. . . 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). [Citation omitted.] 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.

Id.

Unlike UtiliCorp's proposal in the instant case, KPL in Case No. EM-91-213 did not request direct recovery of the acquisition premium in rates. In response to Staff Data Request No. 147 in Case No. EM-91-213, KPL stated that its proposed 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." Although the Commission stated its interest in the merger savings sharing concept proposed by KPL in Case No. EM-91-213, no part of the cost savings tracking system (CSTS) was ever implemented. The Commission stated in its Report And Order as follows:

. . . 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.

. . . [T]he Commission will direct the parties to meet for the purpose of attempting to devise a method of tracking merger-related savings. If the parties are unable to agree on such a system within sixty days, the Commission will hold a hearing to gather the information necessary to decide if any tracking plan can exclude nonmerger-related savings and, if so, which system would be best suited to this purpose.

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

IT IS THEREFORE ORDERED:

9. That the parties to this case be directed hereby to meet for the purpose of attempting to devise a merger savings tracking plan (MSTP) which will ensure that all nonmerger related savings can be excluded from the merger savings to be shared between ratepayers and shareholders. The parties will file this plan with the Commission for its approval on or before November 22, 1991.

Id. at 161.

On December 13, 1991, the Commission in Case No. EM-91-213 issued a two page Order Adopting Staff's Suggestion And Closing Docket. The Commission's December 13, 1991 Order noted that rather than filing with the Commission on November 22, 1991 a merger savings tracking plan, which would ensure that all nonmerger related savings could be excluded from the merger savings to be shared between ratepayers and shareowners, the Staff and KPL filed pleadings proposing procedural schedules and, among other things, the Staff suggested that the merger savings tracking plan issue be decided in KPL's next rate case. In responsive pleadings

Public Counsel supported and KPL did not oppose the Staff's suggestion that the merger savings tracking plan issue be decided in KPL's next rate case. The Commission adopted the Staff's suggestion, stating 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.
>
> (Featherstone Rebuttal, Ex. 702, p. 83).

By KPL's next Missouri rate case, Case No. GR-93-240, KPL had taken the name Western Resources, Inc. In that case, Western Resources' Controller, Jerry D. Courington, indicated that Western Resources had 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.'" (Featherstone Rebuttal, Ex. 702, p. 83, quoting Courington direct testimony in Case No. GR-93-240, pp. 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." (Id. quoting Courington direct testimony in Case No. GR-93-240, p. 15). Western Resources made no adjustments in Case No. GR-93-240 to reflect in rates any recovery of the asserted acquisition premium associated with the KGE merger. (Id.)

Returning to the KPL-KGE merger case, EM-91-213, the Staff would note that although Commissioner Allan G. Mueller did not oppose the merger of KPL and KGE, he dissented from

the Commission's decision to adopt a savings sharing plan. Commissioner Mueller identified the reasons that he opposed KPL's sharing plan as follows (1 Mo.P.S.C.3d at 163-65):

1. A merger savings tracking plan cannot be developed that would accurately distinguish nonmerger savings from merger savings, and a multijurisdictional tracking plan cannot be developed that would be sufficiently sophisticated to protect the interests of Missouri ratepayers.

2. Adoption of the proposed sharing plan sends the wrong signal to companies regarding mergers and acquisitions. Companies will be less concerned about bargaining for the lowest possible price for assets purchased, if they know that the Commission will permit that ratepayers instead of shareowners pay the acquisition premium.

3. Adoption of the proposed sharing plan will create the impression that the Commission promotes mergers.

4. Fairness requires that the Commission should reject the sharing plan because KPL did not offer to share with ratepayers the benefit when it purchased the Gas Service Company below its book value.

5. KPL's management did not deserve the reward of having its shareholders receive 50% of the merger-related savings. KPL denied the Commission access to a full range of information on the propriety of the merger because it did not have available for the Commission the conservative scenario which was developed by Morgan Stanley for KGE.

   "While I believe KPL barely carried the burden of proof to show no detriment to the Missouri ratepayers, given the safeguards this Commission has committed itself to, I do not believe that the case offered to this Commission by KPL deserves the reward implied by even contemplating approval of the sharing plan."

(1 Mo.P.S.C.3d at 164-65).

It should be abundantly clear and not be necessary to address, but given the nature of the Joint Applicants' attack on the Staff's opposition to the direct recovery of merger premiums, the Staff will note that the Western Resources – KCPL merger failed because of the negative effect of Western Resources' Protection One investment on the Western Resources stock price, not because of Western Resources' – KCPL's agreement not to seek in Missouri the direct recovery

of the merger premium that Western Resources agreed to pay for acquiring KCPL or the terms of the Kansas Corporation Commission's authorization of the merger. (Featherstone Rebuttal, Ex. 702, pp. 62-72). The Western Resources – KCPL merger agreement permitted 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. (Id. at 66). On December 31, 1999, Western Resources' common stock price closed at $16.94 per share, and on January 3, 2000, when KCPL announced its termination of the merger, Western Resources' common stock price was $16.50 per share. (Id. at 64-65). KCPL's financial advisor was unable to provide an opinion that the proposed transaction was fair to KCPL's shareholders from a financial point of view. (Id. at 69-70). The January 3, 2000 letter from A. Drue Jennings of KCPL to David Wittig of Western Resources also stated, in part, that "[i]n light of the continuing problems at Protection One, this important strategic rationale for the proposed merger no longer appears to exist." (Id. at 70-71).

The Staff has previously identified UtiliCorp as a utility that operates in the Missouri jurisdiction which has a very aggressive acquisition and merger corporate philosophy which also had a policy of not requesting recovery of any acquisition premiums. Mr. Richard C. Green, Jr., Chairman of the Board, Chief Executive Officer, and President of UtiliCorp stated in a meeting with the Commission in late 1985, early 1986 that MPS' ratepayers would be insulated from all downside risks associated with UtiliCorp's acquisition and merger strategy. He further indicated that all benefits of any acquisition and merger would be flowed to the ratepayers. Mr. Green reiterated this policy in a 1990 interview with the Staff and Public Counsel during the course of the Staff's and Public Counsel's audit of MPS' 1989-1990 rate increase case. He said that at no time had UtiliCorp sought, nor would UtiliCorp seek to recover acquisition premiums from ratepayers in any of the jurisdictions in which it operates. In MPS' 1990 electric rate increase

case, the Commission held as follows regarding the UtiliCorp corporate office/acquisition and merger expense issue:

> The evidence indicates that 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's rates. When UtiliCorp was formed [sic] 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's rates. The Commission is of the opinion that it is inappropriate for MPS's ratepayers to pay for these activities which have little to do with MPS's 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's rates.

Re Missouri Public Service, Division of UtiliCorp United Inc., Case Nos. ER-90-101, et al., Report And Order, 30 Mo.P.S.C.(N.S.) 320, 350-51 (1990).

The Staff's concerns about giving ratemaking treatment to acquisition premiums would not be resolved if the acquisition were an arm's length transaction (i.e., no affiliation or tie between the negotiating parties). The lowest possible or some otherwise appropriate purchase price may not necessarily be attained under an arm's length transaction. If the purchasing utility believes that there will be ratemaking recognition of an acquisition premium, there may be inadequate incentive for the purchasing utility to negotiate the best possible sales terms or an approximation thereto, or to even walk away from a bad offer or unfavorable negotiations. (Featherstone Rebuttal, Ex. 702, pp. 39-40).

The Staff would note what might be viewed by the Commission and merging companies as a major unintentioned consequence of a Commission decision that merger premiums should

be directly recovered in the ratemaking process: the presentation for Commission determination of the issue what is the appropriate price at which the target utility should have been acquired, assuming that the acquisition was appropriate from all other perspectives. The Staff and Public Counsel have broached this matter in this proceeding because of UtiliCorp's effort through its proposed regulatory plan to recover directly from ratepayers the merger premium. Including merger premiums directly in rates as UtiliCorp is proposing places on the Commission and its Staff the matter of determining what is the appropriate acquisition price. (Featherstone Rebuttal, Ex. 702, pp. 40).

Staff witness Michael S. Proctor testified that the adoption by the Commission of a policy of treating acquisition premiums as a merger cost and permitting their direct recovery would (1) remove incentives for utilities to minimize the amount of the acquisition premium and (2) would not mirror what occurs for non-regulated businesses. (Proctor Rebuttal, Ex. 713, p. 4). Dr. Proctor related that the acquisition premium of $275 million can be viewed as being comprised of two distinct components:

> The first component is the difference between the market price per share and the price per share representing the book value of EDE's assests. The second component is the differnce between what will be paid by UCU to acquire EDE and the market price per share. Based on an analysis performed by Staff Witness Charles R. Hyneman of the Accounting Department, at the time EDE shareholders accepted the UCU offer, the market price of their common stock was $21.60/share. Using this price to quantify the two components gives:
>
> Component 1: **Market Value – Book Value**
> ($21.60/share-$13.42/share)*(17.1 x $10^6$ shares) = **$140 x $10^6$**
>
> Component 2: **Acquisition Payment – Market Value**
> ($29.50/share-$21.60/share)*(17.1 x $10^6$ shares) = **$135 x $10^6$**

(Proctor Rebuttal, Ex. 713, p. 6-7).

When the assets of a utility are sold, the difference between market value and book value of the shares of common equity should not be treated as a recoverable cost of the merger. If the merger is not detrimental to the public interest, then the earnings potential of the utility being acquired should not decrease due to the merger. Since the market value of the common equity of the company being acquired represents the market's evaluation of the earnings potential of the company being acquired and the earnings potential has not decreased due to the merger, the merger results in the same, if not better, earnings potential for the entity which is acquiring the target company. Thus, if new shareholders could have acquired the stock of the utility, they would have paid the market evaluation of the earning's potential of the stock that is either the same or better than it was prior to the merger. There is no loss of value in the stock to new shareholders that needs to be recovered through a devise that increases earnings, such as adding to rate base the difference between market value and book value. Existing shareholders should not be thought of as having an investment cost equal to a book value that is lower than the market price paid by the acquiring entity. What existing shareholders historically paid for their shares is a sunk cost to the existing shareholders, and is not relevant to current investment decisions or to what is required as an offer price to sell shares to the acquiring company. (Proctor Rebuttal, Ex. 713, pp. 9-11).

When the assets of a utility are sold, the difference between the acquisition payment and the market value of the stock of the acquired utility should not be treated as a recoverable cost of the merger. In order for the EDE - UtiliCorp merger to occur, at least one-half of EDE's current shareholders must have agreed to the sales price offered by UtiliCorp. Thus, the acquisition price represents the offer price that is expected to cause at least one-half of current EDE shareholders to sell based on their overall evaluation of expected earnings, opportunity costs and

required risk premiums. The market value of the acquired utility represents the value placed on future earnings at the margin. The lowest asking price would be slightly above the current market price, and the acquisition price would be at or above the asking price for two-thirds of the current shareholders. The reason that a company seeking to acquire another company is willing to make an offer that is higher than what other companies are willing to offer is that it sees higher earnings potential, has a lower opportunity cost, or has a difference risk preference than the other companies seeking to acquire another company. (Proctor Rebuttal, Ex. 713, pp. 11-12).

Dr. Proctor testified that regulatory policy should be based on a parallel to what would happen in competitive markets and mergers involving nonregulated businesses offer no recovery of acquisition adjustments. (Proctor Rebuttal, Ex. 713, p. 13). In nonregulated businesses, the acquiring company would look at the earnings potential from acquiring the target company and compare that to other opportunities in making a decision respecting how much to offer to acquire the company in question. In nonregulated businesses, the future earnings potential does not includes some recovery of the difference between an acquisition premium and either market value or book value of the common stock, although an increase in earnings potential can be a factor in the price that the acquiring company is willing to offer the shareholders of entity sought to be acquired. Id. at 13.

Dr. Proctor stated that UtiliCorp has an incorrect causal chain:

> UtiliCorp's incorrect causal chain: The acquisition premium causes a certain level of recovery of the synergies from the merger.
>
> Correct causal chain: A certain level of recovery of the synergies from the merger causes a cap on the offer price for the entity which is to be acquired.

(Proctor Rebuttal, Ex. 713, p. 13-14). The effect of UtiliCorp's incorrect causal chain is an increase in the price that companies would be willing to offer to merge with other companies. (Id. at 13).

Dr. Proctor related that a known policy of allowing recovery of an acquisition premium would result in companies bidding higher for utility companies because of the higher expected earnings that would occur because of a regulatory policy of allowing recovery of the acquisition premium. The synergies expected from the merger should place a cap on what any company would be willing to offer, but where recovery of the acquisition premium is guaranteed as a regulatory policy, there is no such cap and it is impossible to determine where the bidding would stop. A regulatory policy of recovery of acquisition premiums would result in mergers occurring that otherwise might not take place. Dr. Proctor stated that "[a]s a general economic principle, whether a merger occurs should be based on the potential economic gain in the market from the merger, and not on a regulatory policy of adding earning incentives to the market through allowing recovery of an acquisition premium." (Proctor Rebuttal, Ex. 713, p. 15). Since the Commission has not previously permitted recovery of an acquisition premium, it would be presumptuous for a company to make an offer based on the assumption of merger. (Id.).

**B. Pooling vs. Purchase**

Business entities are required to comply with Accounting Principles Board Opinion No. 16 (APB 16), entitled *Business Combinations*, as promulgated by the Financial Accounting Standards Board (FASB). Depending on the nature and characteristics of the merger, APB 16 allows for two completely different methods of accounting for business combinations. The two methods are referred to as the purchase method and the pooling of interests method. (Hyneman Rebuttal, Ex. 705, p. 5-6). Purchase accounting rules reflect the substance of the merger as one

company actually purchasing the assets of another company. The pooling of interests rules reflect that the transaction is not a purchase of assets, but a combination of the shareholder interests in the net assets of the combining companies. (Id. at 6). APB 16 requires that the structure and terms of a proposed merger meet 12 specific conditions to qualify for pooling of interests accounting treatment. If the structure or terms of the merger transaction violates or does not meet any of the 12 pooling conditions, the merger is treated as a purchase for accounting purposes. (Id. at 9-10).

Purchase accounting rules for business entities other than utilities require the acquiring company to record the purchase of the acquired company's assets and liabilities at the fair market value (FMV) on the date of combination. Any excess of the purchase price over the fair market value of the individual net assets acquired is recorded as "goodwill." (Hyneman Rebuttal, Ex. 705, p. 3-4). The term "goodwill" is generally not used for regulated utilities. For regulated utilities, the excess of the purchase price over the net book value (NBV) is the "gain on sale" or the "acquisition adjustment"/"acquisition premium." The term "acquisition adjustment" is applied only to regulated utilities. (Id. at 3, 49)

The Staff uses the terms "acquisition adjustment"/"acquisition premium" to represent the difference between the purchase price UtiliCorp agreed to pay for SJLP's assets, less the net book value of those assets. The term "merger premium," as commonly used, can mean either the purchase price in excess of the book value or the purchase price in excess of the market value of the net assets acquired. Unless otherwise indicated, when used by the Staff, the term merger premium means the purchase price in excess of the book value of the net assets acquired. The Staff believes that merger transaction costs should be added to the merger premium to derive the quantification of the acquisition adjustment used for rate purposes. (Hyneman Rebuttal, Ex. 705,

pp. 5, 42). APB 16 and the FERC USOA require that transaction costs be included along with the purchase price to determine the overall cost to acquire plant assets. (Id. at 42).

In a pooling of interests merger, no valuation adjustments are made and no goodwill or acquisition adjustment is recorded. The book values of the two companies are simply brought together to produce a set of combined financial records. The merger transaction is considered to be between the shareholders and not the companies themselves. Pooling of interest accounting rules are designed to reflect the substance of a transaction as a combination of two ownership groups into a single ownership group. The combining stockholder groups neither withdraw nor invest assets but merely exchange common stock in a ratio that determines their respective interests in the combined corporation. (Hyneman Rebuttal, Ex. 705, pp. 6-7).

The distinction between a merger accounted for as a pooling of interests and a merger accounted for as a purchase is that a purchase is not considered as a joining of stockholder groups, but an acquisition of one company by another company. Since the merger is deemed to be a purchase, APB 16 requires the assets acquired to be revalued from current book value to current fair value. Any amount of the purchase price that is not allocated in revaluing the assets is recorded as a separate intangible asset called goodwill. For utility companies, the total amount of the acquisition price (including transaction costs) over the book value (original cost less depreciation and amortization) of the acquired assets is recorded as an acquisition adjustment. Generally, utilities are not permitted to revalue their assets in any type of ownership change, but must use the original cost of the investments as the value of the assets on their books. The acquisition adjustment is used to reflect the difference between the original cost of the assets and the purchase price paid to acquire those assets. (Hyneman Rebuttal, Ex. 705, pp. 6-7).

For many businesses, pooling of interests accounting for a merger is preferable to purchase accounting for a merger. In a merger accounted for as a pooling of interests, there is no creation of goodwill, and for regulated utilities there is no creation of an acquisition adjustment, which, when amortized to expense, causes a reduction in earnings. The avoidance of this reduction in earnings is the primary reason why pooling of interests is considered for many businesses the preferred method of accounting for mergers. (Hyneman Rebuttal, Ex. 705, p. 12).

The pooling of interest accounting method is especially beneficial for regulated utility companies and utility customers. Ratepayers are not benefited under purchase accounting if recovery of an acquisition adjustment is sought in rates because recovery of the acquisition adjustment in rates will lead to higher rates than would be the case under pooling of interests accounting. Rate recognition of an acquisition adjustment will also reduce the portion of any actual merger savings that would be available to reduce the utility's cost of service. (Hyneman Rebuttal, Ex. 705, p. 13).

Thus, for utilities which use purchase accounting for the transaction, the amortization of the acquisition adjustment creates an expense that puts downward pressure on earnings. If significant, the financial effect of the acquisition adjustment may cause a utility to seek additional revenues and/or cost reductions in an amount equal to the required return "on" and the annual amortization "of" the acquisition premium. (Hyneman Rebuttal, Ex. 705, pp. 12-13).

UtiliCorp prior to the instant proceeding has recognized in a filing with this Commission the benefits of the pooling of interests method. In a merger application with KCPL before this Commission, which established Case No. EM-96-248 on June 7, 1996, UtiliCorp identified the ratemaking benefits of the pooling of interests accounting method. One of the benefits touted by

UtiliCorp and KCPL was that since there was no acquisition adjustment, they would not have to seek recovery of an acquisition adjustment in rates. (Hyneman Rebuttal, Ex. 705, pp. 14-15).

In approving the Amended Merger Agreement with KCPL in 1996, the UtiliCorp Board of Directors specifically stated that the availability of the pooling of interests accounting method was one of the factors that led it to approve the merger agreement. The Board specifically noted that the pooling of interests method "avoids the reduction in earnings which would result from the creation and amortization of goodwill under purchase accounting" (Hyneman Rebuttal, Ex 705, pp. 17-18, quoting from KCPL SEC Form S-4A, June 25, 1996).

