This assessment of value is commonly referred to as the property's "original cost." The acquisition adjustment is made up of two components, the merger premium and the transaction costs. The transaction costs are pre-merger costs to close or complete the merger.

Q. What is original cost?

A. The term "original cost," as defined by the Electric Plant Instruction Section of the FERC Uniform System of Accounts (USOA), relates to:

> All amounts included in the accounts for electric plant acquired as an operating unit or system, except as otherwise provided in the texts of the intangible plant accounts, shall be stated at the cost incurred by the person who first devoted the property to utility service. (Paragraph 15,052 of USOA).

Depreciation and amortization of the utility property from the previous owner must be deducted from the original cost, which results in a net original cost figure to be recorded on the purchaser's books and records. The acquired property is valued at the same value the seller placed on it, hence the "original cost when first devoted to public service," adjusted for depreciation and amortization, concept.

Q. Do utilities endorse the net "original cost" concept?

A. Yes. In a Joint Submission made by the then KPL and Gas Service Company (Joint Submission By KPL And Gas Service Pursuant To Order Of September 20, 1983; attached hereto as Schedule 2 to my testimony) to the KCC, in Docket No. 138,495–U respecting KPL's request for authority to acquire the Gas Service Company (Gas Service), KPL stated the following:

> The Commission has the "duty to ascertain the reasonable value of all property of any [regulated public utility] whenever it deems the ascertainment of such value necessary in order to enable the Commission to fix fair and reasonable rates . . . ." K.S.A. 66–128. The rate base of a public utility represents the reasonable value of all property which is in service and devoted to the public use. [citation and footnote omitted]
>
> **Because the value of the corporation's property remains unchanged as the corporation's stock is bought and sold, the transfer of a utility's stock, the indicia of ownership** in a corporate entity whose stockholders are separate and distinct from the entity itself, **does not affect the value of its property in service and devoted to the public use.** Thus, **no recalculation of the utility's property, or rate base, is appropriate.**
>
> The current rate base of Gas Service is derived from the **original cost of the property when first dedicated to public use**. The purchase of its stock does not affect original cost. A new stockholder does not purchase the assets of the corporation. Nor does a change in, or substitution of stockholders establish a new business entity. Transfer of ownership of common stock does not affect the ownership of the corporation's property, which still belongs to the corporation. [footnote omitted]
>
> In a stock transfer, no assets are removed from public service or transferred to another business entity. **The same assets will continue to be used to provide the same services to the same ratepayers and the assets will remain subject to the same ratemaking jurisdiction of the same regulators.** This continuity makes a recalculation of Gas Service's rate base incongruous.
>
> [Joint Submission, pp. 2–3; emphasis added]

The Joint Submission was requested by the KCC in Docket No. 138,495–U, wherein KPL and Gas Service were directed to provide a legal analysis of whether the Commission should consider adjusting Gas Service's rate base to reflect the purchase price of Gas Service common stock purchased by Gas Service. It is clear that KPL was arguing for Gas Service's rate base to be valued at net "original cost" even though the "transfer of common stock ownership was effected at approximately 89% of net book value." (Joint Submission, page 1). The Joint Submission was signed by David S. Black, at the time Senior Vice President, Law and subsequently Chairman of the Board, President and Chief Executive Officer of KPL.

Q. Is use of net original cost for valuing rate base still the predominant form of regulation?

A. Yes. In the state of Missouri, the use of original cost less depreciation and amortization, i.e., net original cost, to set rates is not only the predominant form of regulation, but to my knowledge, the only form that has been employed by this Commission.

Q. UtiliCorp witness John W. McKinney discusses the use of the concept of Fair Value rate base at pages 27 and 28 of his direct testimony. Has the Commission used Fair Value rate bases to determine rates for public utilities operating under its jurisdiction?

A. Not to my knowledge. During the 1970's and 1980's, Fair Value testimony was filed by both companies and Staff witnesses. However, the Commission determined rates based on net original costs concepts. The parties stopped presenting Fair Value testimony sometime in the last 1980's or early 1990's.

Q. How does an acquisition adjustment result from a utility merger or acquisition?

A. Utility property is recorded on the company's books and records at net original cost. A utility must account for any difference between the acquisition cost or purchase price of property and the net original cost; i.e., the amount paid to the original owner (the seller) for utility property being first placed into service and the recorded net original cost amount. This difference in purchase price is recorded in USOA Account 114, Electric Plant Acquisition Adjustments. The amortization of the acquisition adjustment is made to Account 406, Amortization of Electric Plant Acquisition Adjustments, if authorization is granted to include the adjustment in cost of service for ratemaking purposes (above–the–line treatment). If no authorization is given to include an amortization for ratemaking purposes (i.e., below–the–line treatment occurs), then Account No. 425, Miscellaneous Amortization, must be used.

Account 114 states:

> A. This account shall include the difference between (1) the cost to the accounting utility of electric plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (2) the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated provisions for depreciation and amortization and contributions in aid of construction with respect to such property.
>
> . . . .
>
> C. Debit amounts recorded in this account related to plant and land acquisition may be amortized to account 425, Miscellaneous Amortization, over a period not longer than the estimated remaining life of the properties to which such amounts relate. Amounts related to the acquisition of land only may be amortized to account 425 over a period of not more than 15 years. Should a utility wish to account for debit amounts in this account in any other manner, it shall petition the Commission for authority to do so. Credit amounts recorded in this account shall be accounted for as directed by the Commission.

Account 406 states:

> This account shall be debited or credited, as the case may be, with amounts includible in operating expenses, pursuant to approval or order of the Commission, for the purpose of providing for the extinguishment of the amount in account 114, Electric Plant Acquisition Adjustments.

Account 425 states:

> This account shall include amortization charges not includible in other accounts which are properly deductible in determining the income of the utility before interest charges. Charges includible herein, if significant in amount, must be in accordance with an orderly and systematic amortization program.
>
> ITEMS
>
> 1. Amortization of utility plant acquisition adjustments, or of intangibles included in utility plant in service when not authorized to be included in utility operating expenses by the Commission.

2. Other miscellaneous amortization charges allowed to be included in this account by the Commission.

UTILICORP'S REGULATORY PLAN

Q. Is UtiliCorp seeking recovery of the acquisition adjustment created as result of this merger?

A. Yes. UtiliCorp is seeking direct, as well as indirect, recovery of the merger premium it is paying for Empire as part of the regulatory plan being proposed in this case. UtiliCorp's regulatory plan would make it possible for it to recover in rates a substantial amount, if not the entire amount, of the acquisition adjustment. UtiliCorp is requesting that the Commission authorize Empire a five-year rate moratorium that will result in the post-merger rates being frozen for a period of at least five years after the rate increase filing planned to be made by Empire the last half of this year goes into effect. At the end of the moratorium, UtiliCorp intends to file a rate case that will reflect one-half of the total revenue requirement relating to the acquisition adjustment. This total revenue requirement will represent the return "of" (the amortization component) and the return "on" (the rate base component).

Q. How will UtiliCorp recover a substantial portion of the acquisition adjustment through its proposed regulatory plan?

A. All savings, both merger and non-merger related, will be retained by UtiliCorp during its proposed five-year moratorium. During this moratorium period, UtiliCorp will recover the merger premium indirectly. Subsequent to the five-year moratorium period, UtiliCorp will recover one-half of the return of and on the merger premium directly in rates and the other half indirectly through merger savings retained during the regulatory lag between rate cases. UtiliCorp will also recover the merger premium indirectly from growth opportunities in

non-regulated activities that will be created by or benefit from the merger. UtiliCorp's regulatory plan includes unique regulatory proposals, such as using Empire's pre-merger capital structure in future Empire rate proceedings and excluding savings in the administrative and general (A&G) cost categories for the MPS division from inclusion in rates in future rate proceedings. These proposals will also allow for indirect recovery of the acquisition adjustment. Staff witness Broadwater and I will discuss the "frozen" capital structure issue in our rebuttal testimonies. Staff witnesses Traxler and Oligschlaeger will discuss the "frozen" A&G corporate allocations relating to MPS' and Empire's future rate cases.

Q. Is it appropriate to allow utilities to retain non-merger related savings to pay for an acquisition adjustment?

A. No. The Commission made it clear that utilities must distinguish between merger and non-merger related savings. In several cases, the Commission has required the separation of these two very different types of cost savings. I will address the importance of segregating merger and non-merger related savings in the section of this testimony concerning merger tracking.

Q. Is UtiliCorp's regulatory plan seeking certain ratemaking approvals in this case, even though this is a merger application and not a rate application or general tariff filing?

A. Yes. UtiliCorp's proposal is seeking up-front ratemaking treatment in this case even though this is a Merger Application. Yet, despite the fact UtiliCorp is not seeking a change in its rates in the instant proceeding, it is necessary for the Staff to address the ratemaking ramifications of UtiliCorp's regulatory plan concurrent with UtiliCorp's request for approval of the merger. The regulatory plan presented by the Joint Applicants is an

integral part of the Merger Application. The regulatory plan, as presented by UtiliCorp in the direct testimony of UtiliCorp witness John W. McKinney, seeks a dramatic departure from traditional ratemaking principles that this Commission has employed over its history. UtiliCorp wants assurances that it will receive favorable regulatory treatment from the Commission on an issue, acquisition adjustments, for which the Commission has never allowed rate recovery. Even though UtiliCorp cites in its testimony two cases that it believes supports its view that the Commission is receptive to allowing recovery of the acquisition adjustments, the fact remains that in those two cases, as well as all other instances, the Commission has never allowed direct recovery of this item in any proceeding. Staff believes the treatment afforded acquisition adjustments in the past is exactly the same treatment the Commission should afford the Joint Applicants' acquisition adjustment in this case.

Q. Does UtiliCorp's regulatory plan proposal take Empire's rates off cost-of-service price determination?

A. Yes. UtiliCorp's proposal will take Empire's rates off cost-based ratemaking. The proposed regulatory plan freezes Empire's pre-merger capital structure and attempts to freeze MPS's A&G allocations to a pre-merger basis which will in effect will also take MPS off cost-based ratemaking.

The frozen capital structure will push higher costs on post-merger Empire customers who would otherwise benefit from UtiliCorp's lower-cost consolidated capital structure. Under the regulatory plan being proposed by UtiliCorp, the post-merger customers of Empire will be deprived of this important and significant merger benefit even after the proposed moratorium period ends. The actual cost of capital for the post-merger Empire division should be based on UtiliCorp's consolidated capital structure because that will be the traded stock after the merger

closes. Thus, UtiliCorp's and Empire's proposal to freeze Empire's rates at Empire's pre-merger capital structure level permits UtiliCorp and Empire to keep these merger benefits in total and removes Empire's rates off a cost basis.

In addition, the frozen allocation to MPS of A&G costs relating to UtiliCorp's corporate overheads will also result in MPS going off cost-based ratemaking. In essence, MPS customers will be charged higher rates than actual costs would warrant if this part of the regulatory plan is adopted. Staff witness Traxler addresses the issue of UtiliCorp's corporate overheads and the "MPS frozen allocators" issue in his rebuttal testimony.

Q. Mr. John McKinney states at page 18 of his direct testimony that he does not believe that if the Commission were to make a determination as to the reasonableness of a premium, that it "shift[s] the burden or risk of the premium to the regulators." Do you agree?

A. No. Forcing regulators to become involved in the price determination of the so-called "investments" that mergers and acquisitions are asserted to be will most certainly shift the burden away from the company and places more of the risk on the regulators than they presently have. However, it is not the regulators, but rather the utility customers that the risk of the merger will ultimately be shifted. If utilities are successful in placing merger premiums in rate base as an "investment" like any other rate base item, the regulator will either be required to perform an assessment of the "investment" or be forced to simply accept the utility's valuation and judgment respecting the merger or acquisition. Of course, the utility would much prefer the regulator accept the "we buy it, you put it in rate base at what we paid for it" approach. As it relates to mergers, this philosophy would be "we negotiate a price for a company and you put it in rates." It appears to be simple. Regulators would no more meet their responsibilities if this approach were adopted, than they would have if in the

late 1970's and 1980's, regulators would have taken the approach sought by the utility industry of "we build it, you put it in rate base no matter what it cost us to build it." Fortunately, that regulatory philosophy was not employed during the nuclear construction projects of the mid-1980's or during the construction of the less costly coal-fired base load units of the last 1970's and 1980's. Even the major construction project UtiliCorp had in the early 1990's relating to the refurbishment of its base load Sibley Generating Station placed considerable pressure on the regulators to perform their regulatory oversight function.

Q. Mr. John McKinney seems to imply in his direct testimony on pages 19 and 20 that a merger premium is just like any other investment such as electric plant investments. Are the merger premiums that are being paid in mergers and acquisitions just like other "investments" that are typically placed in rate base?

A. No. An investment in a generating facility or transmission plant has direct, certain and known benefits. They are also required to provide essential utility service to customers in this state. A customer places a demand on the electric facilities. This demand has to be met in order for the customer to have electricity operations. The only way for a utility to meet its obligations to that customer is to generate or purchase the required electricity, and to have transmission and distribution facilities in place to transport the commodity to its destination. The only way the utility can meet its obligation to serve customers, is to have the necessary plant investment in place.

