

Exhibit No.:

Issues: Transition

Transaction Costs

Witness: James M. Russo

Sponsoring Party: MoPSC Staff

Type of Exhibit: Rebuttal Testimony

Case No.: EM-2000-369

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

JAMES M. RUSSO

UTILICORP UNITED INC.

AND

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Jefferson City, Missouri

June 2000

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REBUTTAL TESTIMONY
OF
JAMES M. RUSSO
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REBUTTAL TESTIMONY

OF

JAMES M. RUSSO

UTILICORP UNITED INC.

AND

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Q. Please state your name and business address.

A. James M. Russo, P. O. Box 360, Jefferson City, Missouri 65102.

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

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

Q. What has been the nature of your duties with the Commission?

A. I have directed and assisted with various audits and examinations of the
books and records of public utilities operating within the state of Missouri under the
jurisdiction of the Commission.

Q. Have you previously filed testimony before this Commission?

A. Yes. I have testified in Case No. GR-97-393, Union Electric Company;
Case No. EC-98-573, St. Joseph Light & Power Company; Case Nos. HR-99-245,
GR-99-246 and ER-99-247, St. Joseph Light & Power Company, and Case No.
EM-2000-292, UtiliCorp United Inc. and St. Joseph Light & Power Company.

Rebuttal Testimony of
James M. Russo

1 Q. Have you made an examination of the Application filed by UtiliCorp
2 United Inc. (UCU) and The Empire District Electric Company (Empire) (collectively
3 Companies or Joint Applicants) in regard to Case No. EM-2000-369?

4 A. Yes. I performed an examination of the Application with the assistance of
5 other Commission Staff (Staff) members.

6 Q. What is the purpose of your rebuttal testimony?

7 A. The purpose of my rebuttal testimony is to present the Staff's
8 recommendation concerning treatment of the transaction costs and the majority of the
9 "costs to achieve" (also known as transition costs) that are related to the merger. Staff
10 Accounting witness Steve M. Traxler will address in his rebuttal testimony the Staff's
11 recommendation concerning the "cost to achieve" denoted in Line 12 of UCU witness
12 Vern J. Siemek's Schedule VJS-2. Line 12 is titled "Curtailment costs for retiree medical
13 plan."

14 Q. How does your testimony filed in this merger application compare to the
15 testimony you filed earlier concerning the same issues in the UCU/St. Joseph Light &
16 Power Company (SJLP) merger application, Case No. EM-2000-292?

17 A. This testimony is very similar to that earlier filed in Case No.
18 EM-2000-292 on transaction and transition costs associated with the UCU/SJLP merger.
19 However, UCU/Empire incurred to some degree, different transition costs than
20 UCU/SJLP incurred in their merger transaction, so some of the details of this issue area
21 discussion differ between the two filed testimonies.

22 **TRANSACTION COSTS**

23 Q. Please define transaction costs as they relate to the merger case.

1 A. Transaction costs are costs incurred by both the acquiring company and
2 the acquired company for the purpose of consummating the merger. Examples of these
3 costs are fees paid for legal, banking and consulting services necessary to close the
4 transaction. The majority of transaction costs will be incurred prior to the merger
5 closing.

6 Q. How should transaction costs be accounted for?

7 A. Since these costs are directly associated with the acquisition, they should
8 be included with the acquisition adjustment associated with the transaction. The costs
9 identified as transaction costs by the Companies mirror those listed in Accounting
10 Principles Board (APB) Opinion No. 16, which defines costs of a business combination
11 accounted for by the "purchase" method as direct costs of the acquisition (paragraph 76
12 of APB 16). APB Opinion 16 also states that costs of registering and issuing equity
13 securities are a reduction of the otherwise determinable fair value of the securities.
14 Indirect and general expenses related to acquisitions are deducted as incurred in
15 determining net income. APB Opinion 16 is the authoritative source for business
16 combinations. Under the "purchase" method of accounting for a business combination,
17 direct out-of-pocket and incremental costs of the combination, including finders' fees and
18 fees paid to outside consultants for accounting, legal, engineering investigations and
19 appraisals, are considered direct costs of the acquisition. The proposed merger of UCU
20 and Empire will be accounted for under the "purchase" method.