The use of pooling of interest accounting was so important to the merger that UtiliCorp and KCPL agreed that each was to use all reasonable efforts to allow the accounting for the transactions to be effected as a pooling of interests in accordance with GAAP and applicable SEC regulations and "use all reasonable efforts to achieve such result (including taking such commercially reasonable actions as may be necessary to cure any or circumstances that could prevent such transactions from qualifying for pooling-of-interests accounting treatment)." (Hyneman Rebuttal, Ex. 705, p. 18). Similar language was used in the February 1997, Western Resources – KCPL merger agreement. (Id. at 19).

UtiliCorp witness John W. McKinney makes the assertion at page 15 of his prepared direct testimony (Ex. 4) that regardless of whether or not the merger is recorded as a purchase or a pooling of interests, a merger premium exists when the value of the consideration paid exceeds the book value of the consideration received. Staff witness Hyneman responded that although Mr. McKinney may be theoretically correct that a merger premium could exist in a pooling of interests merger, such a merger premium would not be the type of merger premium that would be a concern in the instant merger case. Mr. Hyneman explained that if UtiliCorp recorded the

merger with EDE as a pooling of interests, there would be no acquisition adjustment, and thus, no acquisition adjustment issue in this case. This is exactly what happened in the 1996 UtiliCorp-KCPL proposed merger discussed above. In that merger application before this Commission, UtiliCorp clearly advised this Commission that because this merger was to be accounted for as a pooling of interests, there is no requirement to seek ratemaking recovery of an acquisition adjustment. (Hyneman Rebuttal, Ex. 705, pp. 19-20).

Moreover, there are instances where electric utilities with retail operations in Missouri, in communications with shareholders and in filings before this Commission, have explicitly stated that no merger acquisition premium exists in a pooling of interests merger transaction:

(1) First Amended Joint Application of KCPL and UtiliCorp, Case No. EM-96-248, p. 10, para. 18.

Prepared direct testimony, p. 8, of Steven W. Cattron, KCPL Vice President of Marketing and Regulatory Affairs in Case No. EM-96-248.

(2) Prepared direct testimony, p. 6, of James F. Purser, of Atmos Energy Corporation, Vice President and Chief Financial Offer in Case No. GM-97-70.

(3) November 13, 1995 UE letter to shareholders respecting proposed pooling of interests merger with CIPSCO.

(Hyneman Rebuttal, Ex. 705, pp. 14-15, 17, 21).

The SJLP – UtiliCorp merger was originally intended to be and was announced as a pooling of interests merger. However, less than two months after the merger was announced as a pooling of interests transaction the method of accounting was changed to a purchase transaction. UtiliCorp witness Jerry D. Myers, adopting the prepared direct testimony of Dan J. Streek in the SJLP – UtiliCorp merger proceeding, testified that the merger had been announced as a pooling of interests transaction prior to a complete analysis of the pooling of interests conditions having been performed. UtiliCorp ultimately determined that its issuance of employee stock options in

November 1998 was an "alteration of equity" under APB 16, paragraph 47, potentially violating one of the conditions for pooling accounting, and thus preventing the SJLP -- UtiliCorp merger from being recorded as a pooling of interests. (Hyneman Rebuttal, Ex. 705, pp. 23-25).

Unlike the SJLP-UtiliCorp merger, the EDE-UtiliCorp merger was not originally intended to be accounted for as a pooling of interests. According to UtiliCorp witness Jerry D Myers, the EDE-UtiliCorp merger does not meet two of the 12 specific conditions to qualify for pooling of interests accounting treatment. (Myers Direct, Ex. 12, p. 3). Mr. Myers' review and assessment as to UtiliCorp's compliance with the 12 pooling conditions is attached as Schedule JDM-2 to his direct testimony. Schedule JDM-2 pages 3 of 8 and 4 of 8 show that Mr. Myers believes that this proposed merger does not meet pooling condition No. 4, "Common Stock for Common Stock" and pooling condition No. 5, "Alteration of Equity Interests."

To account for this merger as a pooling of interest, APB 16, paragraph 47(b) requires that UtiliCorp issue its common stock for at least 90% of EDE's outstanding common stock. This condition is not met because UtiliCorp decided that it will issue a combination of stock and cash to acquire EDE's common stock. This decision by UtiliCorp prevents UtiliCorp from recording the merger as a pooling of interests and, assuming that the transaction is completed, will cause the creation of an estimated $294.3 acquisition adjustment. (Hyneman Rebuttal, Ex. 705, p. 42).

The decision that the consideration paid to acquire EDE would be cash and stock instead of only stock was explained by Mr. Robert Green in a transcribed interview on March 17, 2000. Mr. Green explained that the difference between the SJLP merger (in which UtiliCorp issued only stock) and the EDE merger was based on UtiliCorp's "capital needs at the time." Mr. Green went on to say that EDE is a significantly larger transaction than SJLP, and UtiliCorp "probably

didn't feel the need or have the desire to issue that much equity." (Hyneman Rebuttal, Ex. 705, p. 25).

UtiliCorp could have met the "Common Stock for Common Stock" pooling condition by issuing approximately $190 million in stock instead of cash. This change in financing the acquisition of EDE would not have a negative impact on UtiliCorp's capital structure, and would have allowed UtiliCorp to retain the use of the pooling of interests accounting method. (Hyneman Rebuttal, Ex. 705, p. 26).

APB 16, paragraph 47(c) prohibits a combining company from altering the equity interests of shareholders "in contemplation" of effecting the proposed business combination to be accounted for as a pooling of interests. Under APB accounting interpretations, there is a presumption that any alteration of equity interests of shareholders within two years of initiation of a business combination or between initiation and consummation is in contemplation of effecting the business combination. According to a book published by Arthur Andersen entitled, Accounting For Business Combination, Interpretations of APB Opinion No. 16, Business Combinations, this presumption can be overcome. (Hyneman Rebuttal, Ex. 705, pp. 28-29).

Mr. Myers, the UtiliCorp Director of Corporate Reporting, and Mr. Robert B. Browning, the UtiliCorp Vice President of Human Resources stated in response to a Staff data request submitted in the UtiliCorp/SJLP merger case that "the issuance of options in November 1998 was not done in contemplation of the SJLP merger," and "'there was no relationship between this option issuance and the SJLP merger, which was announced two months later.'" This answer also applies to the EDE-UtiliCorp Merger. No until after the November 1998 stock option issuance was approved by UtiliCorp's Board of Directors did the first discussions of a possible business combination between EDE and UtiliCorp occur. Thus, it would not seem possible for

the stock option issuance to have been done in contemplation of the EDE merger. (Hyneman Rebuttal, Ex. 705, p. 29).

Despite this steadfast position of UtiliCorp that there was no connection between the stock option issuance and the merger with EDE, UtiliCorp did not even attempt to persuade the SEC that its November 1998 issuance of stock options was not done in contemplation of the mergers with SJLP and EDE. UtiliCorp related in response to a Staff data request that rather than consult with the SEC, UtiliCorp relied on the opinion of its independent auditors and interpretations present in published literature. (Hyneman Rebuttal, Ex. 705, pp. 29-30).

There are serious consequences to the loss of the ability to use the pooling of interests accounting method. In this case, the consequences are the imposition of a $294 million acquisition adjustment and a potential $391 million after-tax increase in EDE's cost of service over 10 years. Given these serious negative consequences, the Staff believes that UtiliCorp should have made a serious attempt to retain the ability to use the pooling of interests method by aggressively arguing its case to the SEC that the November 1998 stock option issuance was not done "in contemplation" of the SJLP and EDE mergers. (Hyneman Rebuttal, Ex. 705, p. 30).

Even if UtiliCorp argued its case before the SEC and lost, there was still another way that UtiliCorp could have retained the use of the pooling of interests method. This would have required UtiliCorp to cancel or rescind the November 1998 stock options. The November 1998 stock options could not have been exercised until November 1999, which was at least six months after UtiliCorp concluded that the stock option issuance violated the pooling of interests conditions. However, UtiliCorp chose not to cancel or rescind the November 1998 stock options because, as it advised the Staff in response to a Staff data request, it "did not feel this would have

been in the best interest of employee morale and there were still uncertainties with regard to the eventual consummation of the transaction." (Hyneman Rebuttal, Ex. 705, p. 31).

Mr. Richard Green in a letter to the recipients of the November 1998 stock options explained that the purpose of the Employee Stock Plan is to "'heighten our collective focus on UtiliCorp's stock price.'" (Hyneman Rebuttal, Ex. 705, p. 27). Thus, the benefits of pooling of interests accounting were sacrificed in an effort to raise UtiliCorp's stock price. It is not appropriate for EDE's ratepayers to have to absorb the detrimental aspects of the loss of the pooling of interests accounting, when the reason for the loss was to increase UtiliCorp shareholder value and stock price. (Id. at 27-28).

UtiliCorp witness John McKinney stated that "it is the discretion of the management of UtiliCorp to decide the structure of this transaction and the management of UtiliCorp made that decision." The Staff agrees with Mr. McKinney that it is the discretion of UtiliCorp's management to structure the merger as either a purchase transaction or a pooling of interests transaction. However, if UtiliCorp has the ability to record the merger as a pooling of interests and not record an acquisition adjustment, but chooses to record the merger as a purchase and create an acquisition adjustment that would not exist with a pooling of interests, then management should bear the cost of this decision by the shareholders being held responsible for the recovery of 100 percent of that cost. The use of management discretion which produces no additional benefit but directly causes a significant detriment (a $294.3 million acquisition adjustment) should not be forced upon the ratepayers.

There is another facet to UtiliCorp's choice not to cure the problem purportedly created by the November 1998 issuance of stock options. It is the Staff's view that UtiliCorp's decision not to take action to address the issue whether pooling of interests accounting was available to

UtiliCorp after the November 1998 issuance of stock options actually may have been dictated by UtiliCorp's consideration of whether to dispose of SJLP's and EDE's generating assets after the mergers. APB 16, paragraph 48(c) precludes a company using the pooling of interests accounting method from disposing of a significant part of the assets of the combining utilities within two years after the combination. There is irrefutable indication that UtiliCorp has been considering disposing of some or all of SJLP's and EDE's generating assets after the merger. Mr. Robert Green's February 8, 2000 discussion with financial analysts concerning this matter at the 1999 Year-end Review Conference Call was shown on UtiliCorp's website (www.utilicorp.com). (Hyneman Rebuttal, Ex. 705, p. 37). Mr. Robert Green discusses the potential sale of the SJLP and EDE generation assets as follows:

> But take a look at the mid-continent footprint that we're building on the network side of the business. With the St. Joe and the Empire acquisition, we've brought together some very attractive low-cost generation assets, and we have added some contiguous distribution networks that afford us a significant opportunity for synergies and efficiencies. 75% of those benefits are going to come from the supply side.
>
> And over time, we will look to restructure the supply-side assets and potentially take them out of rate base and provide more of an upside. It might be that the easiest path is to sell some of those assets so we can establish a market value and avoid a stranded cost to base [debate] with the regulator; and then redeploy that capital strategically on the energy grid in other generation assets or other growth investments.

(Id. at 29). Mr. Robert Green further addressed this matter in a March 15, 2000 Conference Call with Salomon Smith Barney (March Conference Call) found on UtiliCorp's Internet website under Investor Information, Presentations. He described how UtiliCorp intends to disaggregate some of SJLP's and EDE's embedded utility businesses and reposition them as nonregulated businesses:

> We've also acquired two distribution assets here in the U.S., St. Joe Power & Light and Empire District. We believe we can significantly enhance the value of

> those assets by disaggregating, breaking apart some embedded businesses, and repositioning them. We've done that in Australia. Since 1995, our IRR in terms of that investment is over 30% and what we've done is break out the retail energy business and we will joint venture that with Shell at a value significantly above what we paid for it.

(Id. at 77).

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_____** (Hyneman Rebuttal, Ex. 705 HC, p. 60).

UtiliCorp's clearly stated intention to disaggregate and reposition its newly acquired generation assets from SJLP and EDE would have to be delayed for at least two years after merger closing. This restriction on UtiliCorp's business operations imposed by APB 16 may very well have been the reason UtiliCorp decided to abandon, or not to try to retain the use of the pooling of interests accounting method to record the SJLP and EDE mergers.

Since UtiliCorp is seeking to recover in EDE's utility rates the merger premium that it is paying for EDE, consistency would require that UtiliCorp also propose above-the-line treatment of any gains on the sale of the EDE Missouri jurisdictional assets. The acquisition premium paid by the acquiring utility is the gain on sale realized by the selling utility. If it is appropriate for UtiliCorp to charge the cost of the acquisition adjustment to EDE's ratepayers, then it is appropriate for UtiliCorp to credit EDE's ratepayers with the gains on the sale of these assets, should UtiliCorp dispose of these assets. (Hyneman Rebuttal, Ex. 705, pp. 56-57).

UtiliCorp's merger with EDE also is beneficial to certain of UtiliCorp's nonregulated affiliates. Additional benefits to UtiliCorp include outsourcing of EDE construction and



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maintenance work to UtiliCorp's nonregulated Quanta Resources, Inc. (Quanta) affiliate; acquisition of EDE's rights of way and fiber optic cable network to support UtiliCorp's own investment in nonregulated telecommunications operations (telecom); and direct access to EDE's electric customers to sell the home energy appliance and service agreement services (under the EDE brand name) offered by UtiliCorp's nonregulated ServiceOne affiliate. (Hyneman Rebuttal, Ex. 705, p. 57; See Id. at 76-90).

### C. Other Jurisdictions

#### 1. State Jurisdictions

In this section of the initial brief the Staff will address the authorities UCU and EDE rely upon as supporting the recovery of the acquisition premium proposed in their regulatory plan. The Staff will then present an overview of how other jurisdictions have treated the recovery of acquisition premiums in recent decisions.[10] In their Joint Application (hereafter "JA") filed in this case, UtiliCorp and EDE seek Commission approval of both a merger agreement and a regulatory plan. (JA, pp. 3-11, ¶¶ 4-17). As proposed by UtiliCorp and EDE, EDE shareholders will receive $29.50 worth of UtiliCorp stock after the closing of the merger (subject to a "collar" premium), regardless of the book value of EDE stock. (JA, Appendix 4, p. 3, §2.02(a)(i); JA, pp. 3-4 ¶ 4). Since $29.50 is greater than the book value of EDE stock, UtiliCorp is offering a premium ("acquisition premium" or "merger premium") for EDE's stock. (JA, p. 7 ¶ 15; John McKinney Direct, Ex. 4, pp. 15, 5). The regulatory plan as proposed provides that UtiliCorp is to receive from ratepayers both recovery of and return on this acquisition premium. (JA, pp. 9-10 ¶ 15; John McKinney Direct, Ex. 4, p. 7).

[10] While the Staff has attempted to provide subsequent history for the cases it has cited, due to some of these cases having been recently decided and the difficulty in locating lower court opinions on review, there may have been lower court actions of which the staff is not aware.

A part of the proposed regulatory plan is a five-year rate moratorium. (JA, pp. 7-9 ¶ 15; John McKinney Direct, Ex. 4, p. 6). During that five-year period merger synergies are to be applied against the acquisition premium (including as premium all costs related to the merger, i.e., transaction costs as well as transition costs). (John McKinney Direct, Ex. No. 4, p. 7; JA, p. 9, ¶ 15). At the end of the five-year period EDE is to file a rate case where it will seek inclusion of fifty percent (50%) of the unamortized (remaining) acquisition premium in rate base and that annual amortization of the acquisition premium be included in expenses allowed for recovery in cost of service. (JA, 9-10 ¶15; John McKinney Direct, Ex. 4, p. 7).

In support of their proposed treatment of the acquisition premium as part of their proposed regulatory plan, UCU and EDE have cited to this Commission's cases of Re Kansas Power & Light Co., Case No. EM-91-213, Report And Order, 1 Mo.P.S.C. 3d 150, 156-57 (1991); Re Missouri-American Water Co., Case Nos. WR-95-205 and SR-95-206, Report And Order, 4 Mo.P.S.C.3d 205 (1995); Re Union Electric Co., Case No. FM-96-149, Report And Order, 6 Mo.P.S.C.3d 28 (1996); and Re Western Resources Inc., Case No. EM-97-515, Report And Order (1999). These and related cases are discussed in the Overall Regulatory Plan section of this initial brief.

In an effort to bolster recovery of the acquisition premium as proposed in the regulatory plan, Mr. John W. McKinney, Vice President–Regulatory Services of UCU, has presented as figure 2 in his direct testimony a summary of jurisdictions that he asserts have allowed the recovery of at least some acquisition premiums. (John McKinney Direct, Ex. 4, p. 23). The legend in the lower left corner of that figure states: "NAWC Sourcebook Updated 6/23/97." As Staff Witness Janis E. Fischer, Regulatory Auditor for the Missouri Public Service Commission, has noted, Mr. John McKinney's Figure 2 correlates with a figure found in a publication titled:

Sourcebook of Regulatory Techniques for Water Utilities, compiled by Ms. Janice A. Beecher, Ph.D., Indiana University, as an update for the Rates and Revenue Committee of the National Association of Water Companies (hereafter "NAWC Sourcebook"). (Fischer Rebuttal, Ex. 703, pp. 72-73 and Sch. 5). In the introduction of the NAWC Sourcebook Ms. Beecher states that the sourcebook is informational in nature and that it is based extensively upon a 1996 survey of commission staff members. Ms. Beecher states that the survey was broad in scope but not highly detailed and that commission staff provided a very general impression of regulatory policy. Ms. Beecher also states "the results should not be taken as a definitive statement of commission policy." (Fischer Rebuttal, Ex. 703, p. 74). As Ms. Fischer notes, the NAWC Sourcebook, including the figure she found, provides more detail than Figure 2 presented by Mr. McKinney. (Fischer Rebuttal, Ex. 703, p. 74 and Schs. 8 and 9). Further, the sourcebook information is limited to water and sewer utility cases. Mr. McKinney made no response in his surrebuttal testimony (Ex. 5) contesting or refuting Ms. Fischer's assertions that Figure 2 of his direct testimony (Ex. 4, p. 23) is simply taken from the NAWC Sourcebook figure attached to Ms. Fischer's rebuttal testimony (Ex. 703) as Schedule 8, and that it is limited to the acquisition premium treatment afforded to water and sewer utilities.