The key difference between the merger "investment" and the plant to serve investment is that the merger "investment" is not necessary and not required to meet the utility's statutorily required provision of safe and adequate service. Mergers do not have to take place nor are they required. Mergers, generally, are about shareholder wealth and

management control issues. These have nothing to do with providing utility customers safe and adequate service at a nondiscriminatory, just and reasonable price. Simply put, mergers and acquisitions are not necessary investments to provision of utility service and cannot and should not be considered like any other utility investment(s) that are placed in rate base.

Q. Mr. John McKinney states at page 20 of his direct testimony that "utility customers would be deprived of merger benefits because shareholders are not permitted to recover reasonable investments that include a premium and shareholders are not provided due process in the review of their investment." Do you have any comment?

A. If any entity is frustrating the Commission's fulfillment of its statutory obligations, it is the Joint Applicants. They are seeking Commission authorization of their proposed merger without providing the Commission and the parties adequate direct testimony and schedules. UtiliCorp and Empire have chosen how to present its case and they will have every opportunity in which to be heard. The Commission's process to this point is the process that the Joint Applicants have advocated to the Commission. In fact, UtiliCorp made note of that in Mr. Robert K. Green's 1999 Year-end Conference Call to Rating Analysts which occurred on February 8, 2000. Mr. Green is the President and Chief Operating Officer for UtiliCorp. He stated therein, in part, as follows:

> Okay, merger activity. We filed the St. Joe rate case in October. We filed Empire in December. The hearing on St. Joe is scheduled for July 10th, and we expect a hearing in the Empire transaction maybe in December of this year. We would hope to close St. Joe certainly this year, and Empire, it would be nice if we can get it closed this year. That might push into the first quarter of next year.
>
> And our Court filings were made in November, so that's all on track. The Commission has generally upheld all of our requests in terms of scheduling, even with the Staff opposed it. So we feel like we've built some good relationships there. Key to these deals is going to be the regulatory bargain we cut, and you're aware that both of these deals

> have regulatory out provisions. So in any transaction like this, synergies are key, and the regulatory deal is key in terms of creating value and growing earnings. And we will be focused on doing both.
>
> [Transcript of February 8, 2000, Robert Green 1999 Year-end Conference Call, on UtiliCorp's Internet web site, www.utilicorp.com, at Investor Information, Presentations].

UtiliCorp will have every opportunity to present their case before the Commission. If the Joint Applicants are unhappy with the decisions made by the Commission, then they certainly can exercise their rights of appeal to the courts. The Joint Applicants will be afforded their due process rights in the review of this Merger Application.

Q. UtiliCorp witness John McKinney states at page 20 of his direct testimony that "when regulators do not allow recovery of a premium and yet pass all of the cost savings to the customer, it is the regulated utility that is disadvantaged." Have regulated utilities been disadvantaged by the Commission's prior treatment of the acquisition adjustment?

A. No. Regulated utilities are not disadvantaged because, in all instances I am aware of, utilities were allowed to retain whatever synergies existed from a merger or acquisition until such time as rates were adjusted, usually through some type of moratorium period. This is known as regulatory lag. Mergers are nothing more than the combining of corporate entities much like a reorganization of existing companies that results in downsizing, re-deployment of human resources, and changes to system processes such as occurs in re-engineering. Utilities make these types of changes to meet the objective of providing more efficient utility service to its customers. Generally, utilities always retain for some period of time the cost savings generated by the efficiencies gained from the reorganization and re-engineering that occur periodically at every utility.

To suggest, as Mr. McKinney does, that companies' shareholders are disadvantaged if merger savings are passed on to customers is clearly wrong. Utilities get first crack at savings up-front. Staff does not, and has not, advocated keeping all the merger savings for customers. To do so would be unreasonable. I agree with Mr. McKinney on this point. However, if anyone is disadvantaged in the rate process as it applies to mergers, it is generally the customers. They must wait for the savings, merger and non-merger alike, to occur and to have those savings reflected in rates. In the case of merger savings, they are highly speculative and may not even occur. It has also historically been much easier to increase rates than reduce them. A good example of this is the 1997 complaint case filed by Staff against UtiliCorp's Missouri Public Service division. Even when cost-of-service savings are discovered, generally as a result of an earnings review, it takes considerable time to fully reflect the savings in rates. During this interim period, the utility, and its shareholders, enjoy the full benefit of the savings and the resulting revenue requirement reduction.

HISTORICAL PERSPECTIVE RELATING TO ACQUISITION ADJUSTMENTS

Q. What is the historical background for the position that net "original cost" should be the basis for setting rates for utility property?

A. Abuses which occurred in the 1920's and 1930's created the need to adopt the original cost concept in setting rates. In the 1920's and 1930's, utilities were acquiring other utility properties for amounts in excess of net book value. This valuation and transfer in excess of book value (i.e., positive acquisition adjustments/merger premiums) created inflated rate bases, which, when included for ratemaking treatment, resulted in higher rates to

the then-existing customers. These customers were paying higher rates for the exact same property that had been providing them utility service prior to the merger and acquisition. It was believed that it was not reasonable to charge customers higher rates for the same utility property simply because the utility providing service was acquired by another company. Thus, the practice of using the "original cost" of the property when first devoted to public service became widely accepted. This principle has served to protect ratepayers from utilities selling properties at inflated prices, and then having the purchaser seek revaluation of the properties at higher levels in order to produce greater profits.

Q. Are the concerns that ratepayers will be paying inappropriate higher rates for utility service if the acquisition costs are included in rates just as valid now as they were in the past?

A. Yes.

Q. Is one of the standards that sometimes has been used to determine the ratemaking treatment of acquisition adjustments whether the purchase of the property was an "arm's length" transaction?

A. Yes.

Q. If the purchase of utility property is an arm's length transaction, would this guarantee that the lowest purchase price would result?

A. No. Simply because an acquisition of utility property would be considered an arm's length transaction (i.e., no affiliation or tie between the negotiating parties), this criterion alone would not guarantee the lowest possible purchase price. This is particularly true if the purchasing utility's management intended that the ratepayers should be required to pay for any premium above net book value. In that circumstance, there certainly would be no guarantee that

the purchasing utility would have negotiated the best possible terms or an approximation thereof.

Q. If the Commission were to determine that acquisition adjustments should be included in the ratemaking process, would there be a need for the Commission to determine the appropriate price at which utilities should acquire other utilities?

A. Yes. Using the Commission's current precedent of not considering acquisition adjustments in the ratemaking process relieves the Commission and its Staff of the burden of determining the appropriate purchase price of acquired utilities. Alternatively, if the Commission were to adopt a position of including acquisition adjustments in rates, this would place the burden of determining the appropriate purchase price of acquired utilities on the Commission and its Staff. Certainly, it is difficult to determine what the "least cost," or otherwise appropriate price, should be for an acquired utility. In order to make that determination, the Commission and its Staff, in essence, would have to place itself in the negotiation process to ascertain if a utility property was being or had been acquired at the lowest possible price. If this were not done, then the Commission could in no way ensure that the public would not be harmed; i.e., that the transaction was not detrimental to the public interest.

By maintaining its current position of not authorizing direct or indirect recognition of either positive or negative acquisition adjustments in rates, the Commission can avoid making a determination that the utility property in question was acquired at the lowest possible, or otherwise appropriate, price. The practical effect of authorizing acquisition adjustments in the ratemaking process is in essence to shift the burden or risk from the company to the Commission and its Staff in making determinations regarding the purchase price of acquired utility properties.

Q. UtiliCorp witness John W. McKinney states at page 19 of his direct testimony that it "would be unreasonable" if regulators flow-through merger savings to customers but fail to allow rate recovery of the premium. Has this ever happened?

A. Not to my knowledge. I am not aware of any time at which the Commission approved a merger or acquisition and flowed all benefits to customers. While, it is true that this Commission has never allowed direct recovery of an acquisition adjustment in rates, it is equally true that this Commission has afforded utilities retention of related merger and acquisition benefits. In every instance I can think of, utilities were given opportunities up-front to capture these savings through regulatory lag.

Q. Why is the Staff opposed to the recovery of acquisition adjustments in rates?

A. Allowing recovery of positive acquisition adjustments in rates does not provide sufficient incentive for the acquiring utility to negotiate the best possible price for the acquired firm. If a utility were allowed recovery of acquisition adjustments, it need not be as concerned, or even concerned at all, that it was negotiating the most favorable terms possible in acquiring a property since the ratepayers would provide recovery through rates. Allowing acquisition adjustments in rates sends signals to buyers of utility property that recovery is guaranteed regardless of the purchase price, which may be an inflated amount above the value of the utility property. In fact, if the acquisition adjustment is allowed in rates, both the purchaser and the seller of said property can benefit from inflating the rate base.

The adoption of positive acquisition adjustments for ratemaking purposes removes from purchasing utilities (the buyer, which in this case is UtiliCorp) incentive to negotiate a lower price or terminate negotiations when a seller requests an unreasonable price for the property in question. A policy of giving ratemaking treatment to positive acquisition adjustments would

place Missouri regulated utilities at a competitive advantage over unregulated entities, since Missouri jurisdictional utilities then would have in essence a "blank check" for recovery of their acquisition expenditures from ratepayers. This situation does not exist for unregulated entities. Thus, if utility executives knew that there would be recovery from ratepayers of an acquisition adjustment resulting from the purchase of utility property for an amount in excess of net book value, i.e., original cost less depreciation and amortization, this would pose the potential for tainting the negotiation process between the buyer and the seller.

Q. How do sellers of utility property benefit from selling above net book value?

A. The sale of utility property above net book value benefits the selling party because such a gain is treated below–the–line, and is therefore realized solely by the shareholders. The higher the price that the utility property is sold at, the larger the gain for the seller. Clearly, if the buyer believes there will be a recovery of the acquisition adjustment from ratepayers, there is a greater potential for an inflated rate base, which in turn results in higher utility rates as well as a larger gain to the seller.

Q. Do utilities benefit from consistent treatment of acquisition adjustments in the manner advocated by the Staff?

A. Yes. Utilities which purchase property below book value, resulting in negative acquisition adjustments, benefit because those utilities receive a return on property valued at its net original cost, not the purchase price. Since these utilities would be receiving a return on the net original cost rate base, their return component would be computed for a rate base greater than that which these utilities actually had invested.

The utility industry in Missouri may be in the position of arguing for net original cost ratemaking when negative acquisition adjustments occur, while at the same time advocating that

positive acquisition adjustments be treated above net original cost. Under either scenario, the utility would benefit, to the potential detriment of the ratepayers. Western Resources, who once provided natural gas service to customers in western Missouri, took such a position in the past when it purchased the former Gas Service Company in 1983 at below book value.

In Case No. GM–84–12, this Commission authorized Western Resources, then KPL, to acquire Gas Service. KPL acquired Gas Service for an amount valued at approximately 89% of net book value. KPL never advocated the use of a negative acquisition adjustment to value Gas Service's rate base in setting rates at any time that it owned the Missouri properties.

Q. Had Western Resources previously argued that negative acquisition adjustments should be ignored in the ratemaking process?

A. Yes. In a Joint Submission (attached as Schedule 2 hereto) filed in Kansas before the KCC in Docket No. 138,495–U, KPL took the position that a negative acquisition adjustment resulting from the Gas Service merger should not be reflected in the ratemaking process in Kansas. (A portion of the Joint Submission has been previously quoted in this testimony.) In this legal analysis filed before the KCC, KPL maintained that net original cost investment should be used. KPL stated as follows:

> Aside from the legal issues raised by the Commission's inquiry, revaluation of utility plant measured by the price paid for common stock would produce practical difficulties of potentially significant dimensions. Revaluation, whether on a stock acquisition or purchase of utility assets, would ultimately tend toward higher costs to consumers, since it would provide no incentive to make acquisitions at less than book value. If it is appropriate to write down rate base when stock is purchased below book value, it would be equally correct to write up rate base when the stock is acquired at a premium.

The Missouri Commission did not recognize the negative acquisition adjustment, but the KCC did. This Commission did not "write down" the assets. Thus, the customers paid higher

rates to KPL under original cost theory than they would have if the below book values were used to determine the rate base. Of course, KPL benefited from the use of original cost theory in Missouri for property that, in effect, was overstated because KPL collected higher rates from its Missouri customers.

