Exhibit No.:
Issues: Regulatory Plan
Witness: John W. McKinney
Sponsoring Party: UtiliCorp United Inc.
Case No.:

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

John W. McKinney

December 1999

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
DIRECT TESTIMONY OF JOHN W. MCKINNEY
ON BEHALF OF UTILICORP UNITED INC.

CASE NO.

INTRODUCTION

Q. Please state your name.

A. My name is John W. McKinney.

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

A. I am employed by UtiliCorp United Inc. ("UtiliCorp") as Vice President-Regulatory Services.

Q. Please state your business address.

A. My business address is 10700 East 350 Highway, Kansas City, Missouri 64138.

Q. Please describe your educational and employment history.

A. I have an MBA and a Bachelor of Science in Business Administration from Central Missouri State University. I have been employed in the public utility industry for more than 35 years in various positions in the fields of accounting, finance, operations and regulation. I have spent more than 25 years being directly involved in and responsible for the development of regulatory policy and the handling of regulatory matters. I have been employed by UtiliCorp and its predecessor, Missouri Public Service Company, since 1977.

Q. Have you ever testified previously in this jurisdiction or before any other utility commission?

A. Yes, I have. In addition to numerous proceedings before the Missouri Public Service Commission ("Commission"), I have also testified before the utility commissions in New Jersey, Michigan and the Department of Public Service in the State of Minnesota.

Q. What is the purpose of your direct testimony in this proceeding?

A. My direct testimony will,

- explain how UtiliCorp plans to operate The Empire District Electric Company. ("Empire") properties as a separate retail energy distribution unit;
- explain UtiliCorp's regulatory plan;
- explain the proposed rate moratorium;
- discuss the synergies expected from the merger;
- discuss why sharing of benefits is appropriate;
- discuss industry experience with acquisition premiums;
- discuss common misconceptions about premiums and merger savings;
- discuss the industry record of regulatory treatment of premium recovery and merger savings;
- discuss appropriate capital structures;
- discuss the sharing of synergy benefits;
- discuss Regional Transmission Organizations ("RTOs") and Market Power;
- discuss the Commission's jurisdiction over the operations of the merged company; and

- provide a brief summary of these comments.

OPERATION OF EMPIRE PROPERTIES

Q. How will UtiliCorp operate the Empire properties?

A. UtiliCorp plans to operate the Empire properties as an entirely separate retail energy distribution unit as described in greater detail in the testimonies of UtiliCorp witnesses Robert Green and Steve Pella. This plan includes separate rates for the current Empire customers..

Q. How do the existing electric rates of UtiliCorp and Empire compare?

A. Figure 1 (below) compares the electric rates of Empire with the electric rates of UtiliCorp's Missouri Public Service ("MPS") operating division as of April 1999.

Missouri LDC Rate Comparison (2)
As of April 1999

	Empire	UtiliCorp
Residential		
Summer @ 1000Kwh	$ 71.88	$ 77.51
Winter @ 750 Kwh	$ 51.85	$ 55.90
Annual Bills (1)	$ 702.32	$ 757.24
Annual Kwh	10,000	10,000
Annual avg $/Kwh	0.0702	0.0757
Commercial		
Winter 50 KW / 12500 Kwh	$ 647	$ 651
Summer 50 KW / 12500 Kwh	$ 893	$ 945
Annual Bills (1)	$ 8,748	$ 8,988
Annual Kwh	150,000	150,000
Annual avg $/Kwh	0.0583	0.0599
Industrial		
Winter 1000 KW / 400000 Kwh	$ 16,839	$ 14,411
Summer 1000 KW / 400000 Kwh	$ 22,139	$ 23,571
Annual Bills (1)	$ 223,268	$ 209,572
Annual Kwh	4,800,000	4,800,000
Annual avg $/Kwh	0.0465	0.0437

(1) Annual bills are calculated by pricing the monthly usage by the base rate effective at the date of this schedule, and includes 12 months of customer charges.
(2) Source Document: Typical Bills and Average Rates Report by Edison Electric Institute

Figure 1

Q. After the companies are merged, will the former Empire customers continue to have separate rates?

A. Yes.

Q. How will the accounting be maintained to allow for the continued separation of rates?

A. In the near term , UtiliCorp will continue to use the existing accounting systems of Empire until this accounting information can be completely transferred to UtiliCorp's system.

Q. Is this important?

A. Yes. Since Empire will be operated as a separate retail energy distribution unit, it is imperative that the integrity and continuity of these accounting records be maintained in order to ensure accurate accounting and reporting. Once the information has been transferred to UtiliCorp's accounting system, it will be maintained in a manner that will allow development of cost of service information necessary to establish specific rates for both the current Empire operations and for current MPS operations.

THE REGULATORY PLAN

Q. What principles were used by UtiliCorp in developing a regulatory plan for the operation of the combined companies?

A. First and foremost, UtiliCorp determined that the combination of the companies would definitely create benefits, and that an equitable plan going forward would permit these benefits to be shared between customers and UtiliCorp shareholders.

UtiliCorp further realized that to complete any transaction of this type the economics of the merger or acquisition must make sense.