The information in Figure 2 presented by Mr. John McKinney does not appear to be particularly relevant to consideration of electric utility merger transactions. As noted by Ms. Fischer, because of problems typically found with small water and/or sewer utilities—problems such as inadequate finances or succession plans for small-investor or individually-owned companies—some jurisdictions have allowed acquisition adjustments related to these transactions in an effort to make takeovers of troubled water and/or sewer utilities more attractive. (Fischer Rebuttal, Ex. 703, p. 74). As an example, expression of this philosophy is

found in the Florida Public Service Commission case of Re Bayside Utilities, Inc., Case No. PSC-99-1818-PAA-WS, Docket No. 981403-WS (Florida Public Service Commission, September 20, 1999). There, the Florida Commission, in declining to impose an unsought negative acquisition adjustment that it considered as a necessary corollary to its practice of allowing positive acquisition adjustments (acquisition premiums) in appropriate circumstances, stated the following:

> In the absence of extraordinary circumstances, it is the practice of this Commission that the purchase of a utility at a premium or discount shall not affect the rate base calculation. . . . .
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> * * * *
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> . . . . By Order No. 25729, issued February 17, 1992, we acknowledged that the ability of the buyer to earn a return on an acquired utility's rate base provides an incentive for larger utilities to look for and acquire smaller, troubled systems.

Re Bayside Utilities, Inc. at 4. Unlike a number of water and sewer utilities with which this Commission has become all too familiar, EDE is not a troubled utility; therefore, the Commission should not rely upon Figure 2 of UtiliCorp witness John McKinney's direct testimony as a basis to support accepting UCU's and EDE proposal for recovery of the acquisition premium at issue in this case.

In his direct testimony, Mr. John McKinney states, "Two decisions are very informative and have direct bearing on this case." (John McKinney Direct, Ex. 4, p. 22). One of these "decisions" is a policy change by the Massachusetts Department of Telecommunications and Energy (DTE), formerly the Department of Public Utilities (DPU), as expressed in Re establishing guidelines and standards for acquisitions and mergers of utilities, Case No. 93-167-

A (Mass DPU August 3, 1994) (hereafter "Mergers & Acquisitions").[11] The other decision is Re Oklahoma Gas and Electric Company, 150 PUR4th 33 (Oklahoma Corporation Commission, February 25, 1994). Despite his statements that these decisions are "very informative" and "have direct bearing on this case," Mr. John McKinney's elucidation regarding the foregoing Massachusetts' "decision" is simply a statement that "[a]fter 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." (John McKinney Direct, Ex. 4, p. 23). His discussion of Re Oklahoma Gas and Electric Company is not quite so terse. With respect to that case he states the Oklahoma Corporation Commission established the following four merger criteria:

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; [and]
4. The transaction must be conducted at arm's length.

(John McKinney Direct, Ex. 4, p. 24). He then concludes that the instant transaction meets these above criteria. Mr. John McKinney has slightly misstated the first criteria. That criteria is whether the transaction in question is in the public interest. Re Oklahoma Gas and Electric Company, 150 PUR4th at 65.

In his direct testimony Mr. John McKinney states that Mr. Green, in his testimony, describes the generic guidelines and standards for acquisitions and mergers of utilities set out by the DPU in his testimony. (John McKinney Direct, Ex. 4, p. 23, l. 3-5). Mr. Green relates in his testimony as follows:

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[11] The full text of the order may be viewed at the website address following: <http://www.state.ma.us/dpu/electric/93-167-a/93-167-a.htm>.

. . . . After years of denying the cost of acquisition premiums, in 1994 the Massachusetts Department of Telecommunications and Energy changed its long-standing policy and now will allow recovery of the premium on a case-by-case basis when denying recovery of that premium would prevent consummation of a merger that would otherwise be in the public interest.

(Green Direct, Ex. 14, p. 19).

Mergers & Acquisitions, where the DPU/DTE made a fundamental shift in approach to treatment of acquisition premiums, was a generic case initiated by the DPU on its own motion on September 22, 1993. Over twenty parties participated in the case. The DPU issued its decision on August 3, 1994. Prior to this decision, merger proposals that envisioned earning an acquisition premium were regarded by the DPU as *per se* impermissible. (Mergers & Acquisitions, Subpart II A. ¶ 2). In the background section of the decision the DPU illuminated the forces driving it to re-examine its approach to acquisition premiums as follows:

> In the instant proceeding, in light of concerns over high utility rates which in part may be the result of duplicative facilities, functions, and services among Massachusetts utilities, the Department has sought to reexamine its current policy towards mergers or acquisitions and determine whether the public interest may better be served by specific policy changes that enhance efficient delivery of utility services in Massachusetts. We note that the issues raised by the Department in this proceeding are an important part of a multitude of issues the Department must consider to achieve its ultimate regulatory goal, which is to ensure that the utilities subject to the Department's jurisdiction provide safe and reliable service at the lowest possible cost to society. As we indicate below, the Department believes that cost-effective mergers are one of several means by which utilities may be able to reduce their cost of service, improve service reliability, and enhance their financial strength.
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> * * * *
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> In the sections that follow, the Department will articulate its policy regarding mergers or acquisitions. In reaching its overall policy, the Department will address specifically (1) the standard of review by which it will evaluate a proposed merger or acquisition, (2) the determination and recoverability of acquisition premiums, and (3) other issues related to mergers or acquisitions.

(Mergers & Acquisitions, Subpart II B ¶ 2). Massachusetts is a high-cost state for electricity, having residential rates of approximately 12 cents per kilowatt-hour (Fischer Rebuttal, Ex. 703, p. 75[12]). As stated by the Florida Public Service Commission at its website, this high residential electricity cost appears to be a primary force causing Massachusetts, and other states, to experiment with alternatives to traditional methods of regulating public utilities. (Fischer Rebuttal, Ex. 703, p. 75-76[13]). In contrast, Missouri is a substantially lower cost state with residential electric rates that average about 7.5 cents per kilowatt-hour. (Williams Rebuttal, Ex. 717, Sch. 4).

Staff witness Janis Fischer, in her rebuttal testimony, has extensively discussed both the DPU/DTE's guidelines and cases in which they have been applied. (Fischer Rebuttal, Ex. 703, p. 77-85). The main statutory standard in Massachusetts regarding mergers and acquisitions is that the transaction be "consistent with the public interest." (Mergers & Acquisitions, Subpart II A. ¶ 1). This equates to a "no net harm" standard. Re Eastern Enterprises, DPU/DTE Case No. 98-27, 188 PUR4th 225, 231 (Massachusetts DTE, September 17, 1998) (hereafter "Eastern-Essex Acquisition") (clarified by the DTE regarding cost allocation issues in DTE Case No. 98-27–A, September 25, 1998). In Mergers & Acquisitions, the DPU made a non-exclusive list of factors to consider in determining, on a case-by-case basis, whether a proposed merger or acquisition should be approved. That non-exclusive list included the following:

(1) effect on rates
(2) effect on the quality of service
(3) resulting net savings

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[12] Ms. Fischer's testimony references States' Electric Restructuring Activities Update, Ch. 4 Retail Competition, Subpart: What is Happening in Other States, from the Florida Public Service Commission's website. The text may be viewed at the following website address: <http://www2.scri.net/psc/general/publications/restructoc.html>.

[13] Ms. Fischer's testimony references States' Electric Restructuring Activities Update, Ch. 4 Retail Competition, Subpart: What is Happening in Other States, from the Florida Public Service Commission's website. The text may be viewed at the following website address: <http://www2.scri.net/psc/general/publications/restructoc.html>.

(4) effect on competition
(5) financial integrity of the post-merger entity
(6) fairness of the distribution of resulting benefits between shareholders and ratepayers
(7) societal costs, such as job loss
(8) effect on economic development, and
(9) alternatives to the merger or acquisition

(Mergers & Acquisitions, Subpart II B; Fischer Rebuttal, Ex. 703, p. 80).

The following language from Mergers & Acquisitions is enlightening on how the DTE reviews acquisition premiums in merger and acquisition cases:

> On the other hand, the Department will not automatically allow recovery of all premiums associated with each and every merger. Rather, we are requiring parties to demonstrate that the recovery of acquisition premiums is allowable as part of the general reckoning of cost and benefit under the G.L. c. 164, § 96 consistency standard. Adoption of a presumptive rule in favor of acquisition premiums might mislead shareholders to expect guaranteed recovery of merger-related costs, regardless of the existence of countervailing advantages. Moreover, a blanket policy favoring recovery of acquisition premiums might have the unintended consequence of preventing market forces from acting as a restraint against what may otherwise be considered unwarranted premium levels. Therefore, based on the foregoing, the Department finds that in the future it will on a case-by-case basis consider individual merger or acquisition proposals that seek recovery of an acquisition premium. Additionally, the Department will consider the appropriate level of a recoverable acquisition premium on a case-by-case basis.

(Mergers & Acquisitions, Subpart III C ¶ 3; Fischer Rebuttal, Ex. 703, p. 81).

These guidelines have been applied by the DTE in at least four recent merger cases. These cases are Eastern-Essex Acquisition cited above, Joint Petition of Bay State Gas Company, Northern Indiana Public Service Company and NIPSCO Acquisition Company for approval by the Department of Telecommunications and Energy pursuant to G.L. c. 164, § 96, of the merger of Bay State Gas Company and NIPSCO Industries, Inc., Case No. DTE 98-31

(Massachusetts DTE, November 4, 1998)[14] (hereafter "NIPSCO-Bay State Acquisition"); Joint Petition of Eastern Enterprises and Colonial Gas Company for approval by the Department of Telecommunications and Energy pursuant to G.L. c. 164, § 96, of the merger between these two companies. Eastern Enterprises and Colonial Gas Company also seek the Department's approval of a Rate Plan for Colonial Gas Company, pursuant to G.L. c. 164, § 94, Case No. DTE 98-128 (Massachusetts DTE, July 15, 1999)[15] (hereafter "Eastern-Colonial Acquisition"); and Joint Petition of Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and Commonwealth Gas Company for approval by the Department of Telecommunications and Energy pursuant to G.L. c. 164, § 94 of a Rate Plan, Case No. DTE 99-19 (Massachusetts DTE, July 27, 1999) (appeal to Massachusetts Supreme Court pending)[16] (hereafter "BEC-CES Acquisition"). The Massachusetts Attorney General and a group of large volume customers have appealed challenging whether the rate plan is in the public interest and the reliance of the DTE upon merger savings estimates in approving the merger. (Fischer Rebuttal, Ex. 703, p. 84).

In Eastern-Essex Acquisition, the applicants proposed a rate plan consisting of a ten-year base-rate freeze and a five percent (5%) reduction in the burner-tip price of gas for Essex customers. Id. at 230; (Fischer Rebuttal, Ex. 703, p. 82). The applicants also sought for Eastern shareholders the opportunity to retain $4.6 million per year for the ten-year life of the rate plan to compensate them for the earnings dilution those shareholders would suffer from the pooling of interests transaction. Id. at 250. The DTE accepted the applicants' argument that, although the

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[14] The text of the decision may be found at the website address following: <http://www.magnet.state.ma.us/dpu/gas/98-31/98-31.htm>.

[15] The text of the decision may be found at the website address following: <http://www.magnet.state.ma.us/dpu/gas/98-128/98-128.htm>.

[16] The text of this decision may be found at the website address following: <http://www.magnet.state.ma.us/dpu/electric/99-19/order.htm>.

proposed transaction was a pooling of interests transaction, because there was an estimated earnings dilution to Eastern Enterprises shareholders of $47.1 million, this earnings dilution should be treated as an "acquisition premium" for purposes of evaluation by the DTE The DTE considered the factors set out in the guidelines and applied a "no net harm" standard of review. (Fischer Rebuttal, Ex. 703, p. 82).

In NIPSCO-Bay State Acquisition, the applicants proposed a five-year base rate freeze for Bay State customers and modification of Bay State's earnings-sharing mechanism. The applicants asserted that the transaction, which was accounted as a purchase transaction, resulted in an acquisition premium of $310 million. (Fischer Rebuttal, Ex. 703, p. 83). The earnings sharing mechanism (hereafter "ESM") proposed by the applicants set a band for return on equity (hereafter "ROE") of 7.4 percent to 15.4 percent. If the ROE calculated under the ESM exceeded 15.4 percent, then the ratepayers would receive 25 percent of the earnings attributable to the difference between the calculated ROE and 15.4 percent. If the ROE calculated under the ESM was less than 7.4 percent, then Bay State would recover from ratepayers the amount to required make up 25 percent of the earnings difference attributable to the calculated ROE and 7.4 percent. The applicants sought to include annual amortization of the acquisition premium in the calculation of ROE for purposes of the ESM. The DTE observed that allowing an automatic increase in rates if ROE fell below 7.4 percent created a risk of a rate increase before the end of the five-year rate freeze and that because the applicants proposed to subtract the annual amortization of the acquisition premium from earnings in calculating return on equity for purposes of earnings sharing, it was unlikely the calculated ROE would exceed 15.4 percent. The DTE declined to approve the sharing plan for potentially eliminating the benefit of the rate freeze and adding further protection of the applicants from their own endogenous actions.

However, the DTE approved the rate freeze and affirmed that the merged company could seek recovery of the acquisition premium in future rate cases. (Fischer Rebuttal, Ex. 703, p. 83). The DTE emphasized that NIPSCO and Bay State had represented that Bay State's ratepayers were not at risk for recovery of any of the acquisition premium during the five-year period of the rate freeze and that the DTE would hold them to this representation. In its decision, the DTE stated that due to decades of little or no acquisition or merger activity, investor-owned energy utilities were highly "Balkanized" and that such geographic fragmentation suggested inefficiencies both in avoidable overhead and ability to take market actions beneficial to customers, particularly market actions related to gas purchasing, corporate financing and staffing.

In Eastern-Colonial Acquisition, Eastern sought to acquire Colonial, a local distribution gas company. The acquisition was to be booked as a purchase transaction. The applicants proposed a ten-year base rate freeze and a 2.2 percent reduction in burner-tip gas price to Colonial customers. They also proposed to recover the acquisition premium and return on the acquiring company's cash investment over 40 years. The DTE determined the proposal included a $199.2 million acquisition premium. The amount of the premium to be recovered remaining at the end of the ten-year base rate freeze was to be determined based on the savings realized during the ten-year base rate freeze. The DTE approved the recovery of the acquisition premium over 40 years noting that the applicants had represented that ratepayers would not bear any risk that operational and synergy savings would be insufficient to cover the annual amortization of the acquisition premium. In response to the Attorney General's criticism that the DTE's policy on acquisition premiums had "propelled mergers" the DTE stated that while in and of themselves acquisition premiums could represent a cost to ratepayers, the DTE's basis for allowing premiums was that transactions otherwise in the public interest might not occur absent allowance

of the acquisition premium and that for such transactions the benefits captured often warranted the costs of the acquisition premiums.

In BEC-CES Acquisition, two holding companies owning energy utilities sought to merge. The transaction was to be treated as a purchase transaction. The DTE approved the applicants' rate plan to freeze distribution rates for four years and to amortize the acquisition premium of approximately $500 million over forty years. (Fischer Rebuttal, Ex. 703, p. 83). Recovery of the acquisition premium was permitted and after the end of the four years, for subsequent ratemaking, merger savings net of merger costs would be taken into account. (Fischer Rebuttal, Ex. 703, p. 83). Other than an extensive discussion regarding the novelty of the transaction from a standard of review standpoint, the DTE included in this decision essentially no discussion of the forces that led it to recognize recovery of the acquisition premium. As noted above, the Massachusetts Attorney General and a group of large volume customers have appealed this case to the Massachusetts Supreme Court challenging whether the rate plan is in the public interest and the reliance of the DTE upon merger savings estimates in approving the merger. (Fischer Rebuttal, Ex. 703, p. 84).

As the foregoing shows, in a generic case established by the DPU due to high-energy rates and forces driving competition in the energy utility industry in Massachusetts, the DPU/DTE changed course from an approach of never allowing recovery of acquisition premiums to now approving the opportunity to recover acquisition premiums. While the DTE stated that the applicants would have the opportunity to seek recovery of unrecovered acquisition premiums in future rate cases, in none of these merger authorization cases did the DPU/DTE actually make a ratemaking decision regarding recovery of the acquisition premium in rates. UCU and SJLP seek such a guarantee from this Commission. (Tr. 579-80). Further, unlike the DPU/DTE, this

Commission previously has not *per se* barred recovery of acquisition premiums. Also unlike the situation in Massachusetts, this Commission has never held a generic case, where all interested parties would have an opportunity to provide meaningful input, for the purpose of establishing guidelines for the allowance of the recovery of acquisition premiums. (The Staff wants to be very clear that it is not suggesting that this Commission create a generic case for such a purpose.) As indicated above, energy rates in Missouri are generally lower than those of other geographic areas and, certainly, current rate levels for SJLP customers provide no basis for allowing recovery of any part of the acquisition premium as an inducement for this merger to close.

Mr. John McKinney refers in his direct testimony, Exhibit 4, at pages 23-24, to the Oklahoma Corporation Commission (OCC) and an Oklahoma Gas and Electric Company (OG&E) acquisition case where the OCC adopted four criteria for allowing acquisition adjustments. Although Re Oklahoma Gas and Electric Company, Cause Nos. PUD 900000898, PUD 910001055, PUD 900001005, Order No. 380443, 150 PUR4th 33 (OCC 1994) addresses the criteria applied by the OCC for allowing recovery of acquisition adjustments, it is not a merger case where the OCC approved the recovery of an acquisition premium. The OCC Order arose from multiple OCC Staff filings challenging, among other things, the reasonableness of transportation and other charges paid by OG&E to its wholly owned subsidiary Enogex, Inc. (Enogex), and OG&E then passed on these charges OG&E's customers through OG&E's fuel adjustment clause. In September 1986 OG&E acquired what later became Enogex. The assets of this unregulated, acquired company included an intrastate pipeline system and gas processing plant, which serviced the natural gas gathering and transmission needs of the gas-fired electric generating facilities of OG&E. OG&E accounted for the transaction as a purchase using the fair market value of the assets. (Id. at 65).

OG&E/Enogex took the position that for ratemaking purposes, the OCC should consider the total purchase price paid for Enogex's predecessor as the value of the purchased assets, i.e., that the purchased price paid was equal to the fair value of the pipeline. The premium above book was treated as a rate base cost for Enogex. A portion of the premium costs was recovered by Enogex through rates charged OG&E, and OG&E passed along the costs to ratepayers through its fuel adjustment clause. 150 PUR4th at 65.