The Joint Submission by KPL further stated:

> Even if the nature of this transaction could be disregarded and treated as a purchase of the assets of Gas Service, there should be no change in the rate base in recognition of the general rule that the rate base represents the original cost of utility property when dedicated to public use regardless of the price at which it is purchased by another utility. [citations omitted]
>
> In Kansas the rate base is not recalculated even when the assets are purchased at less than the original cost. [citation omitted] This Commission determined that the reasonable value of property purchased from other utilities was not its purchase price but rather the higher original cost to the first entity which devoted the property to public service. [citation omitted] The Commission accepted Staff's proposed adjustment to increase the utility's rate base from the purchase price of property already devoted to public service to its original cost when first devoted to public service. The Commission considered the increase to be "a traditional adjustment which recognizes for rate-making purposes that the rate base should be the original cost of plant when dedicated to public use regardless of price at a subsequent sale." [citation omitted]
>
> This carryover of book value is an appropriate valuation method because original cost is an appropriate determinant of reasonable value, and because the purchase price of Gas Service's stock does not accurately reflect the value of its assets. First, even assuming that the purchase price of Gas Service's stock accurately reflected the market value of its assets, there is no sound reason for deviating from the original cost or book value methodology adopted or given great weight in Kansas and most other jurisdictions. [citations omitted]
>
> Because the market value of assets seldom changes precisely in accordance with depreciation, depreciated original cost is often not an accurate proxy of current fair market value. Nonetheless, **original cost accounting is employed to avoid the difficulties of more subjective methods of property valuation. The use of the depreciated original cost valuation method provides an objective**

> **method of valuation without the need for independent assessments of the fair market value of acquisitions.**
>
> The unfortunate result of utilizing purchase price in this case would be to encourage the future transfer of properties at a premium above original cost regardless of fair market value. For example, had KPL paid above book value for Gas Service's stock, Gas Service's rate base would have increased, resulting in greater costs to consumers. **One reason for the applicability of original cost concept to acquisitions was to prevent utilities from artificially inflating their rate bases by acquiring properties at unrealistically high prices.** [citation omitted; emphasis added] . . . .
>
> . . . .
>
> **This inquiry has confirmed the propriety of Commission [KCC] use of original cost as the basis of the value of property devoted to utility service.** [emphasis added]

KPL's position at that time was clear. If the KCC were to consider the negative acquisition adjustment to value Gas Service's rate base, then that position would "logically dictate similar adjustments—up or down—for each utility regulated by the [Kansas] Commission in each rate case." (Joint Submission, Schedule 2).

Q. Did the KCC give consideration to the negative acquisition adjustment relating to the KPL/Gas Service merger?

A. Yes. In Docket No. 148,312–U, the KCC in its June 13, 1986 Order treated the Gas Service acquisition for rate purposes at below book value. In that Order, it was determined that the effective cost below book value was $8.4 million on a total company basis. The KCC adopted for ratemaking purposes an amortization of negative goodwill. This has the effect of increasing revenues and thus decreasing the revenue requirement.

Q. Are there any cases where this Commission has rejected reflection of a negative acquisition adjustment in rates?

A. Yes. In a U.S. Water/Lexington, Missouri, Inc. (U.S. Water) rate case, Case No. WR–88–255, the Commission rejected a negative acquisition adjustment which was proposed by the Office of the Public Counsel (OPC). The negative acquisition adjustment was not used by the Commission to reduce the U.S. Water rate base, or to reflect a negative amortization to the cost of service.

If it is inappropriate to use a negative acquisition adjustment to establish rates, then it would be equally inappropriate to use a positive acquisition adjustment. Fairness would dictate that consistent treatment be given for both positive and negative acquisition adjustments. Acceptance of a positive acquisition adjustment would be a reversal of Commission precedent in the U.S. Water rate case. Re U.S. Water/Lexington, Missouri, Inc., Report And Order, 29 Mo.P.S.C.(N.S.) 552, (March 10, 1989).

As stated in the rebuttal testimony of John C. Dunn, witness for U.S. Water in that proceeding and at one time Chief of Economic Research for the Commission, the Commission has traditionally rejected the use of positive acquisition adjustments in rates. Mr. Dunn stated at page 22 of his rebuttal testimony:

> Further, the Commission has historically adopted a policy of original cost ratemaking. Regardless of purchase prices, when properties are bought and sold, the Commission has, unless there were compelling circumstances otherwise, regulated on the basis of original cost. There are numerous properties within the state which have been acquired at prices above original costs. **The Commission has routinely rejected the use of the purchase price when it is greater than original cost.** It appears to me to be entirely unreasonable for the Commission to now take an asymmetrical position and adopt purchase price as the appropriate standard when the purchase price occurs below original cost. **Either Missouri is original cost ratemaking, or it is not.** [emphasis added]

Thus, the rebuttal testimony of U.S. Water's witness strongly argued that the appropriate and traditional ratemaking theory relating to acquisition adjustments in Missouri is the use of net original cost.

In its initial brief (attached as Schedule 3), the attorneys for U.S. Water argued the concept of "net original cost" rate base. At page 22 of U.S. Water's initial brief, it was stated:

> ...a negative acquisition adjustment would not be appropriate for general ratemaking principles either. Mr. Drees provided a brief review of the situations which gave rise to the "original cost when first devoted to public service" rules. (Exhibit 6, p. 6) This principle has served to protect ratepayers from utilities selling at inflated prices and then seeking to have the regulators revalue the properties at the higher level, just to produce greater profits. Although there are always exceptions, Mr. Drees **concludes that sales of utility property at higher than net book value should be borne by the shareholders. USW is under the impression that is the general principle utilized by this Commission,** although there may have been a few exceptions.
>
> [emphasis added]

Q. Does using net original cost valuation for ratemaking purposes give consistent treatment to utilities?

A. Yes. Using net original cost to determine rate base valuation for ratemaking purposes provides utilities consistency in establishing their rates. It also provides utilities with the incentive to acquire utility properties of what may be troubled utilities where it would be in the public interest for these troubled utilities to be acquired by another company. Mr. Dunn addressed this view in his rebuttal testimony in U.S. Water case. At page 23 of his rebuttal testimony, Mr. Dunn stated:

> . . . troubled properties would never be sold. Here, the Commission was confronted with a troubled property and a buyer willing to purchase that troubled property for less than original cost assuming original cost regulation. That difference was part of the incentive in the transaction. Without the incentive associated with this

opportunity, the property would have never changed hands and improvements wouldn't even have been contemplated.

If the Commission adopts an asymmetrical policy in this proceeding where it uses the lower of purchase price or original cost to make rates, no potential buyer would even consider purchasing a troubled property in Missouri.

Indeed, Mr. Dunn's rebuttal testimony implies that utilities in the state of Missouri have considered and negotiated the acquisition of utility properties with the full knowledge and understanding that Missouri is a net original cost jurisdiction. Utility management in this State has made decisions to acquire utility properties with this belief.

Q. Has Mr. Dunn ever represented UtiliCorp?

A. Yes. Mr. Dunn has appeared as a witness on numerous occasions in Missouri and other states on behalf of UtiliCorp and Missouri Public Service over the past two decades, most recently in the last rate case filed by UtiliCorp in Case No. ER-97-394, as its rate of return witness.

GAINS ON SALE OF UTILITY PROPERTY

Q. How have gains on sale of utility property been treated for ratemaking purposes?

A. Recently, the Commission has not flowed back to ratepayers any of the benefits of the gains on sales. The selling party's shareholders have realized the entire benefit of the gains.

The Commission in its Report And Order in KCPL's 1977 general rate increase case, Case No. ER-77–118, found that none of the gains relating to four transactions should be included "above–the–line" and the Staff's adjustment on this issue was disallowed. At

Re: Kansas City Power & Light Company, Case No. ER–77–118, Report And Order, 21 Mo.P.S.C. 543; 576, (October 20, 1977), the Commission stated:

> It is the Commission's position that ratepayers do not acquire any right, title and interest to Company's property simply be paying their electric bills. It should be pointed out that Company investors finance Company while Company's ratepayers pay the cost of financing and do not thereby acquire an ownership position. Therefore, the Commission finds that the disposal of Company property at a gain does not entitle its ratepayers to benefit from that gain nor does the disposal of Company property at a loss require that Company's ratepayers absorb that loss.

Further, in decisions reached by the Commission in rate cases involving Missouri Cities Water Company, Re: Missouri Cities Water Company, Case Nos. WR–83–14, et. al., Report and Order, 26 Mo.P.S.C.(N.S.) 1, 5–6, 10–19 (May 2, 1983) and again respecting KCPL, Re: Kansas City Power & Light Company, Case Nos. EO–85–185, et al., Report and Order, 28 MoP.S.C.(.S.) 228, 253–56 (April 23, 1986), the Commission found that gains on sale of utility property sold by those utilities would be treated "below–the–line." The Commission has consistently followed this practice of not flowing any gains resulting from sales of utility property to ratepayers. It would be inequitable for the shareholders of a seller of utility property to receive the benefit of any gain therein through below-the-line treatment of the gain, while at the same time, the buyer of utility property is permitted to recover from its ratepayers any "premium," or excess costs above net book value, above-the-line. It would be an unfair approach and disadvantage to the ratepayers, if the seller's gain would be taken below–the–line, while the buyer's premium would be treated above–the–line.

Q. Do utilities sell properties to other utilities and later reacquire the very same properties?

A. Yes, this has happened in the past. In some cases, utilities sell property to another utility and reacquire the sold property back through a merger or acquisition later. This is an instance where the seller's owners reap the profits from any gain and the buying company may request ratemaking treatment for any of the acquisition premium paid for the property. This is a situation where the seller keeps the gains and the buyers' customers are requested to pay for the premiums relating to the acquisition.

Q. Has this Commission seen examples of one of the companies under its jurisdiction entering into a transaction to sell property and then reacquiring the very same property later through a merger?

A. Yes. On March 12, 1992, Union Electric filed an application with the Commission, docketed as Case No. EM-92-225, to sell its Iowa properties to Iowa Electric Light & Power Company (Iowa Electric). On March 31, 1992, Union Electric also filed an application in Case No. EM-92-253 to sell its northern Illinois properties to CIPSCO. The Commission authorized the sale of these properties in its Report and Order dated December 22, 1992. Re: Union Electric Company, Case Nos. EM-92-225 and EM-92-253, Report and Order, 1 Mo.P.S.C. 3d 501 (1992).

Q. Please identify the properties sold to Iowa Electric and CIPSCO.

A. Union Electric's Iowa properties were located in the southeastern part of the state having a service area of 566 square miles and serving approximately 17,000 customers. The northern Illinois service area was located just east of the Iowa service area and had approximately 4,200 customers. (Source: Union Electric witness Gary L. Rainwater, Direct Testimony, pp. 6 and 7, Case Nos. EM-92-225 and EM-92-253.)

Q. When were these properties sold?

A. These properties were sold on December 31, 1992.

Q. Did Union Electric sell these properties for a gain?

A. Yes. The gains Union Electric realized on the Iowa and northern Illinois properties totaled $34 million. Case Nos. EM-92-225 and EM-92-253, 1 MoPSC 3d 501, 503 Report and Order (1992).

The gain associated with the northern Illinois property was approximately $4.8 million. The remaining portion of the gain, or $29.2 million, relates to the Iowa service area ($34 million - $4.8 million).

Q. How was the sale of these properties recorded on the books and records of Union Electric?

A. Union Electric recorded these transactions by removing the properties from plant in service and from accumulated provisions for depreciation. It also recorded the cash received from Iowa Electric and CIPSCO and reflected the gains from the sale.

Q. How did CIPSCO record the purchase transaction?

A. CIPSCO recorded the purchase of the northern Illinois service area and facilities as an increase to plant in service on the "original cost" basis. It recorded the same amount on its books for plant as Union Electric had on its books.

CIPSCO debited the plant account for $8,882,092 and credited accumulated depreciation for $5,168,022. Union Electric credited the plant account and debited the accumulated depreciation account for the exact same amounts. Iowa Electric would have recorded amounts on its books in a similar fashion.

Q. Did CIPSCO identify an amount for an acquisition adjustment?

A. Yes. CIPSCO established an acquisition adjustment of approximately $4.9 million for the property sold to it by Union Electric. Union Electric recorded a gain to Account 421.1, Gain on Disposition of Property, of approximately the same value (the amounts differ slightly for the recording of salaries and other sales expenses recorded by Union Electric).

Q. How did Union Electric treat the gain?

A. The gains from the disposition of the Iowa and northern Illinois properties were treated below-the-line for ratemaking purposes; i.e., the profit from the sale of these properties was flowed back exclusively to the shareholders.

Q. Does CIPSCO still own the property it purchased from Union Electric?

A. Yes.

Q. How did the merger between Union Electric and CIPSCO affect this property?

A. The merger had the effect of bringing the property back to Union Electric shareholders, who became AmerenUE shareholders after the Union Electric/CIPSCO merger. The acquisition created from the sale of the northern Illinois property that was formerly owned by Union Electric and re-acquired as a result of the Union Electric/CIPSCO merger, is now reflected in the accounts of Ameren once again through Ameren CIPS (as an operating company of Ameren).

The property Union Electric sold in 1992 for a gain is reflected on Ameren's consolidated financial statements as an acquisition adjustment. Union Electric shareholders received the full benefit to earnings for this gain, and with the merger, these shareholders received the property back.

Q. How do gains on sale of property relate to the booking of acquisition adjustments?

A. The amount a selling utility books as a gain on sale will equal the amount a buying utility books as an acquisition adjustment.

Q. How did the application for the Union Electric merger with CIPSCO relate to the previous Union Electric sale dockets, Case Nos. EM-92-225 and EM-92-253?

A. In the sale dockets, Union Electric sold certain property to CIPSCO at a gain. This gain was booked below-the-line by Union Electric and was provided to its shareholders. In the Union Electric and CIPSCO merger Application, Union Electric, through Ameren, reacquired the property it earlier sold to CIPSCO that was at issue in Case Nos. EM-92-225 and EM-92-253. However, through Union Electric's proposed regulatory plan for the CIPSCO merger, it sought to charge the additional cost of the merger premium related, in part, to that specific property to its customers. This would have been clearly inconsistent with the treatment afforded the earlier gain on sale. As will be discussed, Union Electric later abandoned its attempt to recover the merger premium associated with the CIPSCO transaction by entering into a stipulation and agreement.