Q. What do you mean by "the economics of the merger or acquisition must make sense?"

A. In any merger or acquisition, sound economics requires that the transaction create sufficient synergies to allow for the recovery of the cost of the transaction in a manner which allows both customers and shareholders to benefit from the transaction. If this cannot be accomplished, the financial profile of the acquiring company will suffer and there would be no sound economic basis for the transaction.

Q. Are there other factors that should be considered in the combination of two utilities?

A. Yes. Any such combination should result in maintenance or strengthening of the efficiency and reliability of the surviving entity. Mr. Pella will address UtiliCorp's customer care model and the new systems that are in place to assure about these desired results.

Q. You mentioned earlier that the economics of a transaction of this type must develop sufficient synergies. Would you explain this statement?

A. Yes. The savings or benefits which result from a transaction must be equal to or exceed the premium paid for the property so that there will be benefits for the customers after the cost of the premium is recovered. This is the case with the proposed merger of UtiliCorp and Empire.

Q. Please explain.

A. The merger will clearly create savings which would not otherwise exist. With an equitable resolution of this case by this Commission, the premium will be recovered by UtiliCorp and the customers will realize benefits that include a lower cost of service. However, as I will elaborate later, it would be inappropriate for all of those savings to be passed on to either shareholders or to customers exclusively without providing for the economic logic of recovery of the costs of the transaction.

Q. Would you please describe UtiliCorp's proposed regulatory plan?

A. Yes. The regulatory plan that will allow this transaction to take place, and for which Commission approval is sought, applies to the first 10 years after the close of the merger and is as follows:

1. UtiliCorp will not file any case with the Commission requesting a general increase or decrease in electric rates for the Empire operating unit, (except for the rate case that is needed to include the new State Line generating station which will become operational in 2001) for a period of 5 years after the effective date of the rate change State Line rate case. The State Line rate case is sometimes referred to as "the Pre-Moratorium Rate Case." The reasons for this case are discussed in Mr. Robert Fancher's testimony.
2. During the fifth year of the rate moratorium, UtiliCorp will prepare and file general rate case for the retail electric operations of the Empire unit. This rate case is sometimes referred to as "the Post-Moratorium Rate Case" and will

have operation of law date which coincides with the conclusion of the 5-year rate moratorium;

3. The Post-Moratorium Rate Case filing will include an accounting of the synergies realized during the moratorium and the balance of the acquisition premium (the 50% that has been assigned to the Empire electric operations) that is yet to be recovered;
4. Included in the Post-Moratorium Rate Case filing will be the complete flow-through of all test-year O&M synergies, adjusted to the forward average level of saving for 5 years following the rate moratorium, net of the costs to achieve the synergies, resulting from the merger;
5. Fifty percent (50%) of the unamortized balance of the acquisition premium paid by UtiliCorp for Empire will be included in the rate base of the Empire unit's retail electric operations and the annual amortization of this acquisition premium will be included in the expenses allowed for recovery in cost of service in the Post-Moratorium Rate Case. The return allowed on this premium, for the recovery period, will be based on the capital structure of 60% debt and 40% equity as established by Mr. Siemek in his synergy study; the net effect of item #4 and #5 is a guaranteed minimum reduction in the Empire revenue requirement of $3 million.
6. The balance of the retail electric rate base in the Post-Moratorium Rate Case will be allowed a return, for the period covered by the regulatory plan, based upon a Empire unit capital structure as found in the Pre-Moratorium Rate Case.

7. The allocation of corporate and intra-business unit costs to MPS in the rate case shall exclude the Empire factors from the methodology for the period covered by the regulatory plan.

Q. Your summary points did not indicate any premium or recovery of premium would be sought from the water operations of Empire. You also did not indicate that any operating unit of Empire would have a rate moratorium except the electric operations. Would you please explain?

A. At the time UtiliCorp valued Empire's operations, Empire was considering a sale of its water operations. That separate sale will not take place, however, and therefore, the water operations will now also be merged with the other UtiliCorp Missouri utility operations. Because the final bid price that was agreed to did not include the expectation of the water operations, none of the premium should be applied to that part of the business. Since the water operations will not be involved in the recovery of the cost of the transaction, there is no need to put a rate moratorium in place for the water properties. UtiliCorp will ensure none of the costs of the transaction will be assigned to the water operations and the rates of the water operations will not be increased as a result of the merger.

THE RATE MORATORIUM

Q. Please explain the details of the rate moratorium.

A. During the five-year rate moratorium, UtiliCorp will not file any case with the Commission requesting a general increase or decrease in the electric rates for the Empire operating unit unless there is the occurrence of a significant, unusual event, such as: an act of God; a significant change in federal or state tax law; a significant change in federal or state utility law or regulation; or an extended outage or shutdown of a major generating unit(s), which has a major effect on Empire jurisdictional operations. The Staff of the Commission will not encourage or assist in the filing of any case with the Commission requesting a decrease in Empire's (electric and water) retail rates or a rate credit or rate refund during the moratorium. However, UtiliCorp may file for approval of mutually agreed to special contracts with its customers and other tariff items that would cause no change in rates.