The OCC Staff asserted that the transaction whereby OG&E acquired the assets of the unregulated, acquired company failed the standard test for rate base treatment of an acquisition premium. The Staff analysis concentrated on whether the acquisition premium constituted the least cost method of ensuring delivery of an adequate quantity of electricity, on a reliable basis, to OG&E's customers at reasonable prices. 150 PUR4th at 65. The OCC determined that a portion of the acquisition premium would be permitted to be passed along to OG&E ratepayers. The OCC stated in part as follows:

> . . . The Commission further finds that the transaction was in the public interest, the price paid was reasonable, the benefits to ratepayers were equal to or greater than the premium level which the Commission allows for rate treatment, and the transaction was conducted at arm's-length. Furthermore, the acquisition is deemed to have been the least cost alternative available to OG&E. These factors were analyzed when the purchase occurred. [Citation omitted.]
>
> The parties concur that the acquisition premium amounts to a purchase price of $133,056,188 above the depreciated book value of the Mustang transportation pipeline and natural gas processing facilities.
>
> However, this amount will not be passed along to the ratepayers in its entirety. Allocation of the acquisition premium is necessary to reflect the share of the acquisition premium which fairly can be recovered from ratepayers. . . . [T]his allocation is shown from the record to be determined by two factors: (1) statistical and financial analysis regarding the split between the transportation and processing segments, and (2) policy considerations involving the choice to pass a portion of the benefits and burdens of the transportation segment along to the ratepayers.

(150 PUR4th at 67.)

Staff witness Janis Fischer testified that the EDE – UtiliCorp merger does not meet the criteria applied by the OCC for recovery of acquisition premiums. She noted that in particular the Staff has concluded that the total merger savings will not exceed the merger premium in the case of the instant proposed merger. (Fischer Rebuttal, Ex. 703, p. 87).

After an extensive survey of approaches taken in other jurisdictions, the Staff has found that state regulatory bodies have taken a number of different approaches to acquisition adjustments. Based on the Staff's review, the status of deregulation of the electric industry in the state can be a major factor in how and when the particular state regulatory body treats recovery of acquisition premium. (Fischer Rebuttal, Ex. 703, p. 87).

Often the issue of acquisition adjustment is not reached because the merging utilities do not seek recovery of an acquisition premium. (Fischer Rebuttal, Ex. 703, p. 87). In some cases where recovery of the acquisition premium is sought, the regulatory bodies outright decline to allow recovery of acquisition premiums. In other cases, the regulatory bodies decline to address recovery of the acquisition premium in the merger case and defer the matter to a subsequent rate case. Another approach the Staff found is for the regulatory body to decline to allow recovery of any part of the acquisition premium until savings are demonstrated. (Id.).

The Staff found the following recent cases where the applicants did not seek direct recovery of any acquisition premium: Re SCANA Corporation, Docket Nos. G-5, Sub 400 and G-43, 198 PUR4th 158 (North Carolina Utilities Commission, December 7, 1999) (Pre-filed testimony commitment to exclude acquisition premium and merger costs from acquired company's accounts for ratemaking purposes) (This case is discussed extensively by Staff witness Hyneman in his rebuttal testimony as being similar to the instant case in many important

respects (Ex. 707, pp. 73-75); Central Illinois Light Company, Docket No. 98-0882, (Illinois Commerce Commission, March 10, 1999)[17] (The applicants asserted there would be no merger savings; the Illinois Commission, required by statute to address the issues, ordered that any premium be recorded below-the-line on the holding company's books and that any merger savings could be considered for possible recovery in future rate cases); In the matter of: Joint Application of PowerGen plc, LG&E Energy Corp., Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of a Merger, Case No. 2000-095 (Kentucky Public Service Commission, May 15, 2000)[18] (The applicants asserted that acquired companies would not be required to record any part of the merger premium of 58% over market value on their books and the Kentucky Commission ordered as conditions of merger approval that all transaction-related costs, including the cost of purchase and premium paid be excluded for ratemaking purposes and from the rates of the acquired companies, and that in the future the companies not seek a return on equity higher than they would have absent the merger).

The Staff found the following cases where the parties reached a settlement in which the utility companies forewent recovery of acquisition premium: Re PacifiCorp, Docket No. 20000-EA-98-141, — PUR4th —, (Wyoming Public Service Commission, November 17, 1999) (The parties stipulated no acquisition premium would be included in rate base and the Wyoming Commission ordered that at least $4 million in savings would be allocated to Wyoming ratepayers for ratemaking purposes, regardless of whether actually achieved. Although invited several times to engage in ratemaking in the merger case, the Commission declined stating such issues should be taken up in a rate case.); Re Enron Corp., UM 814, Order No. 97-196, 177

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[17] The text of this decision may be found at the website address following: <http://www.icc.state.il.us/icc/doclib/sel/0310_ord980882.doc>.

[18] The text of this decision may be found at the website address following: <http://www.psc.state.ky.us/agencies/psc/orders/052000/2000095_15.pdf>.

PUR4th 587 (Oregon Public Utility Commission, June 4, 1997) (The parties agreed that Oregon ratepayers would bear no merger costs, would be held harmless from any effects of the merger and guaranteed that Oregon ratepayers would receive merger benefits totaling $141 million. The merger benefits were implemented by a $105 million refund/credit and a $9 million decrease in cost of service for each of four years).

In Re Atlantic City Electric Company, BPU Docket No. EM97020103, OAL Docket No. PUC4935-97, 183 PUR4th 22 (New Jersey Board of Public Utilities, January 7, 1998) (followed in Re Orange and Rockland Utilities, Inc., Docket No. EM98070433, 193 PUR4th 448 (New Jersey Board of Public Utilities, April 1, 1999), the New Jersey Board, in a contested case, rejected the applicants' proposal to offset the acquisition premium against merger savings to be shared and ordered that ratepayers receive merger savings over a ten-year period through two rate reductions. The New Jersey Board also rejected allowing executive severance packages and name change costs as offsets to merger savings. No other merger costs were discussed in the decision.

The Staff found the following cases where the regulatory body did not address in the merger case the issue of acquisition premium, instead deferring it to a future rate case: Re Northern Utilities, Inc., Docket No. 98-216, 187 PUR4th 71 (Maine Public Utilities Commission June 12, 1998) (The Maine Commission approved a stipulation where the parties agreed the applicants would be allowed in future cases to request the amortization of the acquisition premium in rates and that the Maine Commission permit such recovery to the extent the applicants could demonstrate benefits to ratepayers of the merger equal or exceed the premium sought to be amortized.); Joint Application of Energy East Corporation and Connecticut Energy Corporation for Approval of a Change of Control, Docket Number 99-07-20 (Connecticut

Department of Public Utility Control, December 16, 1999)[19] (The applicants did not seek inclusion of the amortization of acquisition premium for ratemaking purposes and asserted the merger would have no direct impact on rates. Instead the applicants proposed that the amount of the amortization and remaining unamortized balance of acquisition premium be considered when the Connecticut Department determined in the future whether actual earnings are subject to the proposed earnings sharing mechanism. The Department declined to address the earnings sharing mechanism in the merger case and stated it would consider the issue of acquisition premium in a rate proceeding, declining in the merger case to obligate ratepayers to fund any portion of the acquisition costs or allow any portion of the acquisition premium to be considered in setting rates.)

In Application of Wisconsin Energy Corporation for Approval to Acquire the Stock of WICOR, Inc., Docket Nos. 9401-YO-100 and 9402-YO-101 (Wisconsin Public Service Commission, March 15, 2000)[20] the Wisconsin Commission found that the applicants had failed to substantiate sufficient system or economic benefits to obtain direct recovery of the acquisition premium as the applicants requested. The Wisconsin Commission allowed, for financial purposes, 60%, about $478 million, of the premium to be recorded on the books of the acquired company and stated the applicants would have the opportunity to indirectly recover the acquisition premium during the five-year rate restriction period (rate-freeze period) and, at the end of that five years, make a showing to attempt to retain more merger synergy savings. The

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[19] The text of this decision may be found at the website address following: <http://www.dpuc.state.ct.us/FINALDEC.NSF/0d1e102026cb64d98525644800691cfe/0fe51200d5ab9cf78525684a004dc132?OpenDocument&Highlight=0,99-07-20>.

[20] The text of this decision may be found at the website address following: ; <http://www.psc.state.wi.us/orders/download/2000/9401100.doc>.

Wisconsin Commission stated it would not authorize recovery of the transaction costs and that it would not authorize that the unrecovered acquisition premium be treated as stranded costs.

**2. Federal Energy Regulatory Commission (FERC)**

The Staff would note the FERC policy respecting acquisition premiums. In an Order Establishing Further Proceedings issued on July 26, 2000 in Sierra Pacific Power Co., Nevada Power Co. and Portland General Electric Co., 92 FERC Para. 61,069, Docket No. EC00-63-000, the FERC stated that "the [Nevada Public Utilities Commission (Nevada Commission)] will continue to have jurisdiction over retail rates in Nevada and can therefore address its concerns regarding the appropriate recovery of any acquisition premium through retail rates." The FERC, referring to itself as the "Commission," further stated as follows:

> The Nevada Commission, in its request for the Commission to examine the proposed merger's effect on the retail market in Nevada, seeks clarification that it retains authority to set retail rates, and possibly disallow costs, including the acquisition premium, at the state level. [Footnote omitted.] We note that the Transaction would not appear to limit the Nevada Commission's authority to set retail rates. As explained by Applicants, the Nevada Commission would continue to have jurisdiction over retail rates and the ability to address any attempt by Sierra or Nevada Power to recover the acquisition premium in a rate subject to the Nevada Commission's jurisdiction. [Footnote omitted.]

In FERC Order No. 2000, the FERC's Final Rule on Regional Transmission Organizations, issued December 20, 1999 in Docket No. RM99-2-000, FERC Statutes and Regulations, Para. 31,089 at 31,195, the FERC declined to follow the suggestion of a number of commenters that the FERC adopt new policies for acquisition adjustments that would provide assurances to purchasers of transmission facilities that acquisition premiums would be recoverable through transmission rates. In footnote 661, the FERC commented 'See Minnesota Power & Light Company and Northern States Power Company, 43 FERC Para. 61,104 at 61,342 (1988), for a discussion of the Commission's existing policies with respect to the ratemaking

treatment for acquisition premiums. See also Duke Energy Moss Landing LLC, et al., 83 FERC Para. 61,318 (1998)."

Minnesota Power & Light Co. and Northern States Power Co., 43 FERC Para. 61,104 at 61,342-43, reh'g denied, 43 FERC Para. 61,502, reconsideration denied, 44 FERC Para. 61,302 (1988) was, in essence, a request for a declaratory judgment respecting an acquisition adjustment. Minnesota Power & Light Co. (Minnesota Power) and Northern States Power Co. (Northern States), among other things, sought authorization for Northern States to merge and consolidate certain facilities proposed to be sold to it by Minnesota Power, and petitioned for a declaratory order finding that the proposed sale and purchase was prudent and assuring Northern States that it would recover in wholesale rates the acquisition adjustment. The FERC, declining to issue a declaratory order, stated, among other things, that it would not decide the issue of the ratemaking treatment of the acquisition adjustment outside of the case where Northern States sought to reflect the acquisition adjustment in rates:

> . . . We take this opportunity to advise Northern States that recovery of the acquisition costs will turn on an analysis of the benefits conferred on ratepayers and the overall prudence of its investment decision; however, that issue is appropriately considered in a proceeding where Northern States proposes to reflect the acquisition adjustment in its rates.

43 FERC at 61342.

> . . . A utility whose actions were prudent when made runs no risk as a result of the Commission's declining to make an advance determination as to the prudence of its actions. On the other hand, advance prudence determinations pose the risk that the Commission will become involved in day-to-day utility management decisions. In these circumstances, we shall deny the Applicant's petition for a declaratory order as premature at this time. In accordance with Commission precedent, any inquiry as to the prudence of the utilities' decisions should occur at such time as the companies actually seek to reflect the effect of the proposed transactions in rates.

43 FERC at 61,343.

The FERC related that its accounting policy toward acquisition adjustments:

> . . . was adopted in response to widespread abuses in the electric utility industry that arose through the practice of selling properties at large profits to other public utilities followed by the acquiring utility's inflating plant accounts (and rate base) by the premium paid. The result of this practice was that ratepayers paid higher rates for electric service but received no increase in benefits.

43 FERC at 61,342.

In Duke Energy Moss Landing LLC, et al., 83 FERC Para. 61,318 (1998), the FERC accepted for filing, suspended and set for hearing reliability must-run rate schedules that Duke Energy Corporation (Duke Energy) filed in connection with its purchase of the Moss Landing and Oakland reliability must-run electric generating facilities from Pacific Gas & Electric Company (PG&E), and summarily dismissed a proposed acquisition adjustment. This FERC filing was part of a transaction in which three affiliates of Duke Energy (Duke Energy Moss Landing, Duke Energy Oakland and Duke Energy Morro Bay) acquired from PG&E its facilities at Moss Landing, Oakland and Morro Bay in order to participate in the unbundled electric power generation market in California.

In summarily denying Duke Energy Moss Landing's proposed acquisition adjustment, the FERC concluded that the traditional criteria to evaluate the rate recovery of acquisition adjustments, which was established to address an industry regime in which vertically integrated utilities had monopoly power and an obligation to serve wholesale customers, do not apply in the competitive environment in which Duke Energy made its decision to purchase the PG&E units and under which it would sell power from those units:

> . . . the monopoly supplier had an obligation to plan for and acquire the necessary assets to ensure that it could reliably meet the needs of its captive customers and, in return, the supplier had the assurance that its rates would recover the costs that it prudently incurred for that purpose plus the opportunity to earn a reasonable (but limited) rate of return.

> In the situation before us, however, California is moving to reliance on a competitive power market. Customers are no longer captive and no generator has an obligation to plan to meet customer loads, or to acquire assets for that purpose. Indeed, Duke Energy's opportunity to purchase these generating units from PG&E – and its incentive to do so – results from a restructuring that, for the most part, relies on market-based rates throughout the State of California. While it is true that the units purchased by Duke Energy will operate under must-run conditions part of the time and will therefore be under cost-based regulation part of the time, the acquisition premium is associated with units that will make sales at market-based rates and Duke Energy will have the opportunity to recover its acquisition premium through the market-based rates that it will receive when the units are *not* operating as must-run. [Footnote omitted.]

83 FERC at 62,304.

The FERC noted that even if it were to apply the traditional criteria in the Duke Energy Moss Landing case it did not believe that Duke Energy would be able to meet the traditional criteria:

> We note that even if we were to apply the traditional criteria in this case, we do not believe that Duke Energy would be able to meet these criteria. This is because Duke Energy's claimed benefits (reduction of stranded costs, extension of the unit's useful life, assumption life, assumption of environmental obligations, and contribution to a functioning competitive market by ensuring reliability) either are not the type of factors we have traditionally considered, are non-quantifiable, and/or do not raise issues of fact that can be resolved by a hearing.

83 FERC at 62,304 n. 40.

Although, as seen above, some regulatory bodies have indicated a merger approval applicant can seek certain rate treatment of the acquisition premium in the future, none of the foregoing jurisdictions has conducted ratemaking in the context of a merger case. The request of UCU and EDE for this guarantee appears unprecedented, as well as unwarranted.

The Staff has cited all the above cases, not because it in any way endorses the particular treatment of acquisition premiums granted by a state regulatory body, but to present to this Commission some sense of recent state regulatory decisions regarding acquisition adjustments

and to demonstrate there is no discernable general trend toward allowing recovery of merger premiums in customer rates.

**D. Fair Value**

Finally, Mr. John McKinney in his direct testimony, Exhibit 4, pages 27-28 refers to the concept of "Fair Value rate base," and states that "the majority of rate cases today are decided on an original coat basis, and Missouri is normally regarded as an original cost state." He notes that the United States Supreme Court and the Missouri Supreme Court "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" and opines that "the Commission has the right to use its judgment to set the value of property at the level they believes [sic] is proper based upon the total evidence provided to them." (Id.).

Section 393.230 RSMo contains the valuation authority vested in the Commission by the General Assembly. A number of decisions exist which interpret the statute and establish general criteria for the Commission to follow. See, e.g., State ex rel. Joplin Water Works Co. v. Public Serv. Comm'n, 495 S.W.2d 443, 445-46 (Mo. 1973); State ex rel. Dyer v. Public Serv. Comm'n, 341 S.W.2d 795, 798-99 (Mo. 1961); State ex rel. City of St. Louis v. Public Serv. Comm'n, 329 Mo. 918, 47 S.W.2d 102, 105-17 (Mo.banc 1930). The courts have broadly interpreted the phrase "fair value" as applied to the valuation of utility property. Consequently, the Commission has been given great latitude in determining both the value of a utility's property and the proper return to be earned thereon.

The prominent decision is State ex rel. Missouri Water Co. v. Public Serv. Comm'n, 308 S.W.2d 704 (Mo. 1957). In that case, the Missouri Supreme Court extensively examined the Commission's authority under Section 393.230 and identified parameters for the exercise of that

authority. For example, at 308 S.W.2d at 717 the Court affirmed the principle first enunciated in State ex. rel. City of St. Joseph v. Public Serv. Comm'n, 325 Mo. 209, 30 S.W.2d 8, 10 (1930), that:

> There is no fixed rule for determining the fair value of property for ratemaking purposes. *All facts which shed light on the questions must be given due consideration. . . .*

(Emphasis original.)

Based on this principle, the Court at 308 S.W.2d at 719 stated that:

> Consequently, we must and do hold that in determining the price to be charged for (in this instance) water (§393.270, Par. 4) the fair "value of the property" of the water company which the Commission is empowered to ascertain under §393.230, Par. 1, is a relevant factor for consideration in the establishment of just and reasonable rate schedules and must be considered in its proper relationship to all other facts that have a material bearing upon the establishment of "fair and just" rates as contemplated by our statutes and decisions. [Citations omitted.]

In State ex rel. Joplin Water Works Co. v. Public Serv. Comm'n, supra, the Court at 445 elaborated on its holding in Missouri Water Co.:

> The Missouri Water Company case, supra, recognizes that the "fair value" which it requires the Public Service Commission to determine involves an exercise of judgment and is not the product of a simple formula. Consequently, Commissioner Jones expressed the proper function of the evidentiary hearing, i.e., to permit the commission to ascertain the facts upon which it would exercise its judgment in arriving at a fair value rate base. Therefore, the absence of testimony from staff witnesses would not preclude a determination of fair value, if the evidence presented did include the facts required in order to arrive at such determination.
>
> Similarly, the rejection of testimony by appellant's witnesses of fair value would not preclude a finding of fair value otherwise supported by the evidence presented.

The holdings in the above cases, especially the Missouri Water Co. and Joplin Water Works decisions, make it clear that the appellate courts of this State have not used the phrase "fair value" in a restrictive, technical sense, denoting a particular formula of ratemaking, but

rather have interpreted the phrase to mean that the valuation decision reached by the Commission must be just and reasonable, based upon a consideration of all relevant factors. All valuation decisions need not adhere to one particular methodology. However, whatever determination is made must be based on consideration of all relevant factors, and must not be result of regulatory expediency. The question of the lawfulness of a particular valuation therefore hinges on two primary considerations: (1) are the rates which result from the valuation just and reasonable as required by law, and (2) is the valuation decision based on a consideration of all relevant evidence presented on the record.