DISALLOWANCE OF MERGER PREMIUMS IN RATES DOES NOT AFFECT MERGERS BEING COMPLETED IN MISSOURI

Q. UtiliCorp witness John W. McKinney suggests in his direct testimony at page 18, that "by arbitrarily choosing not to include a premium in rates, the regulators inadvertently create disincentives for mergers that may offer net benefits for customers." Will disallowances of recovery of acquisition adjustments in rates create disincentives for utilities to acquire other utilities?

A. No, that does not appear to be the case at all in Missouri. The experience in Missouri appears to be that if the utility considering an acquisition believes that it is in its economic as well as its business interest, it will acquire the other company regardless of any recovery of an acquisition adjustment from ratepayers. There have been numerous mergers and acquisitions that have occurred over the years that were negotiated with merger premiums. No utility to date has received recovery in rates in Missouri for an acquisition adjustment, but that has not stopped any of the mergers from being completed.

Utilities have combined with other utilities independent of receiving recovery of the merger premium directly from their customers. There have been numerous mergers announced and completed in the past, all with the knowledge that this Commission has not ever included a merger premium in rates.

Q. Was there an acquisition adjustment relating to the KPL merger with KGE in Case No. EM–91–213?

A. Yes. Western Resources paid an amount for KGE in 1992 which exceeded its net book value, resulting in an acquisition adjustment identified at the time of the filing in that case of approximately $388.7 million.

Q. Did the Commission ever include any amount of the KGE acquisition adjustment in rates?

A. No. No amount of the KGE acquisition adjustment was ever recovered in rates from Missouri ratepayers.

Q. Was Staff opposed to the recovery of the acquisition adjustment relating to the KCPL and Western Resources merger in rates in Case No. EM-97-515?

A. Yes. Western Resources initially sought recovery of the acquisition adjustment in rates in both states of Missouri and Kansas through its "incentive regulatory plan." To the extent Western Resources attempted to recover from Missouri customers the acquisition adjustment resulting from the proposed KCPL merger, Staff took the position that should be considered a detriment from the proposed merger.

Q. Did Western Resources later agree not to include the acquisition adjustment in rates?

A. Yes. In Case No. EM-97-515, Western Resources and KCPL agreed that the acquisition adjustment would not be recovered in rates. The Stipulation and Agreement in that case stated the following regarding the recovery of the merger premium:

> **2. MERGER PREMIUM**
>
> The **amount of any asserted merger premium** (*i.e.*, the amount of the purchase price above net book value) paid by Western Resources for KCPL **shall be treated below the line for ratemaking purposes in Missouri and not recovered in rates**. The Joint Applicants, including Westar, shall not seek to recover the amount of any asserted acquisition premium resulting from this transaction in rates in any Missouri proceeding and the Joint Application shall be considered as amended in this regard. The Joint Applicants have currently estimated this amount as approximately $870 million. In addition, Westar shall not seek to recover in Missouri the amount of any asserted acquisition premium in this transaction as being a "stranded cost" regardless of the terms of any legislation permitting the recovery of stranded costs from ratepayers.
>
> [Stipulation and Agreement in Case No. EM-97-515; emphasis added]

Q. Did the Commission approve the Stipulation and Agreement for the KCPL merger with Western Resources?

A. Yes. On September 2, 1999, the Commission approved the merger along with the Stipulation and Agreement that contained the "no acquisition adjustment recovery" language.

Q. Has there been a more recent merger case involving other utilities where the merging utilities have agreed to merge without recovery of the acquisition adjustment?

A. Recently, April 20, 2000, in Case No. GM-2000-312, the Commission approved the Stipulation and Agreement requesting the acquisition of the natural gas assets located in Missouri of Associated Natural Gas Company (Associated), wholly owned by Arkansas Western Gas Company (Arkansas Western), by Atmos Energy Corporation (Atmos). Atmos agreed not to seek recovery of the acquisition adjustment from Missouri customers. Previously, Arkansas Western's acquisition of Associated was approved by the Commission in Case No. GM-88-100 on May 13, 1988, at a premium but without recovery of the acquisition adjustment, and Arkansas Western recently sold the property to Atmos for a premium. The language in the recent Atmos acquisition – Arkansas Western Stipulation and Agreement, is almost identical to the language in the Western Resources-KCPL Stipulation and Agreement. The Unanimous Stipulation and Agreement states, as follows:

> **3. <u>Acquisition Premium</u>**
>
> The amount of any asserted acquisition premium (i.e., the amount of the total purchase price above net book value), including transaction costs, paid by Atmos for ANG [Associated Natural Gas] properties or incurred as a result of the acquisition **shall be treated below the line for ratemaking purposes in Missouri and not recovered in rates**. Atmos shall not seek either direct or indirect rate recovery or recognition of the acquisition premium, including any and all transaction costs (e.g., legal fees, consulting fees and accounting fees), in any future ratemaking proceeding in Missouri. However, Atmos reserves the right to present evidence regarding any purported Sale-related savings in any rate complaint proceeding initiated by Staff or Public Counsel. [emphasis added]

Q. Have other utilities committed to not seek recovery of acquisition premiums in rates related to property acquired in Missouri?

A. Yes. In an application of Union Electric to merge with CIPSCO filed on November 7, 1995, Union Electric entered into a Stipulation and Agreement that contained language that it would not seek recovery of a purported merger premium. The Commission on February 21, 1997 approved the merger, along with the Stipulation and Agreement. As part of the Stipulation and Agreement was the language that, "UE shall not seek to recover the amount of any asserted merger premium in rates in any Missouri proceeding. UE has identified this amount as $232 million." In addition, alleged merger benefits were discussed in the Stipulation and Agreement:

> UE shall retain the right to state, in future proceedings, alleged benefits of the merger but UE **commits to forego any additional specific adjustments to cost of service related to the merger savings or any claim to merger savings** other than the adjustments to cost of service and claims to merger savings resulting from the Commission's approval of this document or the benefits and savings which would occur through regular ratemaking treatment or the current Experimental Alternative Regulation Plan ("ARP") or the new Experimental Alternative Regulation Plan ("the New Plan") effective July 1, 1998 pursuant to this document. [emphasis added]

In the application to acquire APL's Missouri properties, Union Electric also agreed to not seek recovery of the acquisition premium. The parties to this Joint Application, designated as Case No. EM-91-29, signed a Stipulation and Agreement on January 25, 1991. As part of the Stipulation and Agreement, Union Electric agreed not to seek recovery of the acquisition premium in any rate case in the future:

> The amount of any acquisition premium (i.e., the amount of the purchase price above net book value) paid by UE to APL for the electric properties of APL shall be treated below the line for ratemaking purposes in

> Missouri and shall not be sought to be recovered by UE in rates in any Missouri proceeding, and the Joint Application should be considered as amended in this regard.

The Staff performed an earnings audit in Case No. EM-91-29, and in Case No. EO-87-175, concurrent with the Stipulation and Agreement in Case No. EM-91-29, Union Electric agreed to absorb a $30 million decrease in revenue requirement allocated to the Small General Service, Large General Service and Primary Service customer classes. Re: Union Electric Co., Case Nos. EM-91-29, et al., Report and Order, 1 Mo.P.S.C. 3d 96, 108 (1991) and Re: Union Electric Co., Case No. EO-87-175, Report and Order, 30 Mo.P.S.C.(N.S.) 406, 410 (1990).

Also, Southern Union, parent of Missouri Gas Energy, agreed in 1993 to not recover the acquisition premium relating to its purchase of the Missouri properties of Western Resources. On August 5, 1993, Western Resources and Southern Union filed an application with the Commission seeking authority from the Commission to make this purchase transaction in Case No. GM-94-40. The Stipulation and Agreement states as follows:

> The amount of any acquisition premium (i.e., the amount of the purchase price above net book value) paid by Southern Union to Western Resources for the gas properties of Western Resources shall be treated below the line for ratemaking purposes in Missouri and neither amortization nor inclusion of the premium in rate base shall be sought to be recovered by Southern Union in rates in any Missouri proceeding.

The Commission approved the Stipulation and Agreement on December 29, 1993.

Utilities operating in this State know the position taken by various parties relating to the non-recovery of merger premiums/acquisition adjustments in rates and the Commission's approval of this. Yet, despite no utility being permitted direct recovery of a merger premium/acquisition adjustment in rates, mergers continue to be pursued and consummated. Other examples of this situation exist.

Q. UtiliCorp witness Robert K. Green cites previous Commission decisions at page 16 of his direct testimony as a basis for UtiliCorp to be "encouraged about the prospect of premium recovery by the policy position articulated by the Commission in these cases." Did the Commission allow recovery of any purported acquisition premium in the cases relied on by UtiliCorp?

A. No. One of the decisions Mr. Green cites is the Missouri-American Water Company case referred to at page 15 of his direct testimony (Case No. WR-95-205). The Commission did not allow recovery of the acquisition adjustment from Missouri-American's customers. The Commission stated in its Report and Order that "[t]he Commission finds in this case that the Company has failed to justify an allowance for the acquisition adjustment." Re: Missouri-American Water Company, Case Nos. WR-95-205 and SR-95-206, Report and Order, 4 Mo.P.S.C. 3d 205, 217 (1995).

Another case cited by Mr. Green was Case No. EM-91-213 which is the case authorizing KPL to acquire KGE. The Commission did not allow recovery of the acquisition adjustment from KPL's customers in that case. The Commission also did not adopt a "tracking" proposal presented by KPL that KPL claimed would have identified, verified and quantified purported merger savings and shared those savings equally between shareholders and customers. No part of the KGE acquisition adjustment was recovered by KPL from Missouri customers.

Staff does not believe the Commission's prior decisions on the subject of acquisition adjustments articulated in the above cases in any way served to "discourage companies from actions which produce economies of scale and savings which can benefit ratepayers and shareholders alike." Re: Missouri-American Water Company, 4 Mo.P.S.C. 3d at 216.

Q. Is there another case decided by the Commission where a utility presented evidence of savings as result of an acquisition, and attempted to justify special rate treatment of the alleged merger savings?

A. Yes. In the Missouri Gas Energy (MGE) 1996 rate increase case, (Case No. GR-96-285), the Commission rejected a proposal by MGE to allow MGE to retain purported savings from Southern Union's acquisition of the Missouri properties of Western Resources in 1994. As part of the Stipulation and Agreement in Case No. GM-94-40, MGE could present to the Commission in its rate case purported evidence of savings resulting from the acquisition. The Commission's Report and Order in Case No. GR-96-285 states in part as follows:

> MGE contends that the stipulation and agreement allows MGE to request recovery of the benefits resulting from the acquisition. MGE contends that an equal sharing of these ongoing savings between customers and shareholders is a reasonable ratemaking approach and is consistent with the terms of the stipulation and agreement.
>
> . . . .
>
> ...Staff recommends that the Commission reject MGE's proposal because it does not represent appropriate or proper ratemaking policy because the alleged savings are not adequately quantified by MGE; the proposal is not fair and equitable; utilities other than MGE have also downsized without expecting any sharing of related savings; the alleged cost reductions benefited MGE at least up until any rate changes resulting from this proceeding; the proposal represents the equivalent of an incentive plan without any safeguards; the proposal shifts risks of MGE's cutbacks and related cost reductions to its customers; the proposal represents an attempted recovery of the acquisition premium from Case No. GM-94-40; and the proposal would take MGE off of cost of service ratemaking (cost-based rates). (Ex. 72, pp. 4-5) The Staff further argues that adoption of MGE's proposal would reward the Company for providing a lower quality of service while at the same time requesting ratepayers to pay higher than cost-based rates.
>
> The Commission finds that MGE's **acquisition savings adjustment should be rejected** in total because adoption of this adjustment would

> be contrary to the provision of natural gas service based on the costs of providing such service and because MGE's experimental gas cost incentive mechanism already rewards MGE's shareholders for making financially sound gas procurement decisions.
>
> [Re: Missouri Gas Energy, Case No. GR-96-285, Report and Order, 4 Mo.P.S.C. 3d 437, 460-461 (1997)]

Q. Would providing UtiliCorp direct recovery of the acquisition adjustments relating to the Empire and St. Joseph mergers be fair to all the other utilities which have agreed to not seek direct recovery of merger premiums or which have had their merger premium recovery proposals rejected by the Commission?

A. No. UtiliCorp is not unique in the sense that it desires to have customers of Empire, St. Joseph and Missouri Public Service subsidize their acquisition strategies. If one can get someone else to pay for purchases, it is likely the purchases will increase and prices paid will also escalate. In prior cases, the utility, whether it was Union Electric seeking recovery of its asserted merger premium "paid" to CIPSCO shareholders or Western Resources paying KCPL's shareholders a substantial premium to merge, all took the position that their mergers justified the recovery of the acquisition premium from their customers. As indicated above, either through Commission order, or stipulation and agreement among the parties, none of the utilities received direct recovery of the merger premium. Under UtiliCorp's proposed regulatory plan, the ultimate recovery of the acquisition adjustment directly from the customers of Empire, St. Joseph and Missouri Public Service would be unfair and unreasonable to all other utilities, which have had to find other means to "pay" for their growth strategies besides requiring their customers to pay for those activities.