Q. Is this rate moratorium similar to other moratoriums approved by this Commission?

A. Yes. UtiliCorp based the language for its proposed moratorium on the language found in the Stipulation and Agreement in Case No. EM-97-515 (Merger Application of Western Resources Company and Kansas City Power & Light Company) as approved by this Commission on September 2, 1999. However, UtiliCorp's moratorium is for a longer period During this moratorium customers will be allowed to enjoy stable low rates, and UtiliCorp will be allowed to recover part of the cost of the merger transaction.

MERGER SYNERGIES

Q. Has UtiliCorp prepared a synergy study in connection with this transaction?

A. Yes. UtiliCorp witness Vern Siemek is sponsoring the overall synergy study. In addition, Mr. Siemek will explain the synergies created by the combining of UtiliCorp's and Empire's transmission and distribution operations as well as the administrative and general savings which will occur as a result of this merger.

UtiliCorp witness Bob Browning will address the savings related to combining the covered employees into one employee benefit program; and UtiliCorp witness Bob Holzwarth will elaborate on the calculations of the savings that will result from operational synergies and the joint dispatch of the generating plants.

Q. Please explain how UtiliCorp will be able to keep track of the synergies during the rate moratorium and determine the level of synergies occurring during the test year for the Post-Moratorium Rate Case that will be filed during year five of the moratorium?

A. Bob Holzwarth and UtiliCorp witness Jerry Myers will describe the tracking methods UtiliCorp plans to use to monitor savings arising from the merger in future periods. Furthermore, each time UtiliCorp appears before the Commission in future rate proceedings, it will have the burden to demonstrate that it has been able to both track and accurately quantify these savings. With this procedure in place, UtiliCorp assumes the responsibility and risk of generating synergies, quantifying them properly and providing that information to the Commission.

Q. How do you address the concern about the need to exactly track the synergies?

A. As the Commission knows, synergies need only be proved to reach the proposed hurdle level in each subsequent rate proceeding. Only if the synergies fall short would there be an adjustment. That adjustment would result in a lower percentage of premium being included in the Empire's electric rate base for recovery. Any synergies above that hurdle level would be used to reduce rates during the normal course of the rate proceeding and result in even lower costs to the customers.

Q. What do you mean by "hurdle level"?

A. The hurdle level is the cost impact resulting from the premium.

Q. As a general matter, should UtiliCorp and Empire customers receive reductions in their cost of service as a result of cost savings?

A. Yes. We believe customers should be a principal beneficiary if a utility devises a more efficient way of providing service. As utilities cut costs, these savings ultimately should be flowed through to customers. For example, many efficiencies have been gained through UtiliCorp's recent re-engineering efforts which were audited and discussed at length in UtiliCorp's most recent Missouri rate case. The savings resulting from these efforts were flowed through to our customers.

Q. Did UtiliCorp incur any costs in the creation of these savings?

A. Yes. The re-engineering project is a very large and complex program that has generated considerable costs.

Q. What happened to these costs from a ratemaking standpoint?

A. The Staff of the Commission recommended and the Commission allowed UtiliCorp to recover these costs through rates, in effect passing the "net savings" on to customers.

Q. How does this concept of netting the premium and synergies compare to what normally takes place in the regulatory process?

A. This is no different than many of the other savings that utilities develop internally. Whether it is obtaining capital at a reduced cost, early retirement programs, renegotiating fuel or purchase power contracts, improving the heat rate for a power plant, or reducing power outage through improved line maintenance; all have a cost to achieve. The net savings are then passed on to customers through the regulatory process.

Q. Do the costs to achieve the type of savings you have just described differ from the costs to achieve the synergies relating to this merger?

A No, there is no difference. The merger involves costs, but the merger and related costs ultimately create savings. The concept of netting the costs ties to a long-held regulatory concept of "matching" that is a mainstay in nearly all regulatory processes. We believe that the costs should be deducted before the savings are distributed, and that only net savings or benefits should be passed on to customers. Without the application of such a commonly understood economic principal, there would be no incentive for companies or shareholders to undertake such a transaction.

Q. Is this approach detrimental to the customers?

A. No. The customers of Empire will not be harmed and they gain the benefit of not having their rates increase as a result of this transaction.

WHY SHARING OF BENEFITS IS APPROPRIATE

Q. Why is UtiliCorp proposing a sharing of the benefits?

A. Sharing is proposed because it is clearly fair to all concerned.

Q. Please explain.

A. If a portion of the benefits are not used to recover the premium, it would discourage further attempts to make beneficial business combinations between Missouri utilities. In the long run, this would be to the detriment of utility customers who would have otherwise benefited from better service and lower rates that flow from such combinations.

Q. If all of the benefits of the merger go to the customers, and all of the costs go to the merging entity's shareholders, how would you characterize this result?

A. It would be both unfair and unreasonable.

Q. Why?

A. We know of no economic system or model where it is considered fair or reasonable to assign all the costs to one party or stakeholder in a transaction and give all of the benefits to another. The benefits should be shared between the stakeholders by allowing the costs to provide those benefits to be recovered.

Q. How would this approach relate to the Commission's long-standing policies with respect to ratemaking?

A. It would be consistent.

Q. Please explain.

A. We are requesting that the Commission first examine our proposal to confirm our determination that significant merger benefits are or will be created as a consequence of this combination. Next, it is appropriate to confirm that the transaction (premium) and transition costs associated with the benefits are reasonable. Finally, our filing demonstrates that benefits will continue to flow after the transaction (premium) and transition costs have been covered. Any other outcome could only be considered unfair and unreasonable.