The weight of judicial authority imposes no requirement on the Commission that rates are to be set based solely upon a reasonable return on fair value rate base. Instead, the Commission is given great latitude in determining both the fair, i.e. equitable, value of a utility's plant in service, as well as the reasonable return which should be earned thereon. The sole limitations placed on the Commission's exercise of its discretion are: (1) the rates which result must be just and reasonable, and (2) all relevant facts must be considered in reaching the rate of return decision.

It should be noted that in State ex rel. Kansas City Power & Light Co. v. Public Serv. Comm'n, 615 S.W.2d 596 (Mo.App. 1981)(KCPL), Kansas City Power & Light Company conceded that the fair value rate base issue was not reviewable due to mootness; KCPL had received interim and permanent rate increase which superseded the rates in question. KCPL argued that despite the conceded mootness of the issue, the Court should retain jurisdiction because the legal issue presented was of public interest, was likely to recur, had not been determined by a fixed principle of law, and would not otherwise be reached by an appellate court. The Missouri Court of Appeals, Western District noted that virtually the same claim was

made in State ex rel. Laclede Gas Co. v. Public Serv. Comm'n, 600 S.W.2d 222 (Mo.App. 1980), appeal dismissed, 449 U.S. 1072, 101 S.Ct. 848, 66 L.Ed. 2d 795 (1981)(Laclede) wherein review was denied by the Missouri Court of Appeals because of mootness. (615 S.W.2d at 597).

In the Laclede case, Laclede Gas Co. appealed the Commission's fair value rate base determination, but by the time the appeal reached the Court of Appeals, Laclede had applied for and received a subsequent rate increase. The Court of Appeals held in the Laclede case that the argument relating to fair value presented no viable legal issue and in conjunction with the prohibition against retroactive rate making was moot. (600 S.W.2d at 226). The Court of Appeals in the KCPL case held that the fair value issue did not present a principle of law that was novel and the fair value issue would be resolved on the basis of existing law and the application of those principles to the facts of the case. Thus, the Court of Appeals state that the arguments put forth for retention of the case despite its mootness were not persuasive. (615 S.W2d at 598).

In Duquesne Light Co. v. Barasch, 488 U. S. 299, 109 S.Ct. 609, 102 L.Ed.2d 646 (1989) (Duquesne Light) the United States Supreme Court reviewed a Pennsylvania law that required that electric rates be set without consideration of expenditures for electric generating facilities, which were planned but never constructed, even though the expenditures were prudent and reasonable when incurred. The Duquesne Light decision cites Federal Power Comm'n. v. Hope Natural Gas Co., 320 U. S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944)(Hope). In the Hope decision, the Supreme Court abandoned "fair value" (i.e., the actual present value of assets employed in the public service) as the only constitutionally accepted method of setting utility rates. The Court held that "prudent investment" or "historical cost" is a valid basis on which to set utility

rates. The Hope Court stated that "it is not theory but the impact of the rate order which counts", i.e., "it is the result reached not the method employed that is controlling." 64 S.Ct. at 287-89.

In the Duquesne Light case, the Supreme Court affirmed that no single ratemaking methodology, whether it be "prudent investment," "fair value," or some other methodology, is required by the Constitution. The Court noted that "[t]he Constitution within broad limits leaves the states free to decide what rate-setting methodology best meets their needs in balancing the interests of the utility and the public." 109 S.Ct. at 620.

## VII. CORPORATE ALLOCATIONS

This section of the Staff's brief deals with the projected level of UCU's corporate overhead costs subject to allocation to all of UCU's divisions, including EDE in the event of a merger. Before discussing this specific issue, Staff would remind the Commission that the Staff is also raising additional issues regarding the proposed Regulatory Plan impact on the UCU corporate overhead cost allocation in future rate cases involving the MPS division. These issues are addressed in Staff's brief in the section called "Frozen" MPS Allocation Factor.

The Joint Applicants presented a 10-year cost/benefit analysis in their direct testimony (Siemek Direct, Ex.6, Sched. VJS-1). The analysis purports to demonstrate sufficient merger savings in years 6 through 10 to cover all merger costs for those years, including a 50% amortization of the acquisition premium, and to provide a minimum $3 million reduction in revenue requirement for EDE customers. This section of the brief will address the inflation factor used to project UCU's total corporate overhead costs used in the 10-year analysis, as well as the Joints Applicants' suggestion that the projection of UCU's corporate costs is unimportant at this time.

The Staff takes issue with the Joint Applicants regarding the 2.5% inflation rate used to project UCU's corporate overhead costs for the 10-year merger cost/benefit analysis. Although, in his pre-filed testimony UCU witness Siemek offers no supporting documentation, the 2.5% figure allegedly reflects the Consumer Price Index for an urban consumer ("CPI-U"). (Siemek Surrebuttal, Ex. 7, p. 6, lines 9-23, p. 7, lines 1-2). An index of the prices a consumer pays for goods and services, however, is a poor indicator of the increases in corporate allocations that UCU can be expected to impose upon its operating divisions. Attached as Schedule SMT-8 to Staff Witness Traxler's Rebuttal testimony is a document published by the United States Bureau of Labor Statistics, which identifies the particular goods and services that comprise the CPI-U. Among them are food and beverages, housing, apparel, medical care, transportation, and entertainment and recreation. (Traxler Rebuttal, Ex. 716, p. 46, lines 18-25) Clearly, the costs of such goods and services have nothing to do with anticipated increases the corporate allocations of a public utility. Such allocations are primarily a function of usage of corporate resources, or of the simple need to allocate corporate costs of, in this case, an aggressive, growth-oriented corporation to its operating divisions.

Mr. Traxler's testimony presents the following comparison of the CPI-U with the actual growth in UCU overhead allocation to MPS for the years 1996 through 1999 (Traxler Rebuttal, Ex. 716, p. 47, lines 11-17):

| | CPI-U Growth Rate | **UCU Overhead** Allocation to MPS |
|---|---|---|
| 1996 | 3.3% | 160.2% |
| 1997 | 1.7% | 53.7% |
| 1998 | 1.6% | 8.8% |
| 1999 | 2.7% | 3.5% |

The comparison illustrates quite dramatically the folly of relying on the CPI-U in an attempt to forecast the growth in UCU corporate overhead allocations.

Moreover, the Commission has in the past rejected the use of general, non-company specific indices as a means of projecting various categories of utility costs, including corporate allocations. In its Report and Order in Consolidated Case Nos. TC-93-224 and TO-93-192, for example, the Commission rejected Southwestern Bell's ("SWB's") proposed use of the Gross National Product Implicit Price Deflator ("GNP-IPD") for such a purpose. As one of its reasons for rejecting the proposal, the Commission stated, in Section B, "Nonwage Expenses," the following: "Additionally, the Commission views the proposal to adjust nonwage items for the GNP-IPD as an inflation adjustment. The evidence is not convincing that this type of national indicator reflects what has actually occurred concerning SWB nonwage expenses. The Commission has traditionally rejected these types of adjustments as not known and measurable and not company-specific. The Commission finds that the evidence in this case is lacking to show a direct relationship with SWB's current operations and the GNP-IPD." In light of the foregoing, it makes far more sense to look to actual historical data on UCU's corporate allocations for guidance, rather than a general index.

In his testimony, Staff witness Steve Traxler challenges Mr. Siemek's assumption of a 2.5% inflation rate for corporate allocations, based on the fact that the actual historical rate of inflation of UCU corporate overhead costs allocated to its existing Missouri division (MPS) has been far higher than 2.5% in recent years. (Traxler Rebuttal, Ex. 716, p. 47). Mr. Traxler's Revised Schedule SMT-7 (Ex. 719, lines 5-7) shows average annual increases in UCU's corporate overhead costs to MPS since 1995, for various multi-year time frames, as follows:

4-year average increase (1996-1999): 45.7%

3-year average increase (1997-1999): 20.0%

2-year average increase (1998-1999) 6.2%

As the figures clearly demonstrate, regardless of whether one looks at a two-, a three-, or a four-year average, a corporate allocations growth rate far in excess of UCU's proposed 2.5% rate is warranted.

In his Surrebuttal testimony, UtiliCorp witness Siemek opposed the use of actual historical figures for this purpose, on the basis that they reflected "historical events that are not likely to recur and definitely should not be used to establish a pattern for future costs." (Siemek Surrebuttal, Ex. 7, p 5, lines 16-18). In particular, Mr. Siemek identifies three non-recurring projects as contributing to, and therefore distorting, the costs considered by Mr. Traxler in developing his recommended inflation rate; namely: 1) the 1995 centralization of many previously autonomous Enterprise Support Functions, 2) the 1997 reorganization of UCU's distribution functions from geographical units to a functionalized basis, and 3) the implementation in 1997, 1998 and 1999 of various re-engineering initiatives. (Siemek Surrebuttal, Ex. 7, p. 5, lines 20-23, p. 6, lines 1-8). Mr. Siemek did not, however, include in his Surrebuttal testimony the dollar impact of any of these three effects. On cross-examination, Mr. Siemek was unable to provide authoritative testimony on the dollar impact of the aforementioned 1995 centralization. (Tr. 621, line 16). Neither did Mr. Siemek see fit to quantify the dollar impact of the re-engineering projects on the actual overhead allocations to MPS that were used by Mr. Traxler. (Tr. 636, lines 21-24). In fact, there is no record evidence of any attempt by UtiliCorp to quantify the year-by-year impact of any of these effects, either in total or specifically with respect to MPS. The UCU witness's failure to provide such basic information

in support of his assertions necessarily raises a credibility question regarding those assertions. Nevertheless, Staff witness Traxler was able to obtain from UCU data regarding re-engineering costs. He then subtracted those costs from the overall dollars allocated to MPS and re-computed the percent increases shown below. (Ex. 720, p.2).

| | |
|---|---|
| 4-year average increase (1996-1999): | 41.2% |
| 3-year average increase (1997-1999): | 15.4% |
| 2-year average increase (1998-1999): | 4.9% |

Thus, these figures, which exclude the effect of the re-engineering projects and the calculation of which was pronounced "substantially correct" by UCU personnel (Ex. 720, p. 6), are not appreciably lower than those presented earlier in this section.

In light of this historical experience with an actual Missouri division of UCU, Mr. Traxler recommends a 5% inflation rate for the purpose of estimating the corporate overhead costs to be allocated to the EDE division, post merger. It can be argued, based on UtiliCorp's historical experience, that even a 5% inflation rate assumption is too low. As shown in Schedule SMT-7, MPS has not experienced a growth rate as low as 2.5% in any year since 1995. (Traxler Replacement Pages, Ex. 719, Sched. SMT-7). Certainly, then, the 2.5% inflation figure used by the Joint Applicants in projecting corporate allocations is unreasonably low and should therefore be rejected in favor of Staff's far more reasonable recommendation of 5%.

Using a more realistic 5% inflation rate for corporate overhead costs allocated to EDE reduces the Joint Applicants' projected total net merger savings in years 6 through 10 by approximately $33.5 million, based respectively upon the Joint Applicants' and the Staff's

projections. (Traxler Replacement Pages, Ex. 719, Sched. SMT-2, Cols. C and D, line 17).[21] As noted herein in the Section dealing with the "Overall Regulatory Plan," Staff's projection of the net "savings" in years 6 through 10 as a result of the merger is a negative $20.0 million, prior to any recognition of 50% of the acquisition premium. By contrast, the Joint Applicants project a savings net of merger costs, prior to recognition of 50% of the acquisition premium, of $107.5 million. (Traxler Replacement Pages, Ex. 719, Sched. SMT-2, Col. D, line 18 and Col. C, line 18, respectively). The difference is $127.5 million, and the above-noted $33.5 million reduction in net merger savings resulting from adoption of Staff's more realistic 5% inflation rate for corporate overhead costs constitutes more than 25% of that $127.5 million difference.

In pre-filed testimony UCU witness Siemek stated that if UCU's allocated costs increased by more than 2.5%, the actual increase in UCU costs would be reflected in the post-moratorium rate case through the operation of the Regulatory Plan. (Siemek Surrebuttal, Ex. 7, p. 5, lines 12-13). The implicit suggestion is that the particular inflation rate currently used is of little importance, since all will "come out in the wash" during the post-moratorium rate case to be filed some five years from now. The problem, however, is that the Commission must consider now the "not detrimental to the public interest" standard on which its ruling on the proposed merger is based, and not five years from now. That ruling can only be made on the basis of projected costs and savings. The Commission, if it is to approve the subject transaction, must satisfy itself now that the Joint Applicants have met the legal standard and that savings will, at a minimum, be sufficient to cover merger costs. It should be remembered that it is UCU's's intention to include all merger costs, including 50% of the acquisition premium, and all merger savings in the determination of cost of service for EDE in the post-moratorium rate case.

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[21] Staff's projected net UCU corporate operating costs allocated to EDE of $130.6 million (Col. D) minus Joint Applicants' net UCU corporate operating costs allocated to EDE of $97.1 million (Col. C) equals $33.5 million.

As a specific example of why the Commission must concern itself now with this issue, consider the detrimental impact of UCU's higher corporate overhead costs on EDE. Staff witness Traxler addresses the increase in cost for General Plant facilities for the EDE division, post merger. (Traxler Rebuttal, Ex. 716, p. 40, lines 14-16). Mr. Traxler explains that EDE's cost for General Plant facilities will increase 81.5% as a result of the additional overhead cost allocation for general plant facilities from UCU. (Traxler Rebuttal, Ex. 716, p. 41, lines 3-5).

Mr. Traxler's calculation of the 81.5 % increase in EDE's cost for General Plant facilities is reflected on Schedule SMT-5 to his Rebuttal testimony. Line 18 of Schedule SMT-5 shows EDE's current revenue requirement for its General Plant facilities to be $4,764,469 annually. Line 23 of Schedule SMT-5 reflects that the additional cost to EDE, post merger, from UCU's allocated cost for General Plant facilities is $3,884,180. This represents an 81.5% increase over the pre-merger cost level. (Traxler Rebuttal, Ex. 716, Sched. SMT-5, line 24).

As Mr. Traxler points out in his testimony, EDE customers are currently receiving adequate service at a fair price. Increasing their costs for General Plant facilities by 81.5% results solely from the merger with UCU and is, in Staff's opinion, completely unnecessary. (Traxler Rebuttal, Ex. 716, p. 41, lines 9-11).

With the foregoing in mind, the Staff would note the following: Even setting aside the question of recovery of acquisition adjustment, Staff's analysis reflects that projected merger costs will exceed savings by $20.0 million over the years 6 through 10 in total. (Traxler Replacement Pages, Ex. 719, Sched. SMT-2, Col. D, lne 18). This means that EDE customers would be subject to a rate increase strictly as a result of the merger. Furthermore, inclusion of 50% of the acquisition premium, as requested by the Joint Applicants, would increase the net

savings deficiency by an additional $92.7 million for years 6 through 10. (Traxler Replacement Pages, Ex. 719, Sched. SMT-2, Col. C, line 23).

## VIII. "FROZEN" MPS ALLOCATION FACTOR

The Corporate Allocations section of the Staff's brief deals with the projected level of UCU's corporate overhead costs subject to allocation to all of UCU's divisions, including EDE, following the proposed merger. In this section, the negative impacts of the Joint Applicants' proposed Regulatory Plan on the allocations of corporate overhead costs to MPS, with resultant detrimental impacts on the MPS ratepayers, will be discussed.

Staff is concerned that the Joint Applicants' Regulatory Plan, if approved, will negatively affect corporate overhead costs allocated to MPS, to the detriment of MPS's ratepayers, in two respects. The first of these stems from the Joint Applicants' intention to "freeze" MPS's corporate allocation factor to exclude the impact of the EDE acquisition. Thus, under the Regulatory Plan, the allocation factor will not be reduced as a result of the EDE merger, even though the normal and natural effect of the transaction would be to reduce the factor for all 27 of UCU's previously existing divisions (both regulated and non-regulated), including MPS. (Traxler Rebuttal, Ex. 716, p. 12, lines 4-20). The Joint Applicants do not dispute this normal result; in fact, Joint Applicants witness Myers stated that under the Regulatory Plan, MPS will not receive the benefits of any savings in corporate allocated costs associated with the EDE transaction. (Tr. 866, lines 17-18).

Although the Joint Applicants plan not to reflect the impact of the EDE merger in the MPS allocation factor for rate purposes, Mr. Myers also admitted that costs allocated to MPS and

reflected on its books for financial reporting purposes will reflect a lower allocation of UCU's corporate costs. (Tr. 867, lines 12-16).

Staff witness Traxler provided an analysis of the dollar impact on MPS ratepayers of the Joint Applicants' intention to freeze the MPS cost allocation factor at its pre-EDE merger value. The analysis shows that, absent this artificial "freeze," MPS could expect to reflect a cumulative reduction in revenue requirements of $50,629,741 for the eight years (through 2010) following its next rate case. (Traxler Rebuttal, Ex. 716, Sched. SMT-3; Tr. 418). Inasmuch as the Joint Applicants do not plan to reflect MPS's actual allocated share of UCU's costs, this amounts to an effective average annual increase in revenue requirement of $6,328,718. (Traxler Rebuttal, Ex. 716, Sched. SMT-3).

The Joint Applicants' proposed ratemaking treatment regarding corporate allocations to MPS is not only abnormal and completely artificial, but it is inconsistent with the manner in which all UtiliCorp mergers/acquisitions have been handled in prior MPS rate cases. UCU has never requested that one of its divisions be excluded from the calculation of its allocation factors in any prior rate case for MPS. Staff takes the position that the Joint Applicants' deviation from past practice in this case makes no sense. Moreover, this proposed deviation from cost-based ratemaking results in a higher cost of service imposed upon UCU's MPS division, causing a detriment to MPS ratepayers to the tune of approximately $6.3 million per year. As Mr. Traxler stated in his Rebuttal testimony, "This recommended ratemaking treatment for MPS is nothing more than a backdoor approach to force UCU's existing Missouri customers to subsidize the net loss from the merger referred to previously. This loss results because projected merger savings are insufficient to cover all merger costs plus the acquisition premium." (Traxler Rebuttal, Ex.

716, p 12, lines 14-17.) The Commission should therefore reject this attempt to have MPS customers subsidize the merger acquisition premium.

The second effect that works a detriment on MPS under the proposed Regulatory Plan stems from the fact that holding the MPS corporate allocation factor at its pre-merger value following completion of the subject transaction with EDE manifestly will not result in MPS receiving the same corporate overhead charges it would have received had there been no merger. The reason is that the pool of corporate charges is going to increase under the Regulatory Plan; hence, a division saddled with an unchanging allocation factor will automatically bear higher corporate overhead costs than it would have borne in the absence of a merger.

Staff witness Traxler's revised Schedule SMT-2 shows that the UCU corporate allocations pool will increase by a total of $75,697,000 over 10 years as a result of the merger with EDE.[22] (Traxler Revised Sched. SMT-2, Ex. 719, Col. A. [or B], line 14 plus line 15). It should be emphasized that both the Joint Applicants and the Staff agree on this dollar amount. If, then, UCU's allocation factor for MPS, currently about 25%, is held constant with respect to the impact of the EDE merger, MPS's share of UCU's corporate overhead costs can be expected to increase by nearly $19 million over the 10-year time frame. Obviously, MPS ratepayers will suffer a detriment under such a proposal.

The Joint Applicants' response to Staff's contention is that incremental increases in corporate overhead costs attributable to the addition of EDE will be the subject of a tracking system to be developed by UCU. In his Surrebuttal testimony, Joint Applicants witness Myers stated: "Additionally, as we proposed in our Regulatory Plan, the customers of MPS should not suffer a detriment from the EDE merger and, as a result, allocations of corporate costs to MPS

[22] $47,859,000 plus $27,838,000 transferred from EDE to UCU's Enterprise Support Function ("ESF") and Intra Business Unit ("IBU") departments, respectively.

should not include the incremental costs of absorbing EDE operations." (Myers Surrebuttal, Ex. 13, p. 5, lines 15-18). During cross-examination witness Myers verified that MPS will not absorb any of such costs, under the Regulatory Plan (Tr. 865, line 24).

As argued vigorously in the section herein dealing with tracking systems ("Savings Tracking"), the Staff is highly skeptical that such a system can ever be successfully developed. Furthermore, the Joint Applicants have presented no concrete proposal regarding how their tracking system will work, so as to ensure that MPS customers will not be detrimentally impacted by the increase in UCU corporate overhead costs resulting from the proposed merger. In effect, the Commission is being asked to accept on blind faith the Joint Applicants' assurances that the MPS ratepayers will not experience a detriment. The Commission should find these assurances wholly lacking and therefore unpersuasive.

In summary, the Joint Applicants are seeking Commission approval of a Regulatory Plan under which the ratepayers of MPS can expect to be impacted detrimentally in two ways. First, in rate cases involving MPS during the 10-year period following approval of the subject merger, MPS's rates will be increased approximately $51 million as a result of allocating UCU's corporate costs on an assumption that the EDE division does not exist. Second, notwithstanding the Joint Applicants' hollow assurances to the contrary, MPS can expect to be detrimentally impacted by the undisputed 10-year increase of more than $75 million in corporate overhead pool costs resulting from the addition of EDE costs to the allocation pool. In light of the "not detrimental to the public interest" standard, the Commission should reject the Joint Applicants' Regulatory Plan on this basis.

## IX. "FROZEN" CAPITAL STRUCTURE

As part of their regulatory plan, the Joint Applicants propose that "[t]he balance of the retail electric rate base in the Post-Moratorium Rate Case" (i.e., all of EDE's rate base *except* the portion of the acquisition premium that would be included in EDE's rate base) will be allowed a return, for the period covered by the regulatory plan, based on the Empire capital structure as determined in the Pre-Moratorium Rate Case. (J. McKinney Direct, Ex. 4, p. 7, lines 20-23).

This capital structure would not be Empire's actual pre-moratorium capital structure, however, according to Empire witness Robert B. Fancher. It would instead be "a normalized Empire only capital structure," because that would be "more appropriate" than the actual capital structure. Mr. Fancher and UtiliCorp witness John W. McKinney both stated that this normalized capital structure would be 47.5% common equity and 52.5% long-term debt. (Fancher Direct, Ex. 8, p. 4, lines 8-20; J. McKinney Direct, Ex. 4, p. 28, line 19 – p. 29, line 2, as corrected at Vol. 2, Tr. 253, lines 14-23).

Empire's "normalized capital structure" would therefore be used for the Pre-Moratorium Rate Case, and throughout the five-year moratorium period. It would also be used for any rate cases that are filed in years 6-10 of the regulatory plan – i.e. the time between the end of the moratorium and the termination of the regulatory plan. (Vol. 5, Tr. 617, lines 11-25). The effect of this proposal would be to freeze the capital structure at the "normalized" level for 10 years following the proposed merger.

Even though the "frozen" capital structure is just one element of the Joint Applicants' regulatory plan, Mr. McKinney indicated that it is critical. He said that if the Commission does not approve the capital structure proposal, "It would require UtiliCorp to significantly restructure

its regulatory plan in order to maintain the financial feasibility of this merger." (J. McKinney Direct, Ex. 4, p. 29, lines 7-10).

Joint Applicants' proposal of a "frozen" capital structure, which is an essential component of the regulatory plan, is unacceptable to the Staff, and the Commission should reject it, because it amounts to nothing more than an attempt to indirectly recover a portion of the acquisition premium from the ratepayers. Implementing this component of the regulatory plan would come at an excessive cost to the ratepayers, as explained below. Changing another component of the regulatory plan "in order to maintain the financial feasibility of this merger" would therefore be just as inappropriate as approving the proposal to "freeze" the capital structure would be.

Empire has historically used conservative financing practices in funding its operations. The ratio of 47.5% common equity to 52.5% long-term debt that Mr. Fancher mentioned is approximately equal to the ratio that existed prior to a 1999 financing for which Empire issued all unsecured debt. Prior to the 1999 financing, Empire had historically used both debt and equity to finance generation additions (Broadwater Rebuttal, Ex. 700, p. 7, lines 31-32; also Broadwater Rebuttal, Ex. 700, p. 16, lines 5-17), but it issued all unsecured debt in 1999, because Empire and UCU had already entered into their merger agreement, and UCU did not want Empire to issue any new common equity that UCU would later have to acquire at a premium. (Broadwater Rebuttal, Ex. 700, p. 7, line 1 – p. 8, line 5).

UtiliCorp, on the other hand, utilizes a capital structure that is much more highly leveraged. "The consensus is that UtiliCorp will fund its operations with approximately 40% common equity on a going forward basis," Staff witness Broadwater testified. (Broadwater Rebuttal, Ex. 700, p. 6, lines 3-4). UtiliCorp's targeted capital structure contains 40% common

equity and 60% long-term debt. (Broadwater Rebuttal, Ex. 700, p. 5, lines 12-13). And UtiliCorp's chief executive officer, Richard C. Green, Jr., stated that UCU is still very comfortable with a 40% common equity/60% long-term debt capital structure. (Broadwater Rebuttal, Ex. 700, p. 6, lines 4-37).

UtiliCorp's preference for a highly leveraged capital structure enables it to acquire capital at the relatively low rates that are available for debt financing, rather than the relatively high rates that are required for equity financing. However, when UCU comes before the Commission, it utilizes every available opportunity to try to obtain a rate of return that is based upon a capital structure that is much more heavily dependent upon equity financing. If the Commission allows UtiliCorp to achieve this result, the effect will be just the opposite of the beneficial effects that UtiliCorp has claimed will result from its merger and acquisition strategy.

For about the last 15 years, UtiliCorp has touted its merger and acquisition strategy as a means to obtain better access to capital markets, thereby reducing its risk and the cost of money. The company said this would have the net effect of reducing UCU's revenue requirements. (Featherstone Rebuttal, Ex. 702, p. 108, line 17 – p. 110, line 4). Fifteen years ago, UtiliCorp said , in answers to a data request, that: "This expected reduction in capital costs will eventually produce reductions in rates of return." (Featherstone Rebuttal, Ex. 702, p. 109, lines 17-18). And again, in response to another data request in the same case, UtiliCorp said: "Higher financial ratings should, in turn, lead to lower rates of return claimed in regulatory proceedings." (Featherstone Rebuttal, Ex. 702, p. 109, line 30 – p. 110, line 2).

UCU has promised for 15 years that it will pass along to its ratepayers the benefits of its greater access to capital markets. But now it seeks to "freeze" the capital structure of Empire at pre-merger levels, thereby denying its ratepayers the very benefits that it has promised.

The method that UtiliCorp has chosen to use, in this case, to try to achieve the higher rate of return that it desires, is "freezing" the capital structure of Empire at approximately the common equity/long-term debt ratio that Empire has historically maintained, while ignoring the fact that the merged companies' financing would actually come, not from Empire, but from UtiliCorp. UtiliCorp seeks to have the benefit of financing its operations predominantly with relatively cheap long-term debt financing, while simultaneously obtaining the benefit of billing its ratepayers based upon a *mythical* capital structure consisting of predominantly common equity financing. The Commission should not tolerate a shell game such as this.

In fact, the "frozen capital structure" – 47.5% common equity and 52.5% long-term debt – would not exist anywhere. Rather, the frozen capital structure would establish a future rate of return based upon the "normalized" conditions of the past. This is wrong for two reasons: First, one cannot know what the capital structure of Empire will be in the future, nor what the capital structure of UCU will be in the future; one can only know what capital structure existed in the past. (Broadwater Rebuttal, Ex. 700, p. 4, lines 10-16). Second, if the Commission adopts this proposal, it would be bound to apply a capital structure that does not exist.

This is actually at least the fourth time UCU has attempted to execute a strategy similar to this. The prior cases are: ER-97-394, ER-93-37 and ER-90-101. (Broadwater Rebuttal, Ex. 700, p. 9, line 20 – p. 10, line 4). In two of those prior cases, the Commission found that UtiliCorp's consolidated capital structure should be used, rather than assigning a hypothetical capital structure to UtiliCorp's MPS division.

In Case No. ER-97-394, the Commission said: "[T]he consolidated capital structure as proposed by the Staff accurately reflects the correct capital structure of UtiliCorp itself, and therefore MPS, during the actual test year." (See the fuller discussion of Case No. ER-97-394 in

Broadwater Rebuttal, Ex. 700, p. 30, line 4 – p. 11, line 39, and specifically at p. 11, lines 33-36). This was similar to the view the Commission had expressed several years earlier, in Case No. ER-90-101, where it said: "[I]t is more reasonable to use the consolidated capital structure for MPS than it is to assign a hypothetical capital structure to MPS." (See the fuller discussion of Case No. ER-90-101 in Broadwater Rebuttal, Ex. 700, p. 12, lines 1-40, and specifically at p. 12, lines 10-13).

As stated by Staff witness Broadwater: "[UtiliCorp's proposal to freeze SJLP's capital structure] is simply a way for UtiliCorp to artificially increase the cost of service to Empire ratepayers, therefore, allowing UtiliCorp to recover, in part, the acquisition premium they paid to Empire shareholders." (Broadwater Rebuttal, Ex. 700, p. 14, lines 23-26).

In the present case, UCU seeks to freeze Empire's capital at 47.5% common equity and 52.5% long-term debt. This ratio is significantly different from the capital structure of UCU, which is presently about 40% common equity and 60% long-term debt, and which probably will remain so. In fact, the financing for Empire will come from UtiliCorp, and not from Empire, so the present, stand-alone, capital structure of Empire is irrelevant to the question of what rate of return UCU will require for its Empire division in the future.

The difference between the revenue requirement that results from using the "frozen" capital structure and the revenue requirement that results from using UCU's actual capital structure may be very significant. Applying the "frozen" capital structure during the period covered by the regulatory plan may be very expensive for Empire's ratepayers. As shown in Schedule 2 to Mr. Broadwater's rebuttal testimony, the extra revenue requirement that results from using the "frozen" capital structure and the cost of capital that was established in UtiliCorp's most recent rate case (No. ER-97-394, et al.) would amount to approximately $2.5

million per year, or a total of $25 million over the ten-year life of UCU's proposed regulatory plan. (Broadwater Rebuttal, Ex. 700, p. 8, lines 16-22). This difference balloons to $5.1 million per year, or a total of $51 million over the ten-year life of the regulatory plan, if the Commission uses the 11.37% cost of capital estimate that UtiliCorp is employing in this case to calculate capitalized merger savings. (Broadwater Rebuttal, Ex. 700, p. 8, line 22 – p. 9, line 2).

The Joint Applicants argue that the frozen capital structure is appropriate, because Empire's capital structure "would not have changed appreciably" but for the merger. (J. McKinney Direct, Ex. 4, p. 29, lines 3-5). By maintaining this position, the Joint Applicants are, in essence, saying that one of the supposed principal benefits of the merger – a lower cost of capital – should not be shared with the ratepayers to any extent. The Staff contends, however, that if the ratepayers receive no benefit from the merger, there is no reason why the Commission should approve it. The Commission does not exist merely to improve the earnings of the Joint Applicants; rather, it must be concerned about the impact of the proposed merger on the ratepayers, as well.

Another argument against the frozen capital structure relates to the fact that UCU's risk should actually decrease as a result of this proposed merger, for reasons set forth in the rebuttal testimony of Staff witnesses Featherstone and Broadwater. (Featherstone Rebuttal, Ex. 702, p. 110, lines 13-22; Broadwater Rebuttal, Ex. 700, p. 8, lines 12-15, p. 9, lines 2-19, and p. 15, lines 6-15). UtiliCorp claims that a major benefit of its growth strategy is that its risk decreases because of its diversification efforts. If the risk decreases, the company should be able to obtain long-term debt and common equity financing at lower rates, and the required costs of capital should correspondingly decrease. (Featherstone Rebuttal, Ex. 702, p. 110, lines 13-22). Yet

UCU proposes, instead, to maintain the cost of capital at the level that Empire required prior to the merger.

It should be noted that neither of the Joint Applicants offered any testimony in opposition to the rebuttal testimony of either Mr. Broadwater or Mr. Featherstone on the "Frozen" Capital Structure issue.

The Commission should reject the Joint Applicants' proposal of a "frozen" capital structure. If the Commission approves the proposed merger, the rates of the Empire division after merger closing should reflect the prudent actual costs of financing the Empire division – i.e., UtiliCorp's actual capital structure, assuming it is found to be prudent.

## X. MERGER SAVINGS

### A. Merger savings estimates are unreliable

UtiliCorp claims the merger with Empire District Electric (EDE) will result in total estimated savings of $383.57 million over a ten-year period. (Fischer Rebuttal, Ex. 703, p. 5 [Response to Staff Data Request No. 1]). Based on the Joint Applicants' witnesses McKinney, Myers and Siemek, UtiliCorp not only believes that it will achieve significant savings from the merger, but asserts that it will be able to identify and quantify actual merger synergies to demonstrate in future rate proceedings that these savings exceed the costs relating to the merger. (Id. at 5). Staff asserts that for several reasons, discussed below, the Joint Applicants' savings estimates are unreliable and lack credibility for the argument that the UtiliCorp/EDE merger is not detrimental to the public interest.

**B. Estimates are unreliable because they were done hastily without full and complete analysis**

The Joint Applicants' developed the merger savings estimates from transition team reports. (Siemek Direct, p. 8). Seven such teams, comprised of employees of EDE and UtiliCorp, were created (Heider Direct, Ex. 21, p. 2 and Sch. VMH-2), and among other tasks, they reviewed and validated the initial estimated merger savings developed during the due diligence process. (Fischer Rebuttal, Ex. 703, pp. 11-12). A Steering Committee comprised of UtiliCorp and EDE operational and human resource personnel will review the teams' work. (Heider Direct, Ex. 21, pp. 2-3). The teams began to meet in September and the estimates they produced are contained in Joint Applicants' witness Vern Siemek's Schedule VJS-1, filed on December 15, 1999. (Heider Direct, Ex. 703, Sch. VMH-1). However, the transition team process has been ongoing and refinements to a final integration implementation plan, with updated merger savings estimates, were not scheduled to be available until October or November, 2000. (Heider, Tr. 837). Joint Applicants' witness Vicki Heider stated, in fact, that final savings estimates would not be ready for Steering Committee review any sooner than October or November, 2000. (Heider, Tr. 838). Ms. Heider stated that the final savings estimates from the transition team are subject to Steering Committee review. (Heider, Tr. 838). Nearly ten months after the original tentative savings estimates were submitted, the Commission has no final or even updated estimates available to review for reliability.

**C. Estimates are unreliable because they are largely based on reductions in a two-utility merger scenario rather than the planned three-utility merger scenario**

The merger savings calculations do not contemplate an eventual three-company merger of UtiliCorp, EDE and St. Joseph Light and Power, except in the areas of general joint dispatch

savings, environmental compliance joint options and in allocated corporate costs. (Fischer Rebuttal, Ex. 703, p. 16).

Ms. Fischer testified that there is a possibility that additional economies of scale may be generated when the three companies are merged. (Fischer Rebuttal, Ex. 703, p. 17). A three-way merger would allow for additional savings though purchase of larger quantities, sharing of project costs for Missouri-specific activities and sharing personnel instead of outsourcing. (Id.) However, the effect a three-way merger will have on labor costs are unknown. (Id. at 17-18). In surrebuttal testimony, Mr. Siemek attempted to respond to the criticisms on this point by stating his belief that there would be no further economies of scale benefits from a three-way merger than from the EDE and Empire District mergers considered separately. (Siemek Surrebuttal, Ex. 7, pp. 11-12). However, Mr. Siemek gave no indication that either the UtiliCorp – St. Joseph Light and Power or the UtiliCorp – EDE transition teams had ever been specifically asked to consider this question when they developed their estimated synergy amounts (Tr. 884-885).

**D. Merger savings estimates associated with employee reductions are overstated.**

A considerable amount of the Joint Applicants' merger savings estimates are associated with assumed reductions in EDE employee positions after the merger. The savings estimates are based upon the salaries and benefits of the current EDE employees who will still be employed after the merger, compared to the salary and benefits associated with the current number of EDE positions examined by the transition teams. However, from a customer perspective, the estimated labor merger savings are overstated because they fail to draw any distinction between normal, non-merger vacancies and merger-related vacancies.

EDE, like other businesses, will have a certain level of employee vacancies at any point in time. For example, Joint Applicants' witness Robert Fancher testified that out of sixty current

job vacancies, forty were merger-related with the other twenty attributable to other reasons. (Fancher, Tr. 507). He acknowledged that typically, salaries associated with vacant employee positions as of the end of a test year are not given rate recovery. (Fancher, Tr. 934). However, the Joint Applicants' method for calculating estimated savings in the labor category included "savings" associated with elimination of vacant positions included in EDE's 1999 budget baseline, which was used by the transition teams as the starting point for their savings estimate work. All sixty of the current level employee vacancies were included in the 1999 budget baseline. (Fischer Rebuttal, Ex. 703, p. 25). Since a level of employee vacancies is assumed in rate proceedings and not given rate recovery, the savings in employee salaries associated with vacant positions are illusory from a customer perspective, since the associated salary expense was never included in rates in the first place. (Id., 26).

To correct this error, the Staff calculated an adjustment to measure estimated merger savings in labor using a starting point of an average of actual position levels filled, similar to the process used for handling salary expense in rate cases. The ten-year total for the adjustment was $10,923,000. (Traxler Rebuttal Replacement Pages, Ex. 719, p. 64).

**E. Estimates of labor savings are unreliable because they may be achievable on a stand-alone basis, without the merger**

The transition teams' analyses concentrated on the labor expenses of EDE and a major portion of the projected merger savings come from EDE labor reductions. (Fischer Rebuttal, Ex. 703, p. 24; Siemek Direct, Ex. 6, p. 12 and Sch. VJS-1).

The Joint Applicants' provided transition team work papers and reports in response to Staff Data Request Nos. 1 and 103. Ms. Fischer states that this information does not provide any explanations for the position reductions and that subjective decisions were made using

assumptions that tended to increase the number of positions to be eliminated. (Fischer Rebuttal, Ex. 703, pp. 24).

Ms. Fischer testified that employee reductions at UtiliCorp have occurred in the past on a stand-alone basis through "re-engineering," and also have been done on a smaller scale at EDE. She believes that some of the planned labor reductions might occur absent the merger, and cites EDE's "Competitive Positioning Process" from 1995-1996, which led to a reduction of 21 employee positions at EDE, as an example of initiatives that EDE can take on a stand-alone basis to achieve labor savings. (Fischer Rebuttal, Ex. 703, p. 27).

**F. Savings estimates are overstated because they are not discounted to present value**

The Joint Applicants used a 2.5% inflation rate in their merger savings calculations, which has a cumulative effect that inflates the savings. (Fischer Rebuttal, Ex. 703, p. 29). On the other hand, according to Ms. Fischer's testimony, costs to achieve the merger are largely current costs. (Id.). Because cost savings estimates have been "escalated" based on the assumed inflation rate--which produces a favorable comparison of merger savings to merger costs—it would be appropriate to discount the estimates to a common point in time to derive a present value of estimated savings. (Id.).

Ms. Fischer's present value analysis of the UCU/EDE estimated merger savings extends through the year 2010 and uses the company's weighted cost of capital for the compounded interest rate. This is an appropriate interest rate because if merger savings are generated, the additional cash flow would be available for UtiliCorp to use so that it could avoid meeting its cash needs by getting financing from the debt and equity markets. If required to seek financing, that weighted capital cost is what UtiliCorp would have to pay to secure needed funds. (Fischer Rebuttal, Ex. 703, pp. 30-31).

The net present value of savings from 2001 through 2010, using an 11.37% discount rate, is $213.5 million, compared to the Joint Applicants' estimated savings of $383.6 million. (Fischer Rebuttal, Ex. 703, p. 31; Sch. 4). Accordingly, the Companies' overstate the merger savings by $170 million. (Id.).

### G. Commission should disregard Joint Applicants' merger savings estimates when considering if the merger is not detrimental to the public interest

Staff concerns with specific categories of the Joint Applicants' estimated merger savings are addressed in separate sections of this initial brief. These concerns include Staff witness Proctor's critique of estimated generation/joint dispatch savings associated with the merger, and Staff witness Traxler's concerns on estimated employee benefit savings, which have led to a settlement of that issue area. Where the Staff believes merger savings estimates can be made under more reasonable assumptions than used by the Joint Applicants, revised estimates have been offered. (Ex. 719, Traxler Rebuttal, Replacement Pages, Sch. SMT-2).

More generally, the Staff recommends that the Commission recognize that the Joint Applicants' estimated merger savings are by definition and necessity speculative and uncertain of occurrence, even without taking into consideration the Staff's criticisms of UtiliCorp's estimated amounts recounted above. Moreover, as discussed more fully in the section of the Brief entitled "Merger Savings Tracking Benchmark," there is no known method by which the Commission or other parties can reliably determine in the future whether any level of estimated merger savings will be attained in actuality. For these reasons, the Staff believes the Commission should disregard the Joint Applicants' estimated merger savings levels when assessing the arguments of the Staff and other parties to this proceeding that approval of the merger will be detrimental to the public interest.

## XI. JOINT DISPATCH

The Joint Applicants contend that if UtiliCorp and EDE continue to operate as stand-alone entities, their total power supply costs over the ten-year period from 2001-2010 will amount to $2,458,725,000. (Holzwarth Direct (subsequently adopted by Joint Applicants witness DeBacker), Ex. 26, p. 15, line 17 – p. 16, line 3). However, they claim that if they are allowed to merge, the total power supply costs over the same ten-year period will be only $2,289,633,000. (*Id.*) Thus, according to the Joint Applicants, the ten-year savings in power supply costs, if the merger is approved, will be $169,092,000. (*Id.*) On the basis of this analysis, the Joint Applicants claim that the "merger savings" from the joint dispatch agreement will exceed $169 million.

The Staff contends, on the other hand, that the "merger savings" are much smaller – only about $6.95 million. (Proctor Rebuttal, Ex. 713, p. 41, lines 5-14). The Staff calculated this "merger savings" on the basis of production model runs by Staff witness Lin, using RealTime® software – the same software that the Joint Applicants used in their production model runs.

This difference in the projection of the "merger savings" is so dramatic as to make it seem that the claimed "merger savings" are almost illusory. It is therefore important to investigate the cause of the disagreement between the Staff and the Joint Applicants.

Joint Applicants witness DeBacker testified, however, that he did not have any material disagreement with Staff witness Lin. In fact, he concurred with the results Mr. Lin obtained, *given the assumptions that Mr. Lin used* in performing his run. Mr. DeBacker attributed the vast difference between the Joint Applicants' estimate of merger savings and the Staff's estimate of merger savings almost entirely to the "scenarios" requested by Staff witness Proctor. See, e.g., the following excerpt from Mr. DeBacker's surrebuttal testimony:

Q. Do you have a general response to the analysis contained in [Mr. Lin's] testimony?

A. Yes. Except for the scenarios specifically requested by Dr. Proctor, I have no material disagreements with Mr. Lin's analysis. Mr. Lin and I used essentially the same database and software to determine the impact of the proposed merger on power costs. As noted in his testimony, Mr. Lin made several minor changes to the input assumptions that for the most part had minor impact on the results. In fact, Mr. Lin's results are quite close to the Applicants' results in all scenarios with the exception of those scenarios requested by Dr. Proctor.

Q. Which scenarios did Dr. Proctor instruct Mr. Lin to prepare?

A. Essentially, Dr. Proctor instructed Mr. Lin to prepare scenarios using the assumption that each stand-alone company had the same wholesale sales opportunities as the merged company.

(DeBacker Surrebuttal, Ex. 18, p. 2, line 19 – p. 3, line 9).

It is therefore fair to say that the testimony of Joint Applicants witness DeBacker essentially attributes all of the vast difference in the two estimates of merger savings to the difference between the scenarios used by Mr. DeBacker and those used by Dr. Proctor.

Mr. DeBacker claimed that: "Dr. Proctor used a very simplistic and unrealistic assumption in order to arrive at this conclusion." (DeBacker Surrebuttal, Ex. 18, p. 4, lines 12-13). He added the following: "The vast majority of the difference rests with Dr. Proctor's assumption concerning wholesale sales volumes and margins. He assumes that there exists a perfect wholesale market and that UtiliCorp's Missouri Public Service ("MPS") operating division, EDE and the merged company will participate in that market on the same basis, i.e.: each entity will be able to sell at the market price and have the same level of market penetration." (DeBacker Surrebuttal, Ex. 18, p. 5, lines 6-10).

Mr. DeBacker finds this assumption to be faulty. He asserts: "The wholesale energy market is not perfect and the abilities and opportunities of each of the market participants are not equal." (DeBacker Surrebuttal, Ex. 18, p. 5, lines 14-15).

This assertion is at the heart of the dispute between the Joint Applicants and the Staff regarding the issue of merger savings.

The Joint Applicants contend that the "abilities and opportunities" that EDE possesses as a stand-alone company are far less than the "abilities and opportunities" that MPS possesses, and they are far less than those that the Joint Applicants will possess after the conclusion of the merger. In fact, according to the Joint Applicants, this "abilities and opportunities" gap is so great, that it accounts for virtually all of the difference between the $169.1 million in energy-related savings that the Joint Applicants expect to realize as a result of the merger and the $6.95 million that the Staff expects to occur as a result of the merger.

The Staff, on the other hand, contends that EDE can overcome the disparity in "abilities" on a stand-alone basis, without the need for the merger, if only it chooses to do so. And the disparity in "opportunities" can also be eliminated, without the necessity of a merger, by implementation of the recently adopted FERC Order 2000.

According to Joint Applicants witness DeBacker, the differences in the "abilities" of EDE and those of MPS relate to the following:

- "EDE has not been and is not now active in the wholesale market" (DeBacker Surrebuttal, Ex. 18, p. 6, line 18), whereas "MPS has been active in the wholesale market since 1996" (DeBacker Surrebuttal, Ex. 18, p. 7, line 9).
- "EDE does not currently have a wholesale marketing group dedicated to pursuing the wholesale market and does not have plans to create such a group," (DeBacker Surrebuttal, Ex. 18, p. 7, lines 3-4), and it would be "very costly [for EDE] to develop and sustain an effective wholesale marketing group," (DeBacker Surrebuttal, Ex. 18, p. 6, lines 20-23), whereas "MPS maintains a fully staffed wholesale marketing group to

pursue opportunities in the wholesale market." (DeBacker Surrebuttal, Ex. 18, p. 7, lines 12-13).

- "EDE elected not to separate its transmission and generation functions due to cost" and cannot sell its excess energy at market rates (DeBacker Surrebuttal, Ex. 18, p. 6, line 25 – p. 7, line 1), whereas MPS "has separated its generation and transmission functions" (DeBacker Surrebuttal, Ex. 18, p. 7, line 11).

To summarize the foregoing, the Joint Applicants contend that EDE lacks the "abilities" that MPS possesses because EDE has *elected* not to develop these abilities *due to cost*, and it therefore does not now have a qualified wholesale marketing group. The cost of developing a qualified wholesale marketing group is certainly a factor that is worthy of consideration. This alone, however, is not a sufficient reason for this Commission to approve a plan that would require the customers of the Joint Applicants to pay one-half – or even more than one-half – of the $275 million acquisition premium that UCU agreed to pay to EDE's shareholders. To authorize such a proposal would be to reward the EDE shareholders for the passive course that the management of EDE has chosen to follow.

Furthermore, it would be relatively inexpensive for EDE to achieve the same level of "abilities" that MPS now possesses. Mr. DeBacker testified that for EDE to do so "would possible [*sic*] cost EDE in the area of $1+ million per year." (DeBacker Surrebuttal, Ex. 18, p. 9, lines 1-10). Mr. DeBacker also testified, however, that this estimate of cost did not include certain risk management expenses, which he made no attempt to quantify. But even if one assumes that the total cost to EDE of acquiring these "abilities" amounts to $2 million per year, the total cost over the ten-year period from 2001-2010 would still be only $20 million. That

would be a very good investment, indeed, if it is all that is required to increase the energy cost savings from $6.95 million to $169.1 million.

With regard to the different levels of "opportunities" that are available to the two companies, Mr. DeBacker said the following: "The operations of the combined company, with its enhanced transmission capabilities, will allow it to expand its efforts in the wholesale market much more efficiently than either of the companies could do separately." (DeBacker Surrebuttal, Ex. 18, p. 7, lines 20-23). Mr. DeBacker later repeated this emphasis on the importance of "enhanced transmission capabilities," saying: "The increase in market penetration and sales activity are primarily due to the transmission interconnects that the new combined company will have via the interconnections that EDE has with other utilities in the Southwest Power Pool ('SPP') and the Southeast Reliability Council ('SERC'), and the increase in available capacity for sale into the wholesale market." (DeBacker Surrebuttal, Ex. 18, p. 8, lines 5-10).

The Staff contends that most of these benefits of an enhanced transmission system will be provided by the implementation of regional transmission organizations ("RTOs"), and that FERC Order No. 2000 will adequately promote the implementation of RTOs.

In response to cross-examination, Mr. DeBacker states: "What we're really talking about here is the increased number of interconnections that the combined company will have with other entities and the larger geographic area that it will cover." (Vol. 5, Tr. 806, line 17-20).

However, through a regional tariff, under an RTO, all of these interconnections with other entities would be available to both EDE and to MPS, on a stand-alone basis.

If all of these benefits of an enhanced transmission system will be provided by the implementation of RTOs, it is hard to imagine what additional benefits would be provided by the merger of the Joint Applicants. The Staff therefore submits that the claimed "enhanced

transmission opportunities" do not justify the approval of the proposed merger, because the Joint Applicants can just as readily obtain these opportunities as stand-alone companies.

The Staff submits that EDE either has or can acquire both the "abilities" and the "opportunities" that are necessary to achieve the claimed "merger savings" without actually merging with UtiliCorp. The vast majority of the "merger savings" that the Joint Applicants claim are not related to the merger at all. As Staff witness Proctor testified: "[O]nly $6.95 million of the $164 million [*sic*] of these energy cost-related opportunities are true merger savings. If the Commission adopts a regulatory sharing plan that includes the [Joint] Applicants' estimate, it should be for reasons other than sharing in true merger savings." (Proctor Rebuttal, Ex. 713, p. 52, lines 15-18).

## XII. ELECTRIC ALLOCATIONS AGREEMENT

The Joint Applicants proposed a form of agreement for allocating power resources and costs "to achieve optimal economies consistent with reliable electric service ... and to establish the basis for capacity commitments" after the merger of the companies. The document the Joint Applicants proposed to use for this purpose was entitled "EDE – MPS Electric Allocations Agreement." It was attached to the direct testimony of Joint Applicants witness Holzwarth, identified as Schedule RWH-10, and consisted of six pages. (Holzwarth Direct, Ex. 26, p. 17, line 15 – p. 18, line 10, and Sch. RWH-10).

In his Rebuttal testimony, Staff witness Proctor suggested certain modifications to the proposed Electric Allocations Agreement. Schedule 4.1, attached to this rebuttal testimony shows the changes Dr. Proctor proposed, and Schedule 4.2 shows the proposed Electric

Allocations Agreement as modified. (Proctor Rebuttal, Ex. 713, p. 42, line 21 – p. 43, line 5, and Schedules 4.1 and 4.2).

Joint Applicants witness DeBacker then testified that he accepted all but three of Dr. Proctor's proposed changes. (DeBacker Surrebuttal, Ex. 18, p. 10, lines 4-8). He only identified two of these areas of disagreement, however. The two remaining areas of disagreement that he identified are the following:

1. Allocation of on-system energy cost savings, between MPS and EDE; and
2. Allocation of profits from off-system energy sales between MPS and EDE.

(DeBacker Surrebuttal, Ex. 18, p. 10, line 9 – p. 11, line 17).

With respect to Issue No. 1 above, the Joint Applicants propose that *100 percent* of the on-system energy savings related to the merger be allocated to EDE. Likewise, with respect to Issue No. 2, they propose that *100 percent* of the profits from incremental off-system sales be allocated to EDE. The rationales that the Joint Applicants offer in support of these two proposals are virtually identical. The Joint Applicants claim that:

- It is the addition of the EDE power supply portfolio and transmission assets that produces the cost savings or the incremental profits; and
- Allocation of 100% of the savings, or of the incremental profits, places the benefits with the division incurring the cost, including the cost of the premium and the other costs incurred to combine the companies and realize the synergies.

(DeBacker Surrebuttal, Ex. 18, p. 10, lines 16-22, and p. 11, lines 10-17).

The first reason given above is fallacious, for the reason stated by Dr. Proctor in his rebuttal testimony. (Proctor Rebuttal, Ex. 713, p 46, lines 15-19). There is no more reason to say that the addition of the EDE power supply portfolio produces the cost savings than there is to

say that the addition of the MPS power supply portfolio produces the cost savings. It would seem to be equally valid to allocate 100% of the cost savings, or incremental profits, to MPS, as it is to allocate them to EDE.

One might ask how the Joint Applicants decided to bestow all of these benefits upon EDE. The answer may be found in the Joint Applicants' regulatory plan. As Dr. Proctor observed: "The true rationale for the allocation of one hundred percent of these energy cost-related opportunities to EDE is that it is a part of the regulatory plan sponsored by UCU witness John W. McKinney." (Proctor Rebuttal, Ex. 713, p. 46, lines 20-22).

Under the regulatory plan, EDE would be under a rate freeze for the first five years of the ten-year plan, and would be prohibited from filing a rate case during this time. Allocating the cost savings and incremental profits to EDE would ordinarily reduce the revenue requirement of EDE; but with a rate freeze in place, there would not be a corresponding reduction in rates.

MPS, on the other hand, would not be subject to the rate freeze, so it would be permitted to seek rate increases throughout the ten-year term of the regulatory plan. But since no cost savings or incremental profits would be allocated to MPS, its revenue requirement might increase and rate increases might be authorized.

The Joint Applicants would thus benefit, under the regulatory plan, by allocating all cost savings and incremental profits to EDE – even though MPS would obviously be making a significant contribution to achieving any cost savings or incremental profits that are, in fact, realized.

In the words of Dr. Proctor, "under the regulatory plan proposed by the Merger Applicants, MPS ratepayers would not share in any energy cost-related opportunities from the

merger for a ten-year period from the consummation of the merger." (Proctor Rebuttal, Ex. 713, p. 47, lines 8-10).

The Electric Allocations Agreement proposed by the Joint Applicants should therefore be revised. It would be far more logical and reasonable for this agreement to reflect, as Dr. Proctor proposes, "an equitable sharing of the energy costs from the joint dispatch of the power supply resources of the two previously separate systems." Specifically, the energy costs should be "allocated between MPS and EDE in proportion to the stand-alone costs calculated for each system in the same month." (Proctor Rebuttal, Ex. 713, p. 43, lines 13-17).

## XIII. SAVINGS TRACKING

### A. Savings tracking cannot be done objectively, so no merger savings can be conclusively proven

Merger tracking is a post-merger process where the merged entity asserts that specific transactions relating to the merger can be identified, verified and the dollar amount quantified. Utilities allege that this process can show if a merger is successful from a savings/synergies perspective. The differences between "tracked" post-merger cost-reduction transactions of the merged entity and the pre-merger baseline of the standalone pre-merger company are noted to show purported merger savings. (Fischer Rebuttal, Ex. 703, pp. 32-33; Featherstone Rebuttal, Ex. 702, p. 72).

The Joint Applicants propose to track merger savings for use in rate cases to expected to be filed beginning in Year 5 following the merger. (Oligschlaeger Rebuttal, Ex. 712, p. 11). As part of the regulatory plan proposed by the Joint Applicants, these savings will allegedly "ensure" a minimum of $3 million annually in revenue requirement reductions in years 6 to 10 following the merger. (Id.).

The Joint Applicants will "track" merger savings generated by the merger by using PeopleSoft accounting software. This is the software that UtiliCorp uses for its present accounting system. (Fischer Rebuttal, Ex. 703, p. 49). Many utilities use this brand of software to capture the costs and revenues of the operations of its different companies and specific business units. (Id.). PeopleSoft provides a means to categorize expenses to very specific cost centers. However, UtiliCorp employees subjectively make the decisions where costs should be booked and how costs are accounted for. (Id. at 69).

The Staff is opposed to the Joint Applicants' proposed regulatory plan in general, and to the tracking of merger related savings in particular, because it believes it is not realistic nor practical to do so. (Fischer Rebuttal, Ex. 703, p. 32 and Featherstone Rebuttal, Ex. 702, p. 72). The Commission should not approve UtiliCorp's proposal to track merger related savings to justify the recovery of the acquisition premium because:

- 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.

(Featherstone Rebuttal, Ex. 702, pp. 75-76)

For these reasons, some discussed further below, Staff recommends rejection of the proposal for merger savings tracking.

**B. Savings tracking is impractical and unrealistic because of the subjectivity involved**

Tracking merger savings on an after-the-fact basis requires a comparison between actual financial results achieved after a merger and what the financial results would have been for an entity if the merger had not taken place. This requires guesswork on someone's part to come up with a hypothetical scenario in order to quantify actual merger savings. For the guesswork, one must assume either that the stand-alone pre-merger entity's financial results can be frozen at a point in time for a period of years, or that one can project prospectively what that entity would have done on a stand-alone basis post-merger, so that the pre-and post-merger situations can be compared. The first assumption is unrealistic in that no entity remains frozen in place for years at a time, and the second assumption involves totally subjective speculation as to the future actions of an entity based on hypothetical situations. (Oligschlaeger Rebuttal, Ex. 712, p. 33).

Utilities are complex organizations with overlapping activities and functional areas. They are dynamic organizations that operate in ever-changing environments. Utilities are constantly organizing and reorganizing functions to streamline activities and obtain efficiencies. Utilities change to obtain efficiencies through implementation of new processes and technologies. It is not realistic to believe that a company will be able to measure the merger

related savings from non-merger related savings in an after-the-fact fashion when there are so many changes that occur during the normal course of operations. Further, it is not realistic to isolate savings from merger and non-merger related causes. It is very difficult to determine and measure the "cause and effect" relationship that exist between taking an action and identifying and measuring the effects of that action and not taking an action and identifying and measuring the effects of the nonaction. (Featherstone Rebuttal, Ex. 702, pp. 73-74). This inherent problem is even worse in the case of a company such as UtiliCorp, which is continually engaged in merger and acquisition activity. How can the cost impacts of one merger be distinguished from that of others? (Fischer Rebuttal, Ex. 703, pp. 60). Any tracking system would have to be sophisticated enough to not only identify categories of prospective savings and costs, but would have to be able to create documentation to support examinations which would be conducted on an after-the-fact basis to recreate the decision-making process surrounding the costs and savings for merger as well as for non-merger related events. (Featherstone Rebuttal, Ex. 702, p. 74).

Disagreements and disputes will occur between the parties as to how to measure, quantify and verify the merger savings. An efficiency one party will assert is the result of a merger, another may view as nothing more than an operational efficiency, addressing a pre-existing condition of an on-going concern. These after-the-fact disputes are certain because utilities have every incentive to identify as much merger savings as possible to capture these benefits for the shareholders. Because of this incentive to identify merger benefits for shareholders, it will be increasingly difficult on a going-forward basis to truly identify and quantify merger savings from non-merger savings since it is not possible to objectively evaluate what would have happened if the merger had not occurred. Utilities will make every effort to take credit for savings, calling them merger related if recovery of the acquisition adjustment is at stake. (Id. at p. 74, Tr. 210).

Joint Applicants' witness Jerry Myers, in a transcribed interview with Staff, stated that the PeopleSoft system would have the capability of tracking non-merger related savings and make a distinction between those that are merger related. Staff witness Janis Fischer interpreted that to mean that if UtiliCorp employees can make the distinction between non-merger and merger-related savings and tell PeopleSoft where to capture it, PeopleSoft could "track" the savings. The software accounting system itself would not be able to make the distinction. Ms. Fischer testified that the PeopleSoft accounting system is not the problem in determining accurately the merger and non-merger related savings; the problem is inherent to the human intervention required for the coding of every possible merger and non-merger related transaction. (Id. at 69-70). Mr. Oligschlaeger further testified that the difficulty in tracking merger savings is not the sophistication of accounting systems, but the inherent lack of knowledge people have of the financial impact of events and actions that did not occur. The best accounting system in the world will not cure that problem. (Oligschlaeger Rebuttal, Ex. 712, p. 34).

**C. No real tracking methodology proposed**

Joint Applicants' witnesses McKinney and Myers direct testimony fails to give any substantive description of how cost tracking is actually going to be accomplished. Mr. McKinney only gives a very general conceptual discussion about how savings tracking will work to guarantee merger benefits to customers. (Oligschlaeger Rebuttal, Ex. 712, p. 34).

Mr. Myers explained how UtiliCorp will track merger savings using PeopleSoft accounting software. (Fischer Rebuttal, Ex. 703, pp. 50-51). During a transcribed Staff interview, Mr. Myers provided a document to illustrate his understanding of how UtiliCorp will identify merger savings. The document was apparently developed for informational purposes to discuss merger savings tracking during the Staff interview of Mr. Myers. (Id. at 50 and Sch. 5;

Myers Surrebuttal, Ex. 13, Sch. JDM-1). The purpose of the document was to demonstrate how the savings "tracking process" would work. (Id. at 50).

The document illustrates the line item components in the merger savings equation: the EDE and UtiliCorp 1999 budget baselines and the UtiliCorp incremental cost, all with an assumed inflation rate of 2.5% added for each year out from 1999 to 2004. The Empire 1999 budget baseline represents the expenses that Empire budgeted for 1999 and the UtiliCorp 1999 baseline represents its budgeted expenses for 1999. The UtiliCorp incremental costs represent Empire overhead costs that will become part of UtiliCorp's ESF and IBU allocations that are distributed throughout the UtiliCorp organization. The UtiliCorp baseline and incremental will be added together and a portion of the sum will be allocated to EDE and deducted from the EDE baseline. This difference represents the alleged merger savings. UtiliCorp baseline and incremental costs will be coded by UtiliCorp employees using the PeopleSoft accounting system, but the EDE baseline will not be coded to PeopleSoft. The actual savings will not be identified in the system since they represent the difference between the uncoded EDE baseline and EDE portion of the sum of the UtiliCorp baseline and incremental costs. (Fischer Rebuttal, Ex. 703, p. 51).

Ms. Fischer testified that the tracking method described by Mr. Myers in his testimony and Schedule JDM-1 of his surrebuttal testimony (See also Fischer Rebuttal, Ex. 703, Sch. 5) will not be able to distinguish between merger and non-merger savings. (Fischer Rebuttal, Ex. 703, pp. 51-52). The changes in costs as the companies move out in time from the 1999 baselines will be indistinguishable from merger savings. In essence, "merger savings" will be calculated as the difference between an escalated pre-merger EDE budget and post-merger costs allocated to the EDE division of UtiliCorp. Using this approach, UtiliCorp will be able to take

"credit" for savings unrelated to the merger, such as increased employee productivity, changes due to technological efficiencies, and additional acquisitions. (Id. at 52).

Apparently responding to the Staff's criticism on this point, Mr. Myers addressed the question of distinguishing merger and non-merger earnings in his surrebuttal testimony. (Myers Surrebuttal, Ex. 13, pp. 3-4). Conceding that his surrebuttal schedule JDM-1 will produce a bottom line result containing both merger and non-merger "savings," Mr. Myers proposed a method for separating the two. He proposed that UtiliCorp would provide dollar estimates of the value of "improvements in technology" and "changes in regulatory requirements" and then subtract those estimates from the pool of "savings" calculated according to schedule JDM-1. Mr. Myers claims that the remaining savings would be assumed to be "merger-related." He states that Staff would have the opportunity to review and audit the non-merger savings quantifications (Id. at 4).

By UtiliCorp completing the tracking of merger savings in an after-the-fact fashion but providing to the Staff an opportunity to review and audit the findings, Mr. Myers' plan really results in a shifting of the burden of proof to Staff, which must rebut UtiliCorp's analysis. It will be the responsibility of the Staff and other opposing parties to "catch" every problem of the tracking system—a system yet to be developed and one that has never been developed. (Featherstone Rebuttal, Ex. 702, p. 76-81).

Mr. Myers admits this approach will not be "100% accurate." (Myers Surrebuttal, Ex. 13, pp. 3-4). The Staff believes this approach to distinguishing merger and non-merger savings, such as it is, has no validity at all. It misses entirely the point of the Staff's criticisms of savings tracking efforts, i.e., that there is no reasonable and objective way by which UtiliCorp, the Staff or any other party can derive estimates of non-merger savings compared to merger

savings after-the-fact, and then claim these estimates can be "audited." Mr. Myers' suggested process would be simply an exercise in taking UtiliCorp's guesses as to achieved merger and non-merger savings, compare them to Staff's guesses, and asking the Commission to decide which guess is "better." Without any attempt to go into more detail than Mr. Myers does as to how UtiliCorp's proposed identification of merger-related savings would work in practice, the Staff still believes UtiliCorp has failed to define its method for tracking merger saving in the future.

Staff also believes that the use of any baseline for tracking purposes will require a complete Staff review to determine what adjustments must be made to normalize expenses. (Fischer Rebuttal, Ex. 703, pp. 57-58). Staff is concerned about Joint Applicants' use of the EDE 1999 budget as the baseline to which future expenses will be compared in determining if merger savings have occurred or at what amount. (Id. at 58-59). The 1999 budget variances demonstrate that the use of EDE's 1999 budget as a baseline may allow non-merger savings to be "tracked" as merger savings. (Id. at 57 and Sch. 7).

The parties to this case do not agree on what starting point should be used if the Commission approves a tracking system. (Tr. 206-207, 209, 240, 819-820 and 858). UtiliCorp was even confused on what Staff's recommendation would be if the Commission approved a tracking proposal. While UtiliCorp is proposing to use Empire's 1999 budget as the baseline, Mr. Myers thought Staff was proposing to use the 1998 budget. (Myers Surrebuttal, Ex. 13, p. 4 and Tr. 862-863). Mr. Empson attempted to leave the impression that there was an agreement between UtiliCorp and Staff or that the two parties were close to an agreement regarding the operation of a savings tracking system. (Tr. 206). However, Staff Counsel made a statement on

the record making it clear there was no such agreement and that the two parties were not close to any such agreement.

> MR. DOTTHEIM: Before we leave the Savings Tracking/Benchmarking issue, I'd like to provide a clarification from the perspective of the Staff.
>
> On Monday when Mr. Empson was on the stand, he indicated that he thought that the companies, the joint applicants and the Staff were close to an agreement respecting Savings Tracking and Benchmarking issues.
>
> I asked Mr. Empson from who on the part of the Staff did he have that impression and he wasn't able to name any Staff member. I subsequently checked with the various members of the Staff who would be aware if the joint applicants and the Staff were close to an agreement on Savings Tracking and Benchmarking, and no one on behalf of the Staff has been able to confirm that.
>
> The Staff—and I'd like to be clear on this—considers that we don't have an agreement with the joint applicants on Benchmarking and Savings Tracking and we are nowhere close to an agreement among the joint applicants and the Staff on Savings Tracking and Benchmarking.

(Tr. 819-20)

Mr. Empson indicated the importance of defining a starting point benchmark so UtiliCorp could know how it was going to measure merger savings.

> MR. EMPSON:
> . . . I think there'll be some disagreement perhaps, but I think if you – once you get the starting points and you know what numbers that you're dealing with, you can minimize that disagreement.
>
> But it's important to define the up-front starting point as clearing as possible and then how you're going to measure it, because we have proposals for how you would measure those differences . . . .

(Tr. 210)

Since there is no agreement on the starting point through the benchmarking process, it will be nearly impossible to develop a tracking system that would identify merger savings sufficient to meet even UtiliCorp's own criteria.

While Staff is opposed to the tracking of merger savings, its position relating to the starting point baseline—should the Commission approve a merger tracking proposal—is that the baseline should be cost of service calculation used in Empire's planned pre-moratorium rate case expected to be filed as result of the completion of that Company's State Line generating facility. (Traxler Rebuttal, Ex. 716, p. 18-19) As previously mentioned, the Joint Applicants are advocating use of the 1999 Empire budget as the savings tracking benchmark. The Staff is opposed to the use of budgeted amounts for this purpose, because budgets are based on estimates of future events a year or more in the future at the time they are prepared. (Traxler Rebuttal, p. 19).

The transition teams will identify payroll and non-payroll costs that will become incremental costs of UtiliCorp after the merger. Procedures will be communicated to key UtiliCorp departments regarding the proper tracking of these incremental costs. The Joint Applicants have not provided to Staff any written procedures to support that the coding process has been determined. Without an analysis of these procedures for company staff that demonstrate coding and allocations of St. Joseph costs into the UtiliCorp accounting system, Staff cannot verify that a tracking mechanism exists. This fact is another reason Ms. Fischer concluded that UtiliCorp in actuality doesn't have a formal tracking proposal. (Fischer Rebuttal, Ex. 703, p. 56).

In this proceeding, UtiliCorp has not been shy about telling the Commission exactly what determinations it expects the Commission to make now concerning its regulatory plan. (McKinney Surrebuttal, Ex. 5, pp. 24). Interestingly enough, the ordering of a specific savings tracking methodology is not one of those determinations. Mr. Jerry Myers states "approval of a specific tracking system is not critical to approval of the merger. Under the proposed regulatory

plan, in future rate proceedings, UtiliCorp will have the burden to quantify merger savings." (Myers Surrebuttal, Ex. 13, p. 6).

In Mr. Myers' testimony, he further explained that the Joint Applicants did not provide to the Commission a detailed and specific plan to track merger savings because the merger transaction had not been approved, and because there had been no agreement by the parties or an order by the Commission concerning what baseline would be used to measure savings tracking. (Myers Surrebuttal, Ex. 13, p. 7)

Even though UtiliCorp believes it is important to formally document the merger tracking system, it did not bother to provide the Commission the opportunity to review any tracking system the Company intends on using in the future. In very revealing testimony, UtiliCorp indicates it does not have a present plan. Given the importance of the $3 million minimum revenue requirement benefit in protecting customers from merger-related detriment (i.e., rate increases)—a benefit which is to be ensured solely through a savings tracking mechanism—the failure of the Joint Applicants to propose a detailed saving tracking procedure is reason enough to reject the regulatory plan in its entirety.

### D. Inability to track savings means that non-merger savings available to EDE on a stand-alone basis can be imputed as merger related savings

Staff believes that UtiliCorp has an incentive to show all savings are merger related since an integral part of their proposed regulatory plan depends on tracking merger savings. (Featherstone Rebuttal, Ex. 702, p. 74; Fischer Rebuttal, Ex. 703, p. 47). In a transcribed interview with Staff (cited in Ms. Fischer's Rebuttal Testimony, Ex. 703, pp. 47-78), Joint Applicants' witness Vern Siemek states that other than tracking savings to cover the $3 million minimum "savings" guarantee for post-merger years 6-10, defining merger and non-merger related savings is not very important. (The Staff notes for clarification that all savings and cost

elements listed on Schedule VJS-1 would need to be tracked, not just the amount of $3 million in net savings.)

Ms. Fischer testified that the ability to accurately determine non-merger related savings from merger savings is important because ratepayers typically get the benefits of non-merger savings through cost of service reductions that ultimately reduce rates. Applying savings toward the regulatory plan proposed by UtiliCorp without clearly separating merger savings from non-merger savings would jeopardize the flow of non-merger savings to ratepayers, regardless of the merger. Customers expect to benefit from the actions of a prudent management operating the utility. When costs increase, customers are generally asked to pay for those increased costs through increased rates. Accordingly, it is equally expected that customers receive the benefits in reduced rates when costs decrease. (Fischer Rebuttal, Ex. 703, pp. 59-60).

Staff has determined several examples of non-merger savings that may occur at both UtiliCorp and EDE within the next few years. UtiliCorp **_____ _____** and it could realize cost savings from the corporate-wide implementation of PeopleSoft for Human Resources software. (Fischer Rebuttal, Ex. 703HC, pp. 61-63). EDE had also implemented PeopleSoft software and would realize stand-alone cost savings from its implementation. Empire could implement **_____ _____** (Fischer Rebuttal, Ex. 703, pp. 63-64). There will probably be many opportunities for savings in the next five years for both UtiliCorp and EDE that cannot be identified at this time, and will not be attributable to the merger.

Staff believes that savings will continue to accrue to UtiliCorp in the next several years due to its company re-engineering efforts under Project BTU ("Building Tomorrow's



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UtiliCorp"), implemented in 1996. These types of non-merger savings will be difficult or impossible to differentiate from merger savings on a going-forward basis, post-merger. Efficiencies developed through the Project BTU re-engineering will be amplified through the EDE and Empire District mergers, making re-engineering non-merger saving nearly impossible to separate from merger savings. (Fischer Rebuttal, Ex. 703, pp. 65).

Ms. Fischer testified that EDE's Competitive Positioning Process (CPP) implemented during 1995, generated savings through labor expense reductions. This type of stand-alone savings through labor force reduction is possible in the future. (Fischer Rebuttal, Ex. 703, p. 67).

Staff believes that there is no mechanism available that can segregate merger savings from savings generated from re-engineering or other cost-saving methods employed on a stand-alone company basis. The UtiliCorp/EDE merger savings "tracking" proposal cannot be relied upon because the estimates contain savings generated from re-engineering and other cost-saving methods. (Fischer Rebuttal, Ex. 703, p. 68). A commitment to achieve the levels of proposed savings does not mean that the level of savings, if achieved, are totally merger-related.

**E. Other merger tracking attempts have failed**

UtiliCorp attempted to track merger savings following their acquisition of West Plains Energy Kansas (West Plains) from Centel in 1991. In Docket No. 175,457-U, the Kansas Corporation Commission (KCC) allowed UtiliCorp to acquire the electric assets of Centel subject to stipulated conditions. The stipulation contained a two-year rate moratorium, a reduction in UtiliCorp's initial rate tariffs, a refund to retail ratepayers within the West Plains service territory and prohibited UtiliCorp form seeking rate recovery of any acquisition premium beyond the level of savings generated by the acquisition. In that case, UtiliCorp did not propose a method for identifying and quantifying merger savings in the initial acquisition case. The

determination of any acquisition premium, the recovery of such costs and the issue of an appropriate measuring mechanism for the merger savings were deferred until the UtiliCorp's next rate case. (Fischer Rebuttal, Ex. 703, pp. 45).

When the issue of documenting the actual merger savings was brought before the KCC to justify recovery of an "acquisition premium," UtiliCorp attempted to include a multitude of cost savings that the KCC ultimately decided were not merger related. (Fischer Rebuttal, Ex. 703, p. 45-46). The following excerpts from the KCC rate case decision (Docket No. 99-WPEE-818-RTS) are instructive:

> 18. The largest claimed savings is based upon the position that the Applicant (UtiliCorp) was entirely responsible for the reduced coal costs at the Jeffrey Energy Center . . . It appears that the primary reason for