There has been no showing that either the Empire merger or the St. Joseph merger is truly necessary other than from the perspective of the shareholders of the companies being

"purchased" and the understandable desire to "cash-in" on the opportunity to sell their shares of stock to UtiliCorp. Customers may or may not ever directly benefit from either one of these mergers, and if there are merger benefits, we may never be able to determine what they are. It is abundantly clear that the mergers will benefit the shareholders of Empire and St. Joseph. It is equally clear that UtiliCorp wants these two companies to supplement and promote their "midwest-continent" strategy. Empire and St. Joseph fit into the growth and acquisition strategy that UtiliCorp has actively pursued for almost two decades. Just as the Staff has consistently, in Missouri Public Service rate cases, raised concerns about Missouri Public Service customers subsidizing UtiliCorp's national and international growth and acquisition strategies, it would be unreasonable and inappropriate for the customers of Empire, St. Joseph and Missouri Public Service to provide the funding for these mergers through their rates.

TERMINATION OF THE KCPL MERGER WITH WESTERN RESOURCES

Q. Did the KCPL merger with Western Resources ever close?

A. No. KCPL terminated the merger after a nearly three-year attempt for those two companies to merge. On January 3, 2000, KCPL announced that it was exercising its rights as identified in the KCPL and Western Resources' merger agreement to terminate the merger.

Q. Do you believe the KCPL merger was terminated because the Commission approved the merger without the direct recovery of the merger premium?

A. No. KCPL terminated the merger with Western Resources because of Western Resources' non-regulated activities. The termination of that merger did not occur because of the

Stipulation and Agreement that Western Resources-KCPL voluntarily entered into with the Staff, Public Counsel and others.

Q. Please provide a history of the KCPL and Western Resources merger.

A. The merger between KCPL and Western Resources had a long history. On May 30, 1997, KCPL filed its initial application with the Commission requesting approval of a merger between KCPL and Western Resources as a result of the Agreement and Plan of Merger (original merger agreement) dated February 7, 1997.

In June 1998 these two companies filed a revised merger application as a result of an Amended and Restated Agreement and Plan of Merger (Amended Merger Agreement) between KCPL and Western Resources dated March 18, 1998. Under terms of this merger agreement, KCPL and Western Resources planned to merge, forming a newly created energy company called Westar Energy, Inc. (Westar). Western Resources planned on operating Westar as a holding company, owning approximately 80 percent of Westar. Both Westar and Western Resources would have been publicly traded on the New York Stock Exchange.

Q. Why did KCPL decide not to merge with Western Resources?

A. KCPL indicated that the stock price of Western Resources was significantly below the level negotiated between the two companies, which would have resulted in a material decrease in the value that the KCPL shareholders would have received if the merger had been closed.

Q. What was the reason that Western Resources stock price was trading significantly below the level KCPL negotiated for its shareholders?

A. Western Resources had invested a substantial part of its assets in a security alarm system business as part of its diversification efforts. Western Resources has an 85% ownership

interest in Protection One. This non-regulated company has experienced substantial operational and regulatory problems that has caused the stock price of Western Resources to deteriorate. KCPL's Board of Directors believed it had no choice but terminate the merger.

Q. What was Western Resource's common stock price at the time KCPL decided not to merge?

A. Western Resource's price of common stock was $16.50 per share on January 3, 2000, the day of the announcement by KCPL that it had made the decision not to complete the merger with Western Resources.

Q. Has Western's Resources common stock price improved since the collapse of the KCPL merger?

A. No. Since the collapse of the KCPL merger, Western Resources' common stock price has continued a generally downward course. As an example, on January 31, 2000, the price per common share was $16.00; on February 29, 2000, the price per common share was $15.437; and on March 31, 2000, the price per common share was $15.812. On April 10, 2000, the price per common share was $15.062. Western Resources has not recovered since the demise of the KCPL merger, hitting a low of $14.937 per common share on April 7, 2000. Western Resources' common stock price for April 28, 2000 closed at $15.75 per share. The yearly high/low tables indicated a range from $29.37 to $14.68 per common share.

At the same time KCPL's stock price has continued to rise. On January 3, 2000, KCPL's stock price closed at $22.437 per common share. On January 31, 2000, the close was $24.312 per common share; on February 29, 2000, the stock closed at $23.00 per common share; on March 31, 2000, it closed at $29.00 per common share. For April 28, 2000, KCPL's

common stock price closed at $25.687. The yearly high/low tables indicated a range from $29.00 to $20.81 per common share.

Q. What were the common stock prices of KCPL and Western Resources during the time the merger was pending?

A. The month-end common stock prices for the two companies were:

Date	Western Resources	KCPL
January 30, 1998	$40.75	$28.375
February 27	$41.00	$30.125
March 31	$42.75	$31.50
April 30	$39.062	$29.75
May 29	$38.375	$28.75
June 30	$38.812	$29.00
July 31	$39.00	$28.937
August 31	$40.312	$28.437
September 30	$41.375	$30.437
October 30	$35.00	$28.812
November 30	$34.937	$29.687
December 31	$33.25	$29.625
January 29, 1999	$31.437	$28.312
February 26	$28.187	$25.50
March 31	$26.687	$24.625
April 30	$27.187	$26.75
May 28	$29.062	$27.812
June 30	$26.625	$25.50
July 30	$26.125	$24.625
August 31	$23.875	$24.062
September 30	$21.375	$24.187
October 29	$23.062	$24.50
November 30	$18.687	$23.062
December 31	$16.937	$22.062

Beginning in first quarter of 1999, Western Resources started to release information to the public that it was having significant problems with its non-regulated operations. This started the decline in Western Resources' common stock price. As long as the merger was "in play,"

KCPL's stock price was tied to Western Resources' stock price, so KCPL's stock price also began its descent at this time as well.

Q. Did the merger settlements approved by the KCC and the Missouri Commission have anything to do with the collapse of the merger between Western Resources and KCPL?

A. No. All the information I have seen regarding the reason for KCPL terminating the merger related solely to the declining value of the merger to KCPL's stockholders resulting from the substantial reduction in Western Resources common stock price. KCPL's stockholders, who initially approved the merger, would have received far less for their shares than they originally would have received at the time of the shareholder vote on July 30, 1998. The merger agreement between Western Resources and KCPL allowed KCPL to terminate the merger if Western Resources' common stock price fell below $29.78 or if the merger was not completed by December 31, 1999. (Amended And Restated Agreement And Plan Of Merger between KCPL and Western Resources dated March 18, 1998, Article XI-Termination, Amendment and Waiver—Section 11.1 Termination (c) and (f).)

A review of Western Resources' common stock prices surrounding the key dates during the regulatory process provides information on the relationship of those events on the stock price.

Event	Date	Western Resources Price	KCPL Price
Western Resources and KCPL shareholders approve merger	July 30, 1998	$39.562	$29.375
KCC Staff filing	February 18, 1999	$28.937	$26.625
	19	$29.375	$26.437

Missouri OPC filing	April 22	$26.50	$24.937
	23	$26.937	$24.625
Missouri Staff filing	April 26	$26.812	$24.562
	27	$27.00	$24.937
KCC Staff settlement	May 6	$27.75	$27.187
	7	$28.375	$27.00
	10	$28.687	$27.25
Missouri settlement	July 19	$25.375	$25.75
	20	$25.375	$26.312
	21	$25.937	$26.125
KCC introduces Missouri settlement	August 2	$26.50	$25.25
	3	$26.625	$24.937
	4	$26.187	$24.375
KCC Staff settlement rejected	August 11	$25.50	$23.625
	12	$24.50	$23.50
	13	$24.25	$23.437
KCC decides terms of approval	August 25	$24.00	$24.375
	26	$24.375	$24.375
	27	$24.375	$24.187
Missouri approval Order	September 2	$23.50	$23.937
	3	$23.437	$24.125
	7	$22.562	$24.187
KCC approval Order	September 28	$20.812	$23.437
	29	$20.75	$23.687
	30	$21.375	$24.187
KCPL terminates merger	January 3, 2000	$16.50	$22.437
	4	$17.062	$23.50
	5	$17.937	$23.875

As Western Resource continued to receive bad news about its non-regulated operation of Protection One, its stock price continued to decline. Since KCPL's January 3, 2000 termination of the merger, Western Resources' stock price has not improved and has continued

to decline from the $16.50 per common share price on that date to the June 19, 2000 closing of $16.312 per share.

There have been several news articles written about the collapse of the KCPL merger and all of them attribute the reason for the termination of the merger to the decline in Western Resources' stock price as a result of Protection One operating and regulatory problems. None of the articles I have seen attributes the decline in Western Resources' stock price to the settlements reached in either of the State jurisdictions. In fact, if these decisions were so bad, then one would have expected to see an increase in Western Resource's stock price, since the termination of the merger also had the effect of terminating the terms of the conditional approvals of the Missouri Commission and the KCC. Western Resources' common price stock has not increased since the termination of the merger by KCPL; rather, the Western Resources stock price has further declined.

Q. How have the credit rating agencies reacted to Western Resources' recent financial problems?

A. Western Resources' ratings were lowered and Western Resources was placed on CreditWatch by the Standard & Poor's rating agency. Western Resources' corporate credit rating was lowered to BB+ from its previous BBB+ rating. Standard & Poor's also placed Western Resources on its CreditWatch with negative implications. Western Resources has also cut its common stock dividend to about $1.20 from the previous $2.14 per share.

Moody's also announced it was placing Western Resources' and KGE's ratings on review for possible downgrade. (KGE is a subsidiary of Western Resources). Fitch placed its ratings of Western Resources and KGE on RatingAlert – Negative. Western Resources filed its Form 10-K with the Securities and Exchange Commission (SEC) on March 29, 2000,

identifying downward pressure to Protection One's ratings, which affects Western Resources and KGE. Western Resources stated the following:

> In response to liquidity and operational issues and the announcement by Western Resources that it is exploring strategic alternatives for Protection One, in November 1999, Moody's, S&P and Fitch downgraded their ratings on Protection One's credit facility and outstanding securities. On March 24, 2000, Moody's further downgraded their ratings on Protection One's outstanding securities with outlook remaining negative.
>
> [Source: Western Resources Form: 10-K404 filing date: March 29, 2000]

Q. Has KCPL explained the reason for the termination of the merger with Western Resources?

A. KCPL has stated it was because of the problems with Western Resources stock price caused by the non-regulated operations of Protection One. In KCPL's Form 10-K405 filing with the SEC on February 10, 2000, KCPL identified the reason its Board of Directors voted unanimously on January 2, 2000 for the termination of the merger as follows:

> A key factor in the KCPL's Board's action was problems at Western Resources' Protection One subsidiary and their impact on Western Resources as a whole. **These problems and the related decline in Western Resources' stock price since the signing of the Merger Agreement had a direct bearing on the value of the contemplated transaction to KCPL's shareholders,** as well as the future prospects of Western Resources and its affiliated companies assuming such transaction was consummated. Western Resources' common stock, which closed at $43.13 per share on March 18, 1998, closed at $16.94 per share on December 31, 1999.
>
> Also critical among the KCPL Board's reasons for their decision was the fact that KCPL's financial advisor, Merrill Lynch & Co., was unable to provide an opinion that the contemplated transaction was fair to KCPL shareholders from a financial point of view.

[Source: KCPL's Form: 10-K405 filing date: February 10, 2000]

In a letter dated January 3, 2000 sent to Western Resources, KCPL's Chairman of the Board and Chief Executive Officer, A. Drue Jennings cited the reasons KCPL was terminating the merger. Mr. Jennings stated the following in his letter to Mr. David Wittig of Western Resources:

> Our Board took this action reluctantly and only after giving extensive consideration to all of the relevant facts and circumstances surrounding the transaction. As you know, our Board has held a number of meetings during the past several months to review and consider the status of the transaction. These meetings included a special meeting on October 28, 1999, at which you addressed the Board concerning the financial condition and future prospects and business plan of Western Resources, Inc. ("Western"), **and in particular, the current problems facing your Protection One subsidiary...**
>
> ....
>
> At these meetings, as well as in other communications between our respective companies and their representatives, **we have expressed our deep concern with the problems facing Protection One and their impact on Western as a whole...**
>
> ....
>
> While we and our advisors have given careful consideration to the information you conveyed to us in these meetings, I regret to say that our Board has concluded that the transaction contemplated by the Merger Agreement is no longer in the best interests of KCPL and its shareholders. Critical among the Board's reasons for reaching this conclusion was the fact that Merrill Lynch advised that it could not opine that the transaction is fair to KCPL shareholders from a financial point of view. In addition, one of the principal reasons that our Board recommended that KCPL shareholders approve the transaction was that it would provide them with an opportunity to participate, "through their ownership of Western Resources Common Stock, in the growth of a larger, more diversified and strategically positioned holding company," which growth was "expected to derive from diversification into unregulated businesses, including Western Resources' investment in Protection One...." (Joint Proxy Statement of KCPL and Western dated June 9, 1998, at page 42.) **In light of the continuing problems**

> **at Protection One, this important strategic rationale for the proposed merger no longer appears to exist.** Finally, we have heard from numerous KCPL shareholders in recent months – both large institutional holders and small individual holders – who, in increasing numbers, have expressed their opposition to the transaction and have strongly urged that we terminate the Merger Agreement.
>
> [Source: Letter dated January 3, 2000 from A. Drue Jennings to David Wittig of Western Resources]

In an article that appeared in The Kansas City Star on March 9, 2000, Mr. Jennings said "doubts about the merger began to rise in the second quarter of 1999 because of problems at Protection One Inc., the monitored-security firm that is 85 percent owned by Western. The continuing decline of Western's stock, which affected what would be paid to KCP&L shareholders, sealed the deal." Another article in the January 4, 2000 edition of the Topeka Capital-Journal, cited the original value of the merger at $2.1 billion at the time of the March 18, 1998 merger agreement was worth approximately $1.4 billion at the time of the termination because of the steep decline in Western Resources' stock price.

Without question the reason KCPL terminated the merger with Western Resources was because of the adverse impact Protection One had on the Western Resources' stock price, which in turn made the value of the merger to KCPL and its shareholders substantially less than when the Board of Directors approved the Merger Agreement on March 18, 1998 and when the shareholders approved the merger on July 30, 1998.

The terms of the merger approval by the Missouri Commission and the KCC were not the reason that the Western Resources-KPL merger was not consummated.

Q. Why is the Staff addressing in such detail the reasons for the termination of the Western Resources/KCPL merger?

A. During the transcribed interviews of Mr. Robert Green and Mr. Terry Steinbecker, they made statements that the Missouri and Kansas settlements were material factors causing the termination of the merger between KCPL and Western Resources.

MERGER TRACKING

Q. Are the Joint Applicants proposing to track merger savings?

A. Yes. The Joint Applicants are proposing a regulatory plan that will allow the post-merger UtiliCorp to recover the merger premium through retention of merger and non-merger related savings and through direct recovery of the acquisition adjustment through rate base and amortization treatment in a rate case after a five-year moratorium. Under their proposal, UtiliCorp and Empire propose to "track" all savings, regardless if they are merger-related or non-merger related. The Joint Applicants' regulatory plan is also addressed in the rebuttal testimonies of Staff witnesses Oligschlaeger and Janis E. Fischer.

Q. What is tracking of merger savings?

A. Tracking of merger savings is the post-merger process where it is asserted that the results of specific actions relating to the merger are isolated so they can be and are identified, verified and quantified. The theory is that the purported results of what would have occurred but for the merger can be and are identified, verified and quantified and compared to substantiated non-merger related savings to determine whether there are merger savings and the amount of those savings. Tracking is the phenomenon by which this comparison of post-merger costs with pre-merger stand-alone costs is alleged to be possible.

Q. Can merger savings be "tracked"; i.e., quantified and verified after–the–fact?

A. Tracking of merger savings is extremely difficult if it can be done at all and, in actuality, it is probably not possible. It certainly is not practical to track merger savings.

Q. Are you saying that it is difficult to prove and verify the actual savings which are purported to result from acquisitions and mergers?

A. Yes.

Q. Why is that the case?

A. The difficulty in identifying, verifying and quantifying merger savings, as well as merger costs, relates to the true difficulty in distinguishing between merger and non–merger events. Disputes will result which most likely will have to be resolved by the Commission. It is difficult to find agreement among the various parties as to what constitutes actual merger savings and, to a lesser extent, merger costs. Certainly, KPL, under the proposal advanced in the KPL/KGE merger case, Case No. EM–91–213, to share all merger savings on a 50/50 basis, had real incentives to identify and quantify as much savings as merger–related as possible, while ignoring merger costs. The more merger savings and the less merger costs KPL could identify and quantify, the more dollars KPL believed it was entitled to recover via the merger premium.

Utilities are complex organizations with overlapping activities and functional areas. They are dynamic organizations that operate in ever–changing environments. Generally, utilities are constantly organizing and reorganizing functions within their corporate structure to streamline activities and obtain efficiencies where possible. Various terms have been used to identify the restructuring of today's utility organizations, such as downsizing, realigning, re-engineering and right-sizing. Most utilities should and do attempt to achieve efficiencies through the implementation of productivity measures. In this environment, it is unrealistic to believe that a tracking system can be put in place to identify and quantify savings and then isolate these savings as merger or non-merger related. It is very difficult to determine and measure the "cause and effect" relationship that may exist between taking an action and

identifying and measuring the effects of that action versus not taking an action and identifying and measuring the effects of the nonaction.

Any cost savings tracking system would have to be sophisticated enough to not only identify categories of prospective savings and costs, but to create documentation so that an examination can be conducted after-the-fact to recreate the decision–making process surrounding the costs and savings. Disagreements and disputes are certain in the context of an after–the–fact analysis. While one party may assert that an efficiency is the result of a merger, another may view as nothing more than an operating efficiency, addressing a pre–existing condition of an on-going concern. Disputes will arise because companies have an incentive to identify as much of the savings as merger-related as possible, to capture as much of the merger savings as possible for shareholders. As stated previously, there will be an incentive for the utility to identify as merger-related as many workforce reductions and corresponding reductions in costs as possible. This inherent incentive makes it increasingly difficult on a going-forward basis to truly identify and quantify merger savings, as opposed to non–merger cost savings, because it is not possible to objectively evaluate what would have happened if the merger had not occurred. Utilities having to prove the existence and the amount of merger savings to justify the inclusion of the acquisition adjustment in rates, will make every effort to take credit for savings that may in actuality be nothing more than non-merger related.

Q. Why is it not possible to "track" merger savings?

A. Realistically, it is probably impossible to accurately "track" merger savings because it requires a comparison of cost structures of the entities being merged on a pre-merger and post-merger basis. If this process is not impossible, it certainly is not practical to accurately identify merger savings. This tracking process would be extremely difficult at best and to my

knowledge has never been done successfully before. The merged entities lose their complete identity post-merger, almost from the first day after the close of the merger. In fact, Empire lost its pre-merger identity the day the merger was announced to the public on May 11, 1999. The pre-merger Empire entity has not existed since.

Upon the announcement of a merger, the merging companies' stock prices are immediately affected. On May 10, 1999, the day before the announcement and the date the merger agreement was completed, the common stock price of Empire was $21.25 per share. On May 11, 1999, the day of the announcement, Empire's stock price increased to $25.50 per share. On May 10, 1999, there were over 79,000 shares traded and on May 11, 1999, there were over 266,000 shares traded.

Every decision made by the companies after the merger is agreed to and announced is affected. Spending levels, human resources decisions, construction projects, etc. are all impacted. Every corporate decision is subject to the terms and conditions of the merger agreement; consequently, the corporate entity as it existed prior to the announcement of the merger no longer exists. While the period during the merger approval process generally results in significant changes at the entity being acquired, certainly after the completion of the merger the acquired entity ceases to exist in every sense. To compare an ever-changing pre-merger stand-alone entity to an emerging post-merger entity presents more than a challenge; it is an incredible task that, to the Staff's knowledge, never has been achieved before.

Q. What are the reasons that tracking is impracticable to do?

A. The reasons the Commission should not rely on UtiliCorp's "tracking" to justify the recovery of the acquisition premium are:

- There is difficulty in establishing a proper baseline and in distinguishing merger and non-merger related impacts on earnings.

- Human intervention is required to subjectively determine how future events and transactions are identified, verified and quantified.
- Tracking has not been successfully done in Missouri.
- UtiliCorp has not provided a detailed or a concrete proposal.
- Empire and UtiliCorp ceased to exist as stand-alone companies the day the merger was announced. It is impossible to identify what would have been a non-merger versus merger savings.
- The merged companies will continue to seek/achieve non-merger savings.
- The sophistication of UtiliCorp's accounting system is not relevant to the success of tracking.
- The attempt to track merger savings will be complicated because of prior difficulties in working with UtiliCorp in providing timely and accurate information and the lack of cooperation that has existed in prior cases.
- The attempt to track merger savings will be further complicated by any future merger and acquisition activity of UtiliCorp.
- The attempt to track merger savings will be further complicated by future organizational and re-engineering changes that every company experiences.
- The attempt to track merger savings will be further complicated by any future restructuring of the electric utility industry in the state of Missouri.

Q. Is Staff aware of anyone using a "tracking" system to identify merger savings to set rates?

A. No. To the best of Staff's knowledge this has never been accomplished in any jurisdiction.

Q. Has Staff addressed the ability to track merger savings and non-merger savings in prior merger cases?

A. Yes. In all the major merger applications filed with the Commission, merger savings tracking has been examined. As has been previously identified in the merger between KPL and KGE, Case No. EM-91-213, tracking of savings was an issue. Also, tracking was addressed in the Union Electric merger with CIPSCO, Case No. EM-96-149, and the KCPL merger with Western Resources, Case No. EM-97-515. In all three of these merger cases, Staff interviewed a consultant hired by the utilities to identify merger savings. The consultant was Mr. Thomas J. Flaherty, national partner for Deloitt & Touche, LLP., who specializes in merger

analyses, especially, merger synergies studies. Mr. Flaherty has been involved in a number of the mergers throughout the United States.

Q. Has Staff ever conducted an interview of Mr. Flaherty in the course of a merger case?

A. Yes. Staff conducted a transcribed interview with Mr. Flaherty on February 26, 1999 relating to his work on the KCPL/Western Resources merger. The transcribed interviews in the Union Electric/CIPSCO merger and the KCPL/Western Resources merger were very similar to the transcribed interviews performed in this case.

During his February 26, 1999, interview, Mr. Flaherty discussed the difficulty of identifying savings and distinguishing them between merger and non-merger related events. He indicated that he was not aware of any attempt to track merger savings after-the-fact and to use the results to set rates.

Portions of his transcribed interview appear as follows:

> Q. As far as from our perspective, at U.E., there was no such requirement, and there has been no, ... to my knowledge, any attempt made to go back and track the achieved cost versus the estimated or forecasted savings. Is there a reason why that it is not done? Is it too difficult?
>
> A. If I recall the arguments we had back in the testimony in the KPL/KG&E case probably still apply. It is an administrative burden, I think, on both parties. It is relatively easy to track the changes in staffing. It is less easy to necessarily identify or attribute the reason for the change in every position circumstance. But once a position is gone, it is generally gone forever. But you could track the head count numbers.
>
> The problem, for example, that a lot of companies have, is that if you offer an early out program of some kind, more people may take it than the actual number of what you were pursuing in the proposed merger reductions. So then you are reduced to sort of sorting out, where did you get those from versus where you thought you got those from.

Once you get to the non-labor areas, it is a lot tougher to necessarily look at unit cost differences and get all the right factors working together, because companies will redefine certain arrangements. It is like insurance. You could look at the cost per thousand dollars of coverage provided between companies, but people have differences in terms of self-insurance philosophy or the level of coverage and the terms of that coverage and the deductibles and things like that. So people tend to look at an overall package again. Just like redoing all your credit facilities for the new company, as opposed to all the separate ones that used to exist there.

So it is harder to separate, which is why people I think have shied away from it. Then when you move to something like the production area or dispatch, it is much more harder to do that than any of the other two preceding categories, staff and early corporate programs, simply because you may have a starting point, but that starting point is only good at that instant it existed. All the facts and circumstances externally changed around gas prices and supply and what happened in the region with available capacity, and the number of customers, customer usage and all those things.

So there were other features that people just sorted to as a more convenient way of getting the sort of the same end of understanding what ultimately happened. An index approach or the reporting requirement after five years or something like that, to revisit rates. It is the administrative burden, I think, and the lack of certainty that necessarily goes with it.

Q. We got into several of these, what you just mentioned, the KPL/KG&E merger as I recall. And some of the argument was that utilities, they are a dynamic ongoing operational entity that, absent mergers, make changes to their organizations. They will always reflect technological changes. And they will have reductions and increases as well. It is difficult to assign what is merger related. This was caused directly because of consolidation, elimination and duplication, so on, so forth, or that which would have been occurring anyway, stand-alone entities. At least as from our perspective that has happened.

Is that really what you're saying? It is hard to identify the reasons for the reductions in work force or the reductions for processes?

A. Well, I think you can get a much better handle on force than you can on cost, in terms of identification, but it is not perfect. You mentioned a number of reasons. It could be more regulatory requirements, which require either additional or a redistribution of existing resources. Or it could be that technology either facilitates the accomplishment of work or

adds requirements for work as the nature of the market changes. So now people have a settlement process they have to go through that they didn't before. That just adds work.

But you can identify raw numbers of head count, easier. But cost information is a lot tougher. So the factors that you're referring to, and that I was referring to, which was really the unit costs are tough to compare. Those reasons are what makes the unit cost tough to compare.

Q. I guess when you look at, say, we used to pick on the controller. You don't need two controllers, so you can eliminate one controller. That's pretty easy to define. Two dispatch centers are consolidated into one. But as you get down through the ranks, does it just become just a very difficult task as to isolating the process that you go through, in terms of identifying it being the merger itself as opposed to just ongoing operations?

A. It gets more difficult both as you go down through the pyramid we talked about before, to sort out all the things that happened, like the clerical level, for example.

Q. You mentioned, I think, as an example a while ago the customer service function. Because there's limited overlap or no overlap, the calls aren't going to change. Isn't that kind of a phenomenon?

A. Well, that one maybe falls in the middle of things. You can go down through a payables organization and you know that to process the amount of work - - if you started with 20, maybe you only need 15 to process that amount of work. If you ended up with 12, you don't know whether the right number attributable to the merger is the five or it might be six or it might be seven. Because maybe you can do better than what the estimate was in terms of processing the work.

So it is just harder to wholly attribute each and every individual event. I think you can get a better handle on labor than you can on cost. But even labor is imperfect. The lower you go down the organization, there are more factors that affect the larger base. Then when you bring the overlay in of offering like a separation program, for example, more people may take than what you expect, and it may come from places you didn't even expect it to come from. So that people really sort of - - rather than fight each of the individual issues and the headache that has, to sort of step back and let's work with the total dollars as opposed to the unique dollars.

Q. I assume the regulatory process may have a bearing also that you are going to get into if we make this claim, someone else may make this

claim, or challenge that particular claim. That we're always going to be at odds in terms of interpretation of what is merger related and what's not. Does that come into play, why perhaps we shy away from or simply don't do the savings track?

A. Which is like that example of moving from the 20 to the 15 to the 12. That maybe everybody agrees that the first five is merger related, but maybe they disagree about that next three in some form.

Q. Someone comes in and says, you can probably achieve the 12 if you just have a reengineering of your processes instead of a merging and consolidation of two entities?

A. Well, I mean, that's been argued. Merger savings can be achieved absent the merger. But remember, the merger savings really reflect overlapping duplication not cost reduction opportunity or streamlining opportunity. So...

Q. It may be hard to identify which is which?

A. Well, overlapping duplication, at least in my mind, is easier to identify. Reengineering opportunity is something that may go above and beyond that. But just – it is like the two controllers. You don't need to reengineer to figure out you only need one controller. When you look at the rest of the support staff, the amount of that support staff that you need is going to be – the ultimate amount is going to be driven by the level of duplication, and then how you elect to operate the business. And how you elect to operate the business may reflect that you have decided to reengineer certain processes as well.

[Source: Transcribed Interview in KCPL/Western Resources Merger Application, Case No. EM-97-515, February 26, 1999 Flaherty interview, pages 62-29.]

Q. Explain how disputes will occur relating to "tracking" merger savings?

A. Any after-the-fact analysis will be very contentious. Disagreements will occur at every turn as to the identification, the verification and quantification of any alleged merger savings. Generally, these quantifications are self-serving in that the utility will have every incentive to identity as much merger savings as possible. Their rate structure and earnings levels will depend on it. Not to mention that the utility will have an especially strong desire to

demonstrate the achievement of the merger savings because it wants to "prove" to the regulators that the merger was successful so that regulatory plans to "pay" for the merger will be implemented.

Q. Did KPL request the recovery of an acquisition adjustment when it proposed the merger with KGE in Case No. EM–91–213?

A. No. However, KPL expected to recover the acquisition premium in rates through a merger savings sharing proposal. In that case, KPL believed there would be sufficient merger savings that could be used to allow recovery of the acquisition adjustment.

KPL proposed, in that case, a unique approach to "share" merger–related savings. The proposal was intended to allow KPL a partial or a full recovery of the acquisition premium; i.e., acquisition adjustment.

Although KPL never specifically stated that the sharing proposal would allow recovery of the acquisition premium, this in essence is what would have happened if such a proposal had been implemented. The only reason that KPL needed such a proposal in place was for regulatory purposes; i.e., to make positive adjustments to test year results in future rate cases. Thus, the merger savings sharing proposal was nothing more than a ratemaking vehicle to set rates at higher levels than the actual costs incurred by KPL.

Q. Why did KPL not directly request any recovery of the acquisition adjustment from the Missouri Commission?

A. KPL, in response to Data Request No. 147, Case No. EM–91–213, stated that its proposed future treatment of merger costs and benefits was based on a number of considerations, including "the jurisdiction's prior treatment of both negative and positive acquisition adjustments." KPL was indicating that the reason that it was not directly proposing

to recover the acquisition adjustment in Missouri was because of the Commission's prior treatment of acquisition adjustments; i.e., the Missouri Commission's decision not recognizing a negative acquisition in KPL's purchase of Gas Service Company in 1983.

Q. Did the Commission adopt KPL's proposal to recover the acquisition premium through the sharing of the merger savings?

A. No. Although the Commission in its Report and Order in Case No. EM–91–213 initially stated its interest in the merger savings sharing concept, no part of the cost savings tracking system (CSTS) was ever implemented. The Commission stated at page 9 of that order:

> **. . . the Commission will not approve at this time the savings sharing proposal.** Staff has persuasively argued that KPL has a strong incentive to view savings as merger–related even if they are not and to classify them in the CSTS so as to increase the pool of savings subject to the sharing plan. **Staff demonstrated several flaws in the CSTS which could allow nonmerger savings to seep into the pool of savings to be shared.**
>
> **The Commission is not opposed to the concept of the savings sharing plan provided that only merger–related savings are shared.** The Commission does not wish to discourage companies from actions which produce economies of scale and savings which can benefit ratepayers and shareholders alike. However, **the Commission *wishes to ensure that savings which would have been offset against* the cost of service without the merger, benefit ratepayers one hundred percent. To avoid any detriment to ratepayers it is *imperative that only savings which would not have occurred* absent the merger be shared by ratepayers with shareholders.**

[Re Kansas Power & Light Co., Case No. EM-91-213, Report and Order, 1 Mo.P.S.C. 3d 150, 156-57 (1991); emphasis added.]

Q. Why was the cost savings tracking system never implemented?

A. The Commission, in its Report and Order in Case No. EM–91–213, directed "the parties to meet for the purpose of attempting to devise a method for tracking merger–related savings." 1 Mo.P.S.C. 3d at 157. No agreement could be reached among the parties to assure

the Commission that nonmerger–related savings would be excluded from the cost savings tracking system. The Commission issued a follow–up Order Adopting Staff's Suggestion And Closing Docket on December 13, 1991 which placed this issue in KPL's next rate case. This two page Order stated in part as follows:

> Based upon these pleadings, the Commission determines that Staff's suggestion should be adopted, to forego consideration of this issue in this docket. If KPL wishes to have the possibility of receiving a share of the merger savings it may use a system it considers appropriate for excluding nonmerger savings from the pool of savings which might be shared and present that approach to the Commission in its next rate case complete with the amounts to be shared. At that time the Commission will consider whether the device employed by KPL is sufficiently foolproof to permit sharing of merger savings with shareholders.

Q. Did KPL address the merits of using the cost savings tracking system to identify merger savings in its next rate case?

A. Yes. KPL's next Missouri rate case was Case No. GR–93–240. By that time, KPL had taken the name Western Resources, Inc. In that case, Western Resources' Controller, Jerry D. Courington, indicated that Western Resources discontinued the use of the cost savings tracking system because of "the level of effort necessary to measure the savings and maintain the tracking system was relatively high when compared to the expected level of merger related savings in the jurisdictions in which it would be used." (Courington direct testimony, pages 14-15). Mr. Courington recognized in his direct testimony that merger costs and savings netted each other out with the Missouri allocated costs being "virtually unaffected in total by the merger." (Courington direct testimony, page 15). Western Resources made no adjustments in its rate case to reflect any recovery of the acquisition premium associated with the KGE merger in rates.

Q. Will it be difficult to "track" merger savings for the post-merger UtiliCorp?

A. Yes. UtiliCorp, not unlike many utilities today, has in the past, and continues at present, to engage in a very aggressive growth strategy through mergers and acquisitions. The constant changes resulting from acquiring new properties, in the situation of UtiliCorp, makes it even more difficult to identify, verify and quantify merger savings from any one transaction.

Q. Has UtiliCorp indicated its knowledge of any Commission "standard" for evaluating the recovery of acquisition adjustments in the context of mergers?

A. Yes. At page 15 of UtiliCorp witness Robert K. Green's direct testimony, he states that "the Commission has articulated a standard for premium recovery in its Case No. EM-91-213 (September 24, 1991)....". Both UtiliCorp witnesses Green and John W. McKinney cite the Commission Order approving the 1992 KPL and KGE merger as the basis for UtiliCorp's view that the Commission will be receptive to the inclusion of the acquisition adjustment resulting from the Empire merger. Staff believes this reliance on the Commission's Order is misplaced and that UtiliCorp has not fully reflected the opinion of the Commission relating to merger savings in that case.

Q. Why do you believe that UtiliCorp has not fully reflected the wishes of the Commission as the result of the merger between KPL and KGE?

A. The Commission in the September 24, 1991 Order approving the KPL and KGE merger, clearly set out the "standard" that merger savings had to be segregated from non-merger related savings. UtiliCorp has indicated this separation was not necessary. In a transcribed interview held on March 2, 2000 with Staff and Public Counsel, UtiliCorp witness Siemek, indicated that:

> the distinction between merger synergies and other synergies, or other costs, is not very important, other than that hurdle rate [of $1.577 in years six through

> ten.]....in our case, it doesn't make any difference as long as....[we make] that hurdle rate. And even that makes no difference, because we've already committed to having that guaranteed reduction in the revenue requirement.
>
> [source: Siemek Transcript– pages 82-83]

Based on this discussion, Staff is concerned that UtiliCorp has no intention of attempting to track merger savings separately from non-merger savings. This is the very basis that forms the assessment as to the success or failure of the merger itself from a regulatory point of view, in particular if the company is requesting ratemaking treatment of an acquisition adjustment.

Q. Why did the Commission want to ensure merger savings were segregated from non-merger savings?

A. In its Order in Case No. EM-91-213, the Commission was explicit that there must be a segregation of merger and non-merger related savings. In fact, when KPL was unable to devise a "tracking" system which would separate the merger savings from the non-merger savings, the Commission issued its December 13, 1991 Order indicating that the savings sharing proposal would be rejected.

The Commission's reason for requiring this separation is that it wanted to ensure that all the non-merger related savings generated by the company would be fully passed on to customers in rates. In the same paragraph cited by UtiliCorp as the basis for what it believes is the merger "standard" the Commission established to evaluate mergers, the Order stated "the Commission wishes to ensure that savings which would have been offset against the cost of service without the merger, benefit ratepayers one hundred percent."

The Commission made it very clear in the KPL/KGE merger Order that savings had to be identified between merger and non-merger related savings as a condition of the initial approval of the savings tracking proposal presented by KPL in that merger request. KPL was

unable to demonstrate the ability to track costs; i.e., identify, verify and quantify savings between merger and non-merger related. Because of this inability to distinguish between the types of savings, the tracking proposal presented by KPL was rejected.

Q. Are merger and non-merger related savings different?

A. Yes. While they are both "savings," they are two very different types of savings. Merger related savings are those savings that can only occur as a result of the combining of two or more separate entities that were previously operating as separate and distinct from one another. Once the combination of the entities occurs there will be savings that will exist over time from the elimination of duplication and the economies of scale that happen through system and process improvements throughout the organization. An example of elimination of duplication would be the position of corporate president. There is need for only one president of the company. One of the two prior positions can be eliminated once the merger takes place. System improvements may result in the combining of activities such as the consolidation of customer call centers. Instead of operating two separate call centers because both pre-merger companies had the need to operate their own call centers, the merger can result in savings from the elimination of one of the call centers that is no longer needed. Process improvements would be the automation of certain functions such as in the areas of purchasing, accounting or human resource functions that may enable savings to occur as the direct result of the merger.

Non-merger related savings are those savings that occur over time as a result of improvements in the technology and the efficiencies from a better trained and skilled work force. An example would be savings from reorganizations and re-engineering that occur periodically. These type of savings also result from negotiating improved contract terms such

as those relating to fuel supply, building leases and health and medical benefits. Reductions in cost of capital and tax rates can result in savings that having nothing to do with merger and acquisition activities. System and process improvements can take place absent a merger and would result in non-merger related savings. Non-merger related savings result on an on-going basis and occur, as labor becomes more efficient and productive. These types of savings occur absent mergers.

These two types of savings are viewed differently and are generally afforded different treatment in merger applications. Non-merger related savings are considered outside the scope of the merger. There is a widely accepted view that customers are entitled to these savings and that cost savings will eventually be provided to customers in the form of rate reductions. An example of reflecting non-merger related savings through a reduction in rates is the recent $15 million rate decrease passed on to KCPL's customers in 1999 (Case No. ER-99-313). Another example would be the $17 million rate reduction for UtiliCorp's Missouri Public Service division in 1997 (Case No. ER-97-394). In both of these cases, the companies experienced cost reductions and revenue growth over a period of time, not related at all to mergers. Both companies enjoyed the benefits of these cost reductions, known as regulatory lag, until the rates were changed.

Q. Did these companies voluntarily reduce rates?

A. In the case of KCPL, it did. Staff performed an earnings audit of KCPL and the parties, KCPL, OPC and Staff, reached an agreement on the dollar amount of reduction. In the case of UtiliCorp's Missouri Public Service division's rates, Staff had to file an excess earnings complaint case to reduce rates. After Staff filed its complaint case, designated as Case No. EC-97-362, UtiliCorp filed a rate increase case designated as Case No. ER-97-394,

which sought a $25 million increase to Missouri Public Service's electric rates. The Staff dismissed Case No. EC-97-362 but subsequently filed another excess earnings complaint case against Missouri Public Service, Case No. EC-98-126, which was consolidated with Case No. ER-97-394. The Commission ultimately reduced Missouri Public Service's electric rates by $17 million in its Report and Order dated March 6, 1998. The filing of the rate increase case by UtiliCorp is a commonly used strategy by utilities to counter Staff's excess earnings case and keep over-earning for as long as possible.

The Staff started reviewing UtiliCorp's rates in the spring of 1996 as part of its examination of the merger application filed by UtiliCorp and KCPL as Case No. EM-96-248. After the merger between KCPL and UtiliCorp failed, Staff continued its review of UtiliCorp's rates and filed a complaint case on March 3, 1997 to reduce rates by $23 million designated as Case No. EC-97-362. From the time Staff started its review of the electric rates of Missouri Public Service division, to the date the rate reduction was implemented, took two years.

St. Joseph employed the exact same approach in Staff's 1999 complaint case (Case Nos. EC-98-573 and ER-99-247) that ultimately resulted in a $2.5 million rate reduction by Stipulation And Agreement. Once a utility increases rates, it generally resists any attempt to reduce rates, regardless of reductions in costs or revenue growth that may have occurred since the last rate rebasing.

Q. What has been UtiliCorp's view on flowing through savings to its customers?

A. UtiliCorp has sought to retain declines in revenue requirements for its shareholders and generally has not been in favor of passing those savings to customers. UtiliCorp has acknowledged that it has been the beneficiary of regulatory lag in the past.

Mr. Richard C. Green acknowledged the benefits of regulatory lag in statements dating back to the latter part of the 1980's. Mr. Green made the following comments at UtiliCorp's 1987 Officers Conference held in Chicago on October 6, 1987:

> ...As you all know, the scenario of how a utility is operated has gone through a number of changes. The 60's was the growth area, the 70's was inflation and consumerism, the 80's the problems are starting to go away. We have less rising costs. They are not going up, so managing a utility is a lot easier. Regulatory lag is in our favor, as Missouri Public Service learned so well in having to give back $15 million because that lag gave us some very good profits there.

Mr. Green also addressed the need to manage UtiliCorp's regulated divisions and the earnings of its subsidiaries at another Officers Conference held in Toronto in 1988. He continued to emphasize the importance of each regulated division and subsidiary knowing where its costs were going to fall and when the dollars were going to come in so that the earnings level could be managed.

Mr. Green indicated further at the 1987 Officers Conference the importance not of not earning excessive returns, which would bring regulatory focus on rates. He stated the following:

> The other point that has become painfully obvious this year, is that the goal in the regulated utility business is not to try to earn the highest return you can. The goal in the regulated utility business is to earn that allowed return and maybe a hair above it, but don't get carried away and start pulling in all kinds of money because you create a hell of a problem for us. Now, Missouri Public Service has had this nice problem since about 1983, and we spent a lot of time managing it then. Then they went through rate decreases and they still have the problem. What you see here is a focus on that problem which is that if we don't manage those earnings, if we don't prudently spend it where it needs to be spent for the integrity of the system, if we let those returns get too carried away, then we're going to be right down there in Jefferson City going through a rate reduction which is not going to be good for anybody to go through. So you look at that and you have to talk about how that return can come down. . . The bulk of the reason that that has come down is because we have exercised, or MPS has exercised,

> options on expenses that they can take care of this year as opposed to next year, or whatever the formula might be, so that in effect, they show a decreasing return for the balance of the year as they report monthly to the regulatory people. Now, I think that's a smart way to do business. I think it's the way we're going to continue to do business, and it really surprisingly distinguishes us from a lot of other utilities. A lot of the properties that we come into do not have this sense of regulatory understanding.
>
> [emphasis added.]

From these comments, it would appear that Mr. Green is advocating managing discretionary expenses so as to control earnings from one period to the next. This discussion indicates that UtiliCorp has wanted to ensure that there is not an appearance of excessive earnings that regulators may want to use to reduce rates.

Q. Has the Commission had other concerns that indicated the importance of maintaining a distinction between mergers and non-merger related events?

A. Yes. In the KPL merger with KGE (Case No. EM-91-213), the Commission wanted to be certain that no merger related costs would be passed to customers. In the same Report and Order cited by UtiliCorp, the Commission stated the following relating to the segregation of merger and non-merger costs:

> The Commission had also found that there is the potential for a detrimental effect on Missouri ratepayers from the merger through increased A&G and capital costs. Therefore, the Commission, in order to shield Missouri ratepayers from such detriment, has made it clear to KPL that such costs will be carefully scrutinized in any future, postmerger rate case to assure that no such detriment is suffered by Missouri ratepayers.
>
> . . . .
>
> The Commission will direct its Staff to carefully audit KPL in future rate cases to screen out costs caused by the merger and to suggest methods, if necessary in future rate cases, such as those recommended herein, which might be used to shield Missouri ratepayers from costs arising from the merger.

> The Commission will also direct KPL to keep its books so that costs associated with the merger are clearly segregated. Abnormal increases in A&G expenses will be carefully scrutinized and, unless persuasively explained as not related to the merger, will be associated with the merger.

[Commission Order in Case No. EM-91-213, pages 10 and 13]

In addition, from prior Commission decisions respecting its rate cases, UtiliCorp is aware of the importance that the Commission has given to the distinction between merger and non-merger related activities. In UtiliCorp's 1990 rate case, Case No. ER-90-101, involving its Missouri Public Service division, the Commission issued its Report and Order stating the importance of segregating UtiliCorp's merger and acquisition costs so those costs would be excluded from rates.

These UtiliCorp merger and acquisition activities have been examined in each of UtiliCorp's rate increase cases and Staff's excess earnings audits, and were specifically identified as an issue in Case No. ER-90-101. In that case, the Commission found as follows:

> The evidence indicates that the Company has removed from its A&G costs most of the known expenses associated with M&A activities. The Commission believes that UtiliCorp's expenses for M&A activities should be removed from the expenses reflected in MPS' rates. When UtiliCorp was formed, Company assured the Commission that the ratepayers would suffer no detriment from UtiliCorp's activities but would experience the benefits associated with UtiliCorp's activities. The Commission believes that it is inconsistent with this pledge to include M&A costs in the expenses reflected in MPS' rates. The Commission is of the opinion that it is inappropriate for MPS' ratepayers to pay for these activities which have little to do with MPS' goal of providing safe and adequate electric service in Missouri. Therefore, the Commission finds that the $70,280 of additional costs for M&A activities should be excluded from the cost of service. Finally, the Commission is concerned that Company has not been accounting for these costs separately. Accordingly, the Commission will direct Company to account for M&A costs separately so that they can be readily excluded in future rate cases from A&G costs reflected in MPS' rates.

[Source: 30 Mo.P.S.C. (N.S.) 320, 350; emphasis added]

In addition, in UtiliCorp's 1997 rate case (Case No. ER-97-394) the Commission adopted Staff's adjustments to assign costs to UtiliCorp's non-regulated activities of mergers and acquisitions, international operations and new product development. Pages 50-51 of the March 6, 1998 Report and Order states that "the Commission finds substantial evidence supports the position of the Staff. The Commission finds the proposed adjustment to be reasonable in light of the poor timekeeping and inadequate records offered by UtiliCorp." In this Report and Order, the Commission affirmed its prior decision to exclude from rates costs relating to the merger and acquisition strategy of UtiliCorp.

Q. You have discussed the KPL cost savings tracking proposal that the Commission rejected in the KPL/KGE merger case. Does UtiliCorp believe it has a system that can "track" savings, merger or non-merger?

A. UtiliCorp claims it has the capability to "track" savings and will use this process to demonstrate that the merger will provide benefits sufficient to justify the inclusion of the acquisition adjustment in rates. UtiliCorp has proposed a "guarantee" of at least a $3.0 million reduction to Empire revenue requirement levels in each of the Years 6 through 10 following the merger. UtiliCorp is making this commitment so it can receive rate treatment of the acquisition adjustment. UtiliCorp witness Myers claims UtiliCorp's accounting system is able to "track" savings relating to this merger.

Q. Does Staff believe that UtiliCorp's accounting will be able to "track" merger savings?

A. No. UtiliCorp's accounting system, just like any other bookkeeping system will be able to categorize costs, and identify those costs to specific accounts when the system

is told through a coding process where those costs should go. This same process is expected to be used to "track" merger savings. The accounting system still will require individuals to identity, verify and quantify the savings, segregating those savings between merger and non-merger related events. UtiliCorp personnel will have to be able to determine what the pre-merger Empire operations were, if they are to compare the costs of the post-merger Empire operations. Those individuals making the "coding" decisions will have to make all kinds of judgments and decisions about assumptions and costs on how the impacts of the merger affected the post-merger Empire's operations. During an interview on March 1, 2000, with Mr. Myers, he indicated that coding would have to be completed by individuals to enter into the accounting system. [Transcript, pages 19-26]. While the Joint Applicants have not fully explained in detail how they intend to implement the tracking procedures, it is apparent that UtiliCorp is not going to distinguish between merger savings and non-merger savings to the level that was envisioned in the KPL/KGE cost savings tracking system.

Q. What is the significance of individuals making the coding decisions to the accounting system?

A. These decisions are made in an after-the-fact fashion about a company that no longer will exist. The many judgements that have to be made to identity and verify the existence of merger related savings will undoubtedly cause much disagreement and dispute. That would be the case as individuals are making the determinations as the information is entered into the accounting system. Unfortunately, the review process that takes place so that merger costs, and ultimately, merger savings, can be "carefully scrutinized" as required by the Commission in the KPL/KGE merger, takes place well after the decisions are made (coded) and information is entered into the accounting system. The ability to identify the

merger savings will be even more difficult under the UtiliCorp proposal because the regulatory plan proposed by UtiliCorp provides for a five-year moratorium after a rate case that will mean the first time anyone will have an opportunity to "carefully scrutiniz[e]" the merger savings will be in excess of five years after the close of the merger. This will not provide the kind of review the Commission expected the Staff to perform in regard to alleged merger savings in the KPL/KGE merger as contemplated in Case No. EM-91-213.

Q. Will the tracking system being proposed by UtiliCorp require cooperation of the Company and other parties reviewing the merger tracking process?

A. Yes. UtiliCorp's proposal will require a tremendous effort among those who will be responsible to review the tracking process when UtiliCorp files the rate cases to reflect the acquisition adjustment in rates, if the Commission adopts the proposed regulatory plan. The data requirements will be substantial to identify and separate the merger and non-merger savings.

The merger tracking system will require significantly more cooperation from UtiliCorp than the experimental alternative regulation plan currently being used for Union Electric requires of Union Electric. As the Commission is aware, the Union Electric alternative regulatory plan requires an annual review.

Q. Has UtiliCorp ever requested approval an alternative regulation plan?

A. Yes. In Case No. ER-97-394, UtiliCorp requested such a plan for its Missouri Public Service division. UtiliCorp called its incentive plan an "Efficiency Earnings Model" (EEM).

Q. Did the Commission approve the UtiliCorp alternative regulation plan proposal?

A. No. The Commission rejected UtiliCorp's proposal, in part, because of discovery problems and lack of cooperation. At page 68 of the Commission's Report and Order in that case, the Commission identified the reasons it believed the alternative regulation plan could not be adopted:

> First, the Commission finds that the sharing grid, as proposed by UtiliCorp, is not in the interest of the MPS ratepayers and is neither fair nor reasonable.
>
> Second, the Commission notes the concerns of both the Staff and OPC in regard to the long-term problems encountered in this litigation in regard to discovery and cooperation between the parties. The Commission will not assign fault in this matter but states that a successful incentive regulation plan requires proper and accurate accounting and other record keeping, and substantial cooperation between the parties.
>
> Third, the Commission agrees with Jackson County to the extent that the approved Incentive Plans to date have all been experimental and have had a fixed expiration date.
>
> Therefore, for the above reasons, the Commission will reject the proposed incentive regulation plan.

Q. Has UtiliCorp shown a willingness to provide timely and accurate information during the course of this merger case?

A. Yes. While Staff has no quarrel with the level of UtiliCorp's responsiveness in this case, a merger application is not the same as a rate case, and certainly not the same as a complaint case. The level of detail and the information necessary for review to construct an entire rate case generally requires substantially more detailed information than is required for merger applications. Since UtiliCorp has not had a rate case before the Commission since Case No. ER-97-394, it is not known to what extent future differences will exist. In any event, based on past problems between UtiliCorp and the other parties relating to discovery disputes, one of the reasons Staff is not in favor of the merger tracking system being

proposed is the belief that UtiliCorp will not provide sufficient detail and adequate information in which to fully substantiate the merger and non-merger savings in future post-merger, post-moratorium rate cases.

CUSTOMERS ARE ENTITLED TO SAVINGS GENERATED BY UTILITIES FOR EITHER MERGER OR NONMERGER EVENTS

Q. Are Empire's customers entitled to rate reductions related to cost savings?

A. Yes. Historically, customers have enjoyed the benefits of cost reductions, as well as declines in rate base and growth in revenues. As utilities experience productivity gains through technology improvements and downsizing of their work forces, cost increases have been kept in check. Through restructuring, reorganizations and re–engineering programs, utilities have been experiencing cost decreases (or, at least, cost increases have been kept to a minimum, allowing for revenue gains to outpace them) through improvement in methods and processes which have occurred over time. This is not to say that decreasing costs are not also the result of developments other than efficiencies, such as decreasing interest rates.

Q. Why are customers entitled to benefit from savings?

A. Through the regulatory process, the utilities generally benefit most immediately from cost reductions and growth in revenues. When significant cost reductions take place over time, public utility commission staffs or offices of consumer advocates may perform earnings reviews to determine the need for possible rate reductions. There are several factors that may cause reductions in rates:

1. Reduction in capital costs is one of the most significant causes for declining revenue requirements.