Q. Why is it important that the Commission approve the recovery of premium?

A. It is important that the Commission not create an economic road block to modernizing the electric utility industry in Missouri. The industry should be permitted and encouraged to develop itself on sound economic principles to meet the competitive requirements being imposed upon it today.

ACQUISITION PREMIUM

Q. Please explain how UtiliCorp proposes to recover the acquisition premium.

A. In the Post-Moratorium Rate Case, UtiliCorp will request that 50% of the unamortized premium be included in the rate base of Empire's electric unit and the amortization of the premium be included in the cost of service.

Q. How do you characterize this approach?

A. As reasonable.

Q. Why?

A. When a merger between two electric utilities creates quantifiable benefits through cost savings, the premium and the costs to bring about those benefits should receive rate recognition, otherwise there would be little incentive to pursue such transactions and the potential benefits would never be realized.

Q. Generally, how are premiums included in the rate making process?

A. The inclusion of premiums in rate making is accomplished through the booking of a premium in an acquisition adjustment account. The assets are required by the FERC's Uniform System of Accounts to be recorded at original costs, and the premium in the acquisition adjustment account, which is amortized as an expense over a period of years, as approved by the Commission. Generally, the premium is treated as another part of the company's investment in serving customers which it is entitled to recoup and earn a reasonable return on through the rates set by the Commission.

Q. How is the premium determined?

A. The premium, when being reviewed for rate making treatment for an electric utility, is the difference between the amount of consideration paid in cash, other assets, equity or the assumption of the acquired company's debt and the book value of the acquired company's net assets.

In the case of a "pooling-of-interests transaction," the premium is considered to equal the difference between the amount of consideration paid and the acquired company's book value of equity.

A premium may exist in a merger transaction regardless of the manner in which the premium is treated for regulatory and financial reporting purposes. That is, regardless of the accounting treatment, a premium exists when the value of consideration paid exceeds the book value of consideration received.

Q. Is this transaction a pooling-of-interests transaction?

A. No. The premium will not be recorded on the accounting books as a pooling-of-interests transaction. This merger transaction is a "purchase transaction."

Q. What is the significance?

A. In a purchase transaction, the portion of the premium commonly referred to as "goodwill" is recorded in the financial statements and is the difference between the total consideration, as described for the pooling-of-interests transaction, and the fair value of the identifiable net assets acquired. In a purchase transaction, goodwill does not necessarily equal the premium. That is, goodwill equals the premium only when the book value of the acquired net assets equals the fair value of the net assets.

The premium, commonly referred to as an "acquisition adjustment", recorded on the regulatory accounting books is equal to the difference between the consideration paid and the book value of the identifiable net assets.

Q. Is there a distinction among the terms "premium," "goodwill," or "acquisition premium" or "acquisition adjustment?"

A. Not really for purposes of my discussion. These are just various accounting terms referring to the same value. For the purpose of setting rates, the amount we are discussing is the amount paid over the net book value of the assets of Empire.

Q. How can determination be made with regard to the recovery of a premium in utility rates?

A. Historically, real assets have usually been included in a utility's rates at the original cost of the assets when they were dedicated to utility service. When these assets are acquired by another utility, the regulatory body should evaluate the reasonableness of including the premium in the cost of service. In other words, if the purchaser pays more than the depreciated original cost for the assets (or more than the book value of equity of the acquired company), the commission should judge the reasonableness of the consideration paid from an evaluation of the merger benefits generated through synergies.

Q. Please continue.

A. Including the premium in the cost of service results in the increasing of the revenue requirement when one does not consider the offsetting cost savings provided through merger synergies. When a utility can demonstrate significant cost savings created from the merger and the value of these savings eliminates the revenue requirements for the premium, the premium should be considered a reasonable cost for inclusion in rates.

Q. How should the rate making treatment for the premium be viewed when compared to other efforts used by electric utilities to become more cost efficient?

A. It should be viewed in the same way. Generally, utility commissions include in cost of service the investments and expenses incurred in cost efficiency programs. This treatment is considered to be reasonable because savings from the program are flowed-through to customers. UtiliCorp believes the rate making treatment for the premium and related merger savings should be the same as for other cost savings initiatives which it undertakes on behalf of its customers.

MISCONCEPTIONS ABOUT PREMIUMS AND MERGER SAVINGS

Q. How do you respond to the suggestion that a premium should not be included in the cost of service because it increases the rates for the customers?

A. I disagree with this argument because it does not consider the aggregate impact on rates from a merger. Specifically, it does not take into consideration the cost savings generated through synergies. When the premium and resulting cost savings are appropriately analyzed together, the Commission will see that inclusion of the premium in the cost of service will not increase Empire's rates, but in fact, it will lower them. Consequently, the suggestion represents an incorrect application of the public detriment standard.

Q. Please expand on this last statement.

A. When the impact on revenue requirements related to the premium is viewed separately from other elements of a merger, it could understandably be perceived as a detriment. However, a correct application of the public detriment standard should be to determine whether the aggregate impact from the merger is a benefit or detriment to customers. In the merger of UtiliCorp and Empire, the cost savings from synergies should be fairly considered and weighed against the cost of the premium.

Q. How do you respond to the suggestion that including the premium in the cost of service provides an incentive for the buyer to "bid up" the purchase price?

A. This is a misconception that stems from an erroneous "all or nothing" approach to premium recovery. When the ratemaking treatment of the premium is judged for its reasonableness based on the value of aggregate merger benefits, the purchasing utility actually has an incentive to minimize the premium paid for the acquired utility because it may not receive full cost of service recognition for the premium.

Q. If the Commission were to make a determination as to the reasonableness of a premium, does that shift the burden or risk of the premium to the regulators?

A. No, definitely not. When the utility acknowledges that the premium will be evaluated for reasonableness, it accepts the risk related to recovery of this element of cost in rates. Actually, by arbitrarily choosing not to include a premium in rates, the regulators inadvertently create disincentives for mergers that may offer net benefits for customers.

On the other hand, when the regulatory body chooses to evaluate the reasonableness of a premium it is simply fulfilling its responsibility to set just and reasonable rates. Generally, the review process for the premium should be perceived no differently by the Commission than the audits that its Staff conducts for the reasonableness of investments and expenses.

Q. What if regulators flow-through merger savings to customers, but fail to allow rate recovery of the premium?

A. That approach would be unreasonable.

Q. Why?

A. Some regulators may believe it is correct to pass merger savings along to customers even though the premium is not allowed in the utility rates. Frequently, this position is advocated because commissions generally do pass productivity gains to customers. I agree that it is common to pass cost savings to customers when achieved, but commissions also allow rate treatment for the investments and expenses used to develop the savings. Likewise, the Commission should perceive that a reasonable premium is an investment made to develop merger savings. Therefore, the premium deserves rate making recognition if savings are passed on to customers.

Q. If the Commission were to determine the reasonableness of the premium, would it need to be involved in the merger negotiations?

A. No. The Commission could determine the reasonableness of the premium just like it determines the reasonableness of other investments and expenses incurred by utilities. For example, it is common for regulators to evaluate the reasonableness of electric plant investments based on capacity needs and other economic and accounting criteria. Usually, the regulator performs this evaluation of construction costs without participating in the utility management's negotiations with contractors, equipment suppliers and board of directors. Also, sometimes regulators believe that to establish a precedent of not allowing a premium in the cost of service relieves the commission of the burden of testing the purchase price for reasonableness. That's not true, however, as a commission is charged with the responsibility of determining the reasonableness of utility rates. Arbitrarily excluding a premium from rate determination may make the review process simple for the regulators, but it would be contrary to the obligation of the regulators to serve the public interest and would undoubtedly discourage beneficial mergers. Thus, 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.

Q. Some regulators may assert that unregulated companies are placed at a disadvantage when compared to regulated utilities if premium recovery is allowed in rates. Do you agree?

A. No. This assertion ignores the fact that the unregulated firm retains the cost savings from synergies created through the merger. That is, in the case of the unregulated firm, there is no regulatory commission requiring merger savings to be flowed to customers. Therefore, the unregulated firm recovers the premium through merger savings. Actually, when regulators do not allow recovery of a premium while passing the all the cost savings to the customers, it is the regulated utility that is disadvantaged.

Q. Why?

A. Because the regulated utility is not allowed to recover any part of the investment in the premium on the one hand, while on the other it makes all the merger savings available for its customers. The combined effect of this treatment is to lower the utility's earnings below the level it would achieve without the merger. Under such economically unsound circumstances, a merger probably would not even be proposed.

REGULATORY TREATMENT OF PREMIUM RECOVERY AND MERGER SAVINGS

Q. What is your understanding of the Commission's position regarding rate recovery of premiums or acquisition adjustments?

A. The Commission has stated that it is not opposed to consideration of acquisition adjustment for ratemaking purposes. Specifically, the Commission has indicated that it is not opposed to the concept of a savings sharing plan (as part of an acquisition adjustment request) provided that only merger-related savings are shared. The Commission has said that it does not wish to prevent companies from producing economies of scale and savings which can benefit ratepayers and shareholders alike (Kansas Power & Light / Kansas Gas & Electric Case No. EM-91-213), a position we enthusiastically support The Commission has evaluated each merger on its own merits and has concluded that different circumstances have necessitated different approaches and solutions. For example, in one case an earnings sharing grid was approved with target returns set high enough to allow for full or partial recovery of the premium or acquisition adjustment (Union Electric / Central Illinois Public Service Co. Case No EM-96-149). In another case, rate freezes were established for a period of time that allowed for a full or partial recovery of the acquisition adjustment (Western Resources / Kansas City Power & Light Case No. EM-97-515).

Q. Have other regulatory commissions addressed the questions of premiums, acquisition adjustments or the sharing of merger benefits?

A. A quick reference of the states that have addressed the issue and have allowed at least some recovery of premiums is presented in Figure 2.

Q. Have you reviewed any of the details of the various commissions decisions regarding premiums, acquisition adjustments or the sharing of benefits from mergers?

A. Yes. I have closely examined summaries of commission proceedings to determine how acquisition adjustments and sharing of savings have been treated in other jurisdictions.

Q. Please summarize the results of your review.

A. As can be seen on Figure 2, a large number of states have permitted rate recovery of a portion or all of acquisition costs. The recovery is generally limited to savings and most of the decisions focused on sharing the net benefits.

Q. Are any of these cases noteworthy for purposes of the UtiliCorp/Empire merger?

A. Yes. Two decisions are very informative and have direct bearing on this case.

As Mr. Green describes in his testimony, the Massachusetts Department of Public Utilities ("Department"), set forth generic guidelines and standards for acquisitions and mergers of utilities. Prior to the generic investigation, the

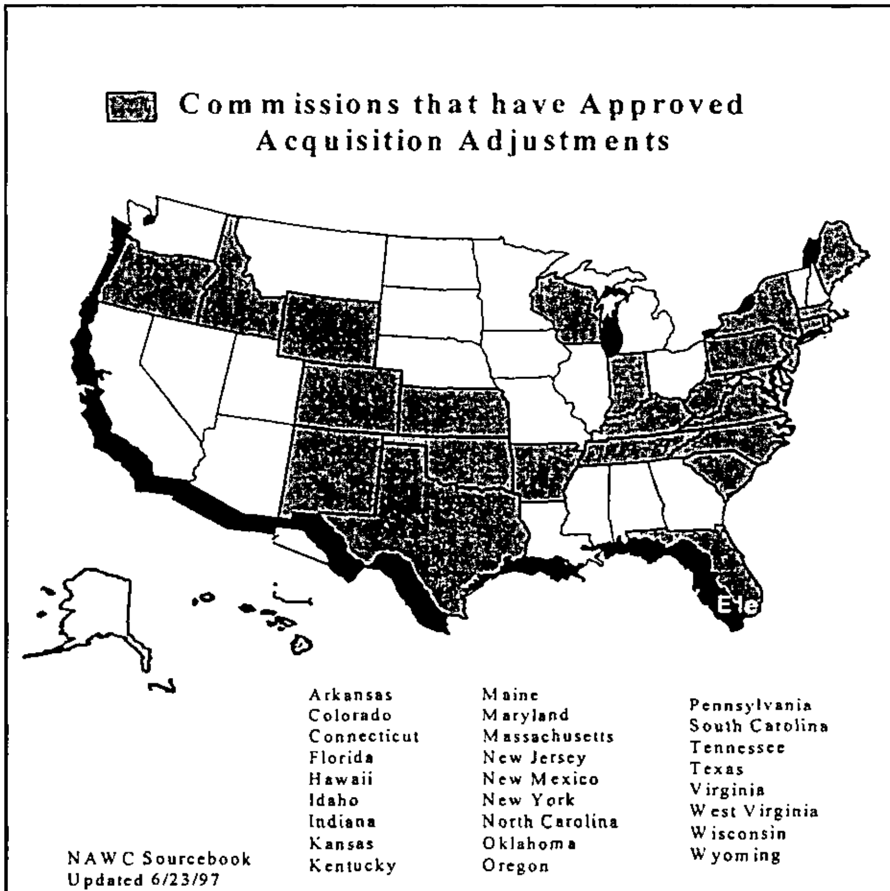

Figure 2

Department maintained a policy of disallowing acquisition adjustments. Importantly, after the generic hearings, the Department determined that where potential benefits for customers exist, it is not in the interest of the customers, the shareholders, or the state to maintain a barrier against mergers.

The Oklahoma Corporation Commission, (in an Oklahoma Gas and Electric Company acquisition) established criteria which are pertinent to the UtiliCorp/ Empire transaction. The Oklahoma Commission criteria are as follows:

1. The public interest must be considered.
2. The purchase price must be reasonable.
3. The benefits to ratepayers must equal or exceed the cost of the acquisition premium.
4. The transaction must be conducted at arm's length.

Q. How do these points relate to this merger?

A. They precisely describe this transaction.

Q. Please explain.

A. This transaction is a result of a confidential bidding process which is clearly an arm's length transaction between the parties. As explained by Mr. Green the purchase price is reasonable. The transaction meets the test of not being detrimental to the public interest and in fact creates net benefits for customers and shareholders. If this transaction does not take place, benefits which could accrue to the customers of both companies will not be realized.

Q. Have you made a review of accounting publications in connection with your research?

A. Yes, I have. In **Accounting For Public Utilities**, by Robert L. Hahne, Gregory E. Aliff, and Deloitte & Touche (1998 ed.), the issue of acquisition adjustments is addressed. The general rule related to the acquisition of utility plant previously used in the utility function is that the rate base component for the plant includes only the original cost of the property to the first owner devoting the property to public service. The excess amount paid is referred to as an acquisition adjustment and is placed in a separate account to be treated for ratemaking purposes as so authorized by the regulatory commission. The necessity of this separate accounting treatment is largely a consequence of certain abuses in the utility industry during the 1920s and 1930s. Commonly owned utilities were able to inflate their rate bases by purchasing affiliated companies at inflated prices. However, rate base treatment and/or cost of service treatment has been allowed by various regulatory commissions under a variety of circumstances.

Q. Under what circumstances?

A. The reasons most commonly cited for allowing rate base treatment of acquisition adjustments are as follows:

1) when acquisitions represent an essential or desirable part of an integration of facilities program devoted to serving the public better;
2) when acquisitions are clearly in the public interest, because operating efficiencies offset the excess price over net original cost; and
3) when acquisitions are determined to involve arm's-length bargaining.

Q. Does the UtiliCorp/Empire transaction meet these tests?

A. Yes.

Q. Have other commissions considered and employed these standards?

A. Yes. A number of cases exist where rate base and/or cost of service treatment has been allowed as a result of satisfying the criteria listed above. For example: The **Tennessee Public Service Commission** in 1969 allowed both rate base and cost of service treatment for acquisition adjustments of a telephone company where the acquisitions were found to be in the best interest of the public and not for the purpose of inflating the rate base.

In a 1955 <u>**Virginia Supreme Court of Appeals**</u> decision, the court ruled that the Virginia State Corporation Commission had properly allowed both rate base and cost of service treatment for an amount paid at arm's length bargaining in excess of original cost.

Q. Are there other such cases ?

A. Yes. For example, as far back as 1946, the <u>**Louisiana Public Service Commission**</u> allowed rate base and cost of service treatment for an electric company's acquisition adjustments stating that the criteria specified above had been met.

Importantly, The Commission stated that:

"The owners of a public utility are entitled to earn and receive a fair rate of return upon the money prudently invested in property used and useful in rendering public service. Money is prudently invested, even though it is in excess of the original cost of the property purchased, if the excess of purchase price over original cost was paid as the result of arm's-length bargaining between nonassociated buyer and seller, if the excess was necessary for the integration of the property into a larger and more efficient system, and if the purchase necessitating the excess did or reasonably should have resulted in public benefit by improvement of service to customers or in lowered rates or both better service and lowered rates. This integration cost or excess of purchase price over original cost termed in prescribed system of accounts as 'Utility Plant Acquisition Adjustments' should remain a part of the prudent investment during the life of the physical property to which it was applied, and its extinguishment from the investment when and if required by the Commission, should be accomplished by amortization through annual charges to Operating Revenue Deductions during the life of the property remaining after the date of the purchase which created the excess."

More recently, commissions have begun to apply the sharing principles. Using a different approach, the **Kansas Corporation Commission** in 1992 allowed Western Resources the opportunity to recover an acquisition premium (as well as the return on the premium) incurred in connection with its acquisition of Kansas Gas and Electric Company. However, rather than permitting rate base treatment and amortization in cost of service, the Commission allowed Western Resources to retain part of the anticipated cost savings to be realized in future years from merging the operations of the two companies.

In an interesting case that discusses what is meant by "Original Cost", the **Vermont Public Service Board** in a gas rate proceeding in 1973 stated that: "Original cost" relates to the cost incurred by the utility purchasing the facility, not the original cost of a prior owner. Assuming prudent investment, the stockholders should be allowed to earn a return on their actual 'out-of-pocket' investment; the fact that the marketplace may place a higher or lower valuation on the property does not affect the amount of the actual price paid by petitioner."

Q. In the previous answer, the term "Original cost" is used and in an earlier answer the term "Fair Value" is used. Would you explain the difference?

A. Yes. "Original cost" is normally defined in regulatory accounting as the cost of the asset when it was first devoted to serving the public. "Fair value" of properties is not the original cost of those properties, but the market value of the assets at a given point in time.

Q. Is net original cost the only method used by the Commission to determine the value of assets?

A. No. The Commission has in the past used the concept of Fair Value rate base determination many times in the setting of rates for electric utilities. While the majority of rate cases today are decided on an original cost basis, and Missouri is normally regarded as an original cost state, the United States Supreme Court (Southwestern Bell Telephone v. Public Service Commission of Missouri, 262 U.S.276; 43 S.Ct.544; 67 L.Ed. 981 [1923]) and the Missouri Supreme Court (State ex rel, Missouri Water Co. v. Public Service Commission, 308S.W.2d 704, 718-19 [Mo. Banc 1957]) have stated in at least two opinions that the Commission is to consider Fair Value information in the setting of rates when that information is provided by the utility. Since I am not an attorney, I can only offer a layman's view. From my reading of those decisions, I would say the Commission has the right to use its judgment to set the value of property at the level it believes is proper based upon the total evidence provided to it.

CAPITAL STRUCTURES

Q. The regulatory plan refers to the Empire capital structure in the context of The Post-Moratorium Rate Case. Will you please explain this point?

A. In addition to the capital structure proposal that is to be used for the premium recovery, an additional part of the regulatory plan proposal in this case is a determination by the Commission that the normalized capital structure (47.5%

debt, 52.5% equity) of Empire as a standalone operation be used as the capital structure in setting future rates for the Empire customers.

Q. What is the basis for this aspect of the regulatory proposal?

A. Absent the merger, this capital structure would not have changed appreciably. Retaining that capital structure results in no new cost to the existing Empire customers.

Q. If this capital structure proposal is not approved by the Commission, what would be the impact on the regulatory plan?

A. It would require UtiliCorp to significantly restructure its regulatory plan in order to maintain the financial feasibility of this merger.

ALLOCATIONS

Q. The last item in the regulatory plan refers to the allocation of UtiliCorp's corporate and intra-business unit costs and how the merger will impact those allocations. Will you please explain this point?

A. Yes. The current allocation methodology is familiar to the Commission, having been used by UtiliCorp for some time, and allocates those costs through the use of various drivers (factors) to the different business units.

Q. What is the effect on the MPS operations from excluding the Empire factors from the corporate allocations?

A. It is not adverse. The corporate and intra-business unit allocations to MPS will not increase if the Empire factors are excluded.

Q. Why should the Empire factors be excluded from the MPS allocation calculations?

A. Including the Empire factors would artificially shift the existing Empire overhead savings to the MPS customers. MPS customers should continue to be allocated their existing level of corporate costs, as no change in the level of service will be effected by this merger. Therefore, in future MPS rate cases , the allocation factors should not be impacted by Empire.

Q. Is this portion of the plan one of the items necessary to make the transaction's economics work?

A. Yes. While many items call for special regulatory treatment. The total regulatory plan provides means that allow the economics of the transaction to work and ensure, when considered in aggregate, that customers will be benefited and not be harmed.

RTOS AND MARKET POWER

Q. Has the Commission requested other public utilities that have filed applications requesting approval of mergers or acquisitions to provide other information that is not mentioned in the Commission's rules?

A. Yes. The Commission has requested other public utilities address Regional Transmission Organizations ("RTOs"). Joining an RTO is not an issue for the merged company. UtiliCorp has been in favor of RTO formation since the beginning of this decade and has stated many times that UtiliCorp will join the RTO that is responsible for the service area where its transmission facilities are located. UtiliCorp wants to be sure that the RTO it becomes a member of is the best organization to serve the needs of UtiliCorp's native customers and to ensure all parties have open access to all markets. The direct testimony of UtiliCorp witness Mr. Richard C. Kreul will explain in detail UtiliCorp's position in regard to RTOs.

Q. Does the Commission have a rule that requires merging companies to file a Retail Market Power Study as a part of any merger application?

A No. However, the Commission has ordered some companies to file market power studies when the Commission believed it was necessary to review the issue in the context of a merger proceeding.

Q. Has UtiliCorp and Empire provided a retail market power study in connection with this proceeding?

A. No. UtiliCorp and Empire have included, as part of their merger filing with the Federal Energy Regulatory Commission ("FERC"), (Docket No. EL-00-28-000), a market power analysis as required by the FERC. The Commission has been served with a copy of that filing including this analysis. In this regard, there is considerable debate as to the form of the analysis necessary to determine if merging companies will exert market power. At this time the FERC only requires all merging companies to complete an "Appendix A" analysis, which reviews the market power position of the merged company on the wholesale market.

Q. At this time can UtiliCorp and Empire complete a Retail Market Power analysis?

A. Not a meaningful one.

Q. Why?

A. Retail competition does not yet exist in Missouri, and we are not sure when choice will come for retail customers. At this time, the only competitive market is the wholesale market, and therefore, that is the only market that can be meaningfully analyzed.

Q. When can such an analysis be accomplished?

A. It is premature to consider retail market power issues at this time. Once the Missouri General Assembly and the Commission have decided the form of the market and when competition will be allowed for the Missouri retail customer, we will be able to perform a meaningful retail market power analysis. In any event, UtiliCorp, as the third largest retail electric company in Missouri -- both before and after the merger -- does not believe that the merged company will exercise any significant measure of retail market power.

Q. Are you suggesting the Commission should not be concerned with market power issues?

A. Not at all. The Commission should view market power as a critical issue and take steps to bring appropriate wholesale issues to the attention of the FERC during its review of the UtiliCorp/Empire merger application before that body. Retail market power, on the other hand, is an important issue that should be reviewed later when retail competition becomes a reality in Missouri.

Q. How have other electric utilities that have filed merger applications in Missouri handled this market power issue?

A. In the proposed settlement of the Western Resources Company/Kansas City Power & Light Company merger, the parties have agreed to the same basic concept of deferring the retail market power study. UtiliCorp and Empire are asking for similar treatment from the Commission in this proceeding.

Q. When should the merged company file a retail market power study?

A. UtiliCorp will file a retail market power study at that point in the future when the Commission determines that the study is needed, either as a result of legislative action, because the commencement of retail competition, or for any other reason. UtiliCorp will file the study in conformance with the guidelines and orders put forth by the Commission at the time the study is to be completed. To agree to market power conditions and guidelines today without the knowledge of what the retail market will really look like would not be a meaningful or productive exercise.

COMMISSION JURISDICTION

Q. What impact will this merger have with respect to the jurisdiction of the Commission?

A. None to my knowledge. It is my understanding that the Commission's jurisdiction will remain intact, including jurisdiction over operations, customer service, revenues, rules and the retail rates. The corporate offices for the combined company will remain in Missouri, and the Commission will maintain complete access to the books and records of the merged company.

SUMMARY

Q. What is the standard that UtiliCorp and Empire must meet for the Commission to approve this transaction?

A. The sole determination that the Commission must make is that the transaction is not detrimental to the public interest.

Q. Does UtiliCorp and Empire meet this requirement?

A. Yes, definitively The merger of the companies results in a stronger Missouri based utility that will be able to provide continued excellent service to its customers at a reduced level of cost. There is no detriment to the public interest as a result of this transaction.

Q. Does this conclude your direct testimony?

A Yes.