21 Q. To what Federal Energy Regulatory Commission (FERC) Uniform System
22 of Account (USOA) does Staff propose that transaction costs be charged?

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1 A. The Staff proposes that the transaction costs be posted to Account 425,

2 Miscellaneous Amortization:

3 This account shall include amortization charges not
4 includible in other accounts, which are properly deductible
5 in determining the income of the utility before interest
6 charges. Charges includible herein, if significant in
7 amount, must be in accordance with an orderly and
8 systematic amortization program...Items-1 Amortization of
9 utility plant acquisition adjustments, or of intangibles
10 included in utility plant in service when not authorized to
11 be included in utility operating expenses by the
12 Commission. (Emphasis added.)

13
14 Account 425 is a non-operating "below-the-line" account and accordingly will not
15 be included in UCU/Empire's cost of service to customers.

16 Q. How have UCU and Empire accounted for actual transition costs for the
17 merger to date?

18 A. UCU has accounted for transaction costs by booking them to Account
19 186.2, Miscellaneous Deferred Debits. Empire has accounted for transaction costs by
20 booking them to Account 921, Office Supplies and Expenses, and expensing these costs
21 in the year they were incurred.

22 Q. How do the Joint Applicants propose to treat, for rate purposes,
23 transaction costs associated with the merger?

24 A. The Companies propose to defer and amortize the transaction costs over
25 10 years or 40 years for financial reporting and rate purposes. The Joint Applicants'
26 response to Staff Data Request No. 45 states:

27 ... Briefly, most transaction and transition costs should be
28 deferred and amortized over either ten years or forty years.
29 The synergies created from the merger should be offset by
30 that amortization before any rate reductions are made.
31 Carrying costs on that investment by UCU is not currently

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1 being requested. Effectively, the synergies help pay for the
2 transition and transaction costs.

3
4 Furthermore, UCU witness Siemek states on page 8 of his direct testimony:

5 Most of the Costs to Achieve were amortized over the first
6 ten years of the combined operations. The bank fees and
7 bond solicitation costs were amortized over forty years.

8
9 In addition, Mr. Siemek states in his definition of "costs to achieve," on page 6 of
10 his direct testimony that:

11 ... Cost to achieve also includes the legal costs and banker
12 fees to accomplish the transaction. All of these costs are
13 necessary to realize the synergies from the transaction.
14

15 The Staff disagrees that legal costs and banker fees should be considered "costs to
16 achieve," but instead believes they should be considered transaction costs.

17 Q. Has UCU/Empire proposed the same treatment for the transaction costs as
18 recommended by UCU and SJLP in their merger case (EM-2000-292)?

19 A. No. In the UCU/SJLP merger case all of the transaction costs were
20 proposed to be amortized over 10 years. However, in the UCU/Empire merger case the
21 banker fees and bond solicitation cost components of the transaction costs are proposed
22 to be amortized over 40 years. Staff Accounting witness Mark L. Oligschlaeger will
23 address in his rebuttal testimony the significance of UCU's proposed 40-year
24 amortization of bank fees and bond solicitation costs. Staff witness David P. Broadwater
25 of the Financial Analysis Department also discusses bond solicitation costs in his rebuttal
26 testimony.

27 Q. What is the estimated level of transaction costs for this merger?

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A. When asked this question, the Companies' response to Staff Data Request No. 96 refers to Schedule VJS-2, also referred to as Appendix VSJ-A of the testimony of Mr. Siemek. Schedule VJS-2 lists transaction costs of \$7,347,000 for banker fees, \$5,852,000 for bond solicitation costs, \$3,275,000 for legal fees, \$300,000 for proxy vote costs and \$2,500,000 for other costs. The total of the transaction costs listed on Schedule VJS-2 is \$19,274,000.

Schedule VJS-2 also summarizes the transition costs (costs to achieve) associated with the merger. These will be further discussed later in my testimony.

Q. What amount of transaction costs have actually been recorded by UCU/Empire?

A. According to UCU's response to Staff Data Request No. 100, through December 31, 1999, UCU has deferred \$5,772,293 in transaction costs. In its response to Staff Data Request No. 44, through July 31, 1999, Empire indicates that it has previously expensed transaction costs in the amount of \$3,322,418. The following table separates the actual transaction costs that have been incurred by UCU/Empire into descriptive categories:

Transaction Costs Through August 31, 1999

<u>Type</u>	<u>UCU TOTAL</u>	<u>Empire TOTAL</u>
Investment Banker	\$ 310,650	\$ 123,339
Consulting Fees	4,673,401	2,575,143
Legal	780,057	623,312
Travel & Miscellaneous	8,184	623
Total Transaction Costs	\$5,772,292	\$3,322,418

Q. What is the Staff's general position on transaction costs incurred by UCU/Empire?

1 A. The Staff believes that, in general, transaction costs of UCU/Empire are
2 direct costs of the acquisition and should therefore be treated in the same manner as the
3 acquisition premium. Absent the merger, these transaction costs would not have been
4 incurred. As explained in other Staff testimony, the Staff further believes that the
5 acquisition adjustment is not the responsibility of the ratepayers to pay under the premise
6 of making the "shareholders whole." Likewise, the recovery of transaction costs, as
7 stated in APB Opinion 16, is associated with the amortization of the acquisition premium
8 in purchase transactions and therefore should not be the responsibility of the ratepayers.
9 The Staff believes that the shareholders should absorb the transaction costs since they are
10 seeking the merger as a way to increase the value of their investment. The risks that arise
11 as a result of the merger should be taken by the shareholders since they are the parties
12 responsible for the merger, and the transaction costs represent known costs associated
13 with the risks of the merger. The Staff would also propose, as a condition of the merger,
14 that the Commission require UCU to continue to track transaction costs so they may be
15 excluded in future rate cases.

16 Q. In the event the Commission should decide in this docket to allow the
17 recovery of UCU/Empire's merger transaction costs, does the Staff have any additional
18 recommendations to make?

19 A. Yes. The Staff would have the following recommendations for the
20 Commission if the Companies' position for rate recovery of transaction costs is accepted:

- 21 • Require that the remaining transaction costs be amortized over
22 40 years, thus corresponding to the amortization of the
23 acquisition adjustment.
24

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- Prohibit any recovery of the transaction costs that were originally expensed by Empire that are outside of a test year used in a future rate proceeding.
- Allocate a portion of amortized costs to non-regulated companies.
- Prohibit rate base treatment of transaction costs.

Q. What recovery period would the Staff recommend if the Commission accepts the proposal of the Joint Applicants to amortize transaction costs for rate purposes?

A. If the Commission decides to allow UCU/Empire to recover the transition costs from ratepayers, the Staff would recommend that the recovery be made over an extended period. For purposes of this case, the Staff proposes that the recovery period for all transaction costs be 40 years. The Joint Applicants are already proposing that the banker fees and bond solicitation costs be amortized over 40 years. In addition, the Joint Applicants propose to amortize the acquisition adjustment over 40 years. Since the transaction costs are considered direct costs of the acquisition, it is appropriate for them to be amortized over the same period as the acquisition adjustment.

Q. Does the Staff agree with UCU/Empire's proposal for the future recovery of the 1999 transaction costs expensed by Empire?

A. No. It is the Staff's recommendation that any future recovery of the transaction costs expensed by Empire be limited to those transaction costs that are incurred within the ordered test year for any future rate case. As a general matter, the Staff would oppose the recovery in rates of any costs booked outside of the test year that have not either been capitalized or deferred.

1 Q. What is Staff's recommendation if the Commission allows the transaction
2 costs to be amortized and recovered from ratepayers?

3 A. If the transaction costs are amortized and recovered from ratepayers, a
4 portion of the costs should be allocated to the non-regulated operations of UCU and
5 Empire. The Staff would recommend that 50% of these costs be allocated to non-
6 regulated operations, on the basis that the Joint Applicants have not provided to the Staff
7 any information concerning a reasonable allocation of the acquisition adjustment to non-
8 regulated operations. The significance of UCU's non-regulated operations, as they
9 pertain to the acquisition adjustment issue in this proceeding, is explained in the rebuttal
10 testimony of Staff Accounting witnesses Charles R. Hyneman and Mr. Oligschlaeger.

11 Q. What is Staff's recommendation to the Commission on rate base treatment
12 of these costs?

13 A. The Staff would recommend that the transaction costs not be included in
14 rate base to the extent that the Commission would allow these costs to be amortized.

15 **COSTS TO ACHIEVE**

16 Q. What are "costs to achieve?"

17 A. "Costs to achieve" are costs that the Companies will have to incur in order
18 to combine the systems and processes of Empire into UtiliCorp after a merger is
19 approved. Accounting systems will have to be combined; computers will have to be
20 reprogrammed; procedures and practices will have to be consolidated; call centers will be
21 integrated; and Human Resources will have to redesign benefit packages for consistency.
22 These changes all have costs associated with their implementation.

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1 Q. Please describe the "costs to achieve" that UCU/Empire are proposing to
2 recover.

3 A. More than half of the "costs to achieve" that UCU/Empire is seeking to
4 recover are associated with workforce transition costs. According to the testimony of
5 Company witness Siemek, page 6, these costs include estimated relocation costs,
6 severance costs, mapping conversion costs and retention payments. Besides these items,
7 Mr. Siemek lists two additional items on lines 4 and 5 of Schedule VJS-2 as "costs to
8 achieve." The first is "Paid Advisory Board-Three Years" in the amount of \$250,000
9 (line 4). The second is "Curtailment costs for retiree medical plan" for \$2,732,000
10 (line 12).

11 Q. Does the Company characterize any other costs as being "costs to
12 achieve?"

13 A. Yes. Mr. Siemek states in his direct testimony, page 6, lines 18 thru 22
14 and page 7, lines 1 thru 3:

15 . . . Estimated costs to convert Empire computer systems to
16 UtiliCorp's systems are \$2.7 million. These conversion
17 costs include the costs to convert the customer billing,
18 financial systems and new equipment. The cost of
19 converting Empire computer systems to UtiliCorp systems
20 were estimated by UtiliCorp's Information Technology
21 function. Transaction costs were estimated to be \$19.3
22 million, which includes the legal fees, bond solicitation
23 costs, and Empire's investment bank fees to complete the
24 transaction. These are the costs incurred to both achieve
25 the combination and to implement the synergies.
26

27 Q. Does the Staff agree with the above statement in Mr. Siemek's direct
28 testimony?

1 A. No. As stated previously, the Staff believes that the legal and bond
2 solicitation costs of the Companies and the banker fees of Empire are transaction costs
3 and not "costs to achieve." Please refer back to my earlier testimony for the Staff's
4 proposed treatment of transaction costs.

5 Q. What is UCU's and Empire's estimate of "costs to achieve" for this
6 merger as stated in Mr. Siemek's direct testimony?

7 A. UCU's and Empire's estimate of "costs to achieve" for this merger (under
8 the Staff's definition) is approximately \$13,885,800 according to Siemek Schedule
9 VJS-2. The following chart identifies the UCU/Empire estimated costs by category:

10 **Summary of Costs to Achieve Synergies**

11	Distribution Severance	\$ 1,303,700
12	Officers Severance/retention	1,406,000
13	Transmission Severance and Relocation	316,000
14	Paid Advisory Board-3 Years	250,000
15	Cost of Mapping Conversions	2,000,000
16	Severance Payments for Non-Officer Key Employees	998,800
17	Gen Admin Subgroups-Fin Acctg Severance and Retention	1,262,000
18	Human Resources-Severance	20,000
19	Information Technology-Severance	476,000
20	Regulatory/Legislative Severance	152,800
21	Generation Severances	266,000
22	Curtailment Costs for Retiree Medical Plan	<u>2,732,000</u>
23	Total Transition Costs	\$11,183,300
24	IT Transition Costs	<u>2,702,500</u>
25	Total Costs to Achieve Synergies	\$13,885,800

26
27 Q. What is UCU/Empire's position on the accounting and rate recovery of
28 "costs to achieve?"

29 A. Mr. Siemek indicates on page 8 of his direct testimony that UCU will
30 amortize the "costs to achieve" over the first 10 years of combined operations. This is

1 the same treatment proposed by the Company for what the Staff considers to be the
2 majority of transaction costs.

3 Q. What is the Staff's position as it relates to the accounting treatment and
4 recovery of these "costs to achieve?"

5 A. The Staff believes, in general, that prudent actual "costs to achieve"
6 incurred by the Company should be allowed recovery in rates, as the Company will incur
7 these costs in order to create the opportunity for savings if the Commission approves the
8 merger. The Staff recommends that these costs be expensed in the period in which they
9 occur, thereby offsetting any merger savings that are actually realized during the same
10 time period. The direct expensing of the "costs to achieve" also eliminates any problems
11 that could develop later while trying to segregate "costs to achieve" from normal
12 operating expenses. The Company can request recovery of these amounts incurred in
13 future test years in rate proceedings, if desired. The Staff will make rate
14 recommendations concerning the amount of expense recovery of prudently incurred
15 "costs to achieve" at that time.

16 Q. Why is the Staff's position to allow recovery of "costs to achieve"
17 different from its position not to allow recovery of transaction costs?

18 A. Transaction costs are directly associated with acquisition adjustment and
19 pertain to costs incurred prior to the merger actually taking place. They should be paid
20 by the shareholders since the merger is taking place primarily for the benefit of the
21 shareholders and, absent the merger, these costs would not be incurred. "Costs to
22 achieve," on the other hand, are costs that will occur after the merger is approved. There
23 is a direct correlation between the "costs to achieve," which facilitate the joining of the

1 UCU and Empire organizations, and the merger savings that are estimated to arise
2 following the completion of the integration process. At that point, the customers will
3 hopefully share in the savings that are generated from the merger and, therefore, should
4 also share in the prudent "costs to achieve" the merger savings.

5 Q. What is the Staff's view concerning possible amortization of "costs to
6 achieve?"

7 A. While the Staff believes that its position to expense "costs to achieve" in
8 the period they occur is most appropriate, the Staff realizes that amortization of "costs to
9 achieve" is another option that the Commission will review. If the Commission orders
10 amortization of these costs, the Staff would recommend a 10-year amortization period.
11 Ten years appears to be reasonable in light of the magnitude of these costs (\$13.9
12 million) and UCU/Empire's assertion of merger benefits occurring over this period.
13 However, the Staff believes that if UCU/Empire is allowed to amortize "costs to
14 achieve," they should be carefully defined prior to any accounting deferrals.

15 Q. If the Commission wishes to make a ratemaking determination concerning
16 "costs to achieve" in this docket, does the Staff believe that all "costs to achieve"
17 identified by UCU/Empire should be allowed recovery in rates (other than transaction
18 costs)?

19 A. No. The Staff proposes that costs associated with the Paid Advisory
20 Board and the Officer's Severance/Retention Plan be excluded from being recovered
21 from ratepayers. Staff witness Traxler will address in his rebuttal testimony the item
22 entitled "curtailment costs for retiree medical plan."

23 Q. What is the Paid Advisory Board (Advisory Board)?

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1 A. Page 2 of the UCU/Empire Merger Agreement (Schedule RKG-1 to UCU
2 witness Robert K. Green's testimony) describes the Advisory Board as five persons
3 nominated by the Company (Empire) and approved by UCU. Members on the Advisory
4 Board will serve for a period of at least three years following the closing date of the
5 merger. The members of the advisory board will receive an annual fee of \$15,000 plus
6 reimbursement for reasonable out-of-pocket expenses incurred in connection with their
7 service on the Advisory Board.

8 Q. Why does the Staff propose the exclusion of \$250,000 for the Advisory
9 Board from being recovered from ratepayers?

10 A The Staff has not seen any documentation that would indicate the
11 Advisory Board will be providing any benefit to the ratepayers.

12 Furthermore the UCU/Empire Merger Agreement indicates that the Advisory
13 Board will be involved in advising UCU on such matters as charitable contributions and
14 economic development activities in the Company's current service area. This type of
15 activity on the Advisory Board's part further argues for below-the-line treatment of the
16 Advisory Board fees. Charitable contributions have traditionally never been allowed in
17 customer rates by this Commission, and economic development expenses are subject to a
18 cost/benefit test before inclusion in rates.

19 Q. Has UCU made any type of commitment on providing continued
20 charitable and economic development support to the Empire service territory?

21 A. Yes. Page 45 of the UCU Prospectus/Proxy Statement of Empire states:

22 The merger agreement provides that for a period of at least
23 five years following the effective time of the merger, UCU
24 will provide charitable contributions and community
25 support within Empire's current service area at levels that

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1 are at least comparable to the level of charitable
2 contributions and community support provided by Empire
3 within that area during the two years prior to the effective
4 time of the merger.
5

6 Q. Please provide some of the details of the Empire Severance Agreements
7 (i.e., agreements governing executive separation costs).

8 A. In the case of Empire's Severance Agreements, the President and Chief
9 Executive Officer, Vice President-Energy Supply, Vice President-Finance, Vice
10 President-General Services, and Vice President-Commercial Operations of the Company
11 are included. The agreements provide the executives with approximately three times
12 their annual salary if a change in control occurs. UCU supplied the estimated severance
13 and retention cost by officer for Empire in Schedule SR-3, provided in response to Staff
14 Data Request No. 1. A copy of Empire's employment contract for officers was provided
15 to Staff in response to Staff Data Request No. 17.

16 Q. Please explain why the Staff believes that executive separation costs of
17 \$1,406,000 should not be recovered in rates.

18 A. Executive severance packages within an organization are compensation
19 packages that typically guarantee payments to top executives and key employees on the
20 occasion of a takeover, merger or some other related situation to ensure officers'
21 neutrality. The industry refers to these severance packages as "golden parachutes."
22 Payment of such "golden parachutes" does not have any direct correlation or benefit to
23 ratepayers. Instead, these are the costs that benefit only a very few employees, and are
24 primarily created for their personal protection. Staff further believes these costs are
25 shareholder costs, because these severance packages are also designed to ensure the

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1 officers' neutrality in considering potential takeovers, sales and acquisitions. The Staff's
2 position, therefore, is that no recovery of these costs from ratepayers is warranted.

3 Q. Does this conclude your rebuttal testimony?

4 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

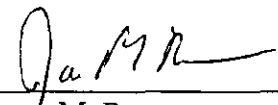
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of)
UtiliCorp United Inc. and The Empire District)
Electric Company For Authority To Merge The)
Empire District Electric Company With and Into) EM-2000-369
UtiliCorp United Inc. and, In Connection)
Therewith, Certain Other Related Transactions,)
Filed.)

AFFIDAVIT OF JAMES M. RUSSO

STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

James M. Russo, is, of lawful age, and on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 16 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.



James M. Russo

Subscribed and sworn to before me this 17th day of June, 2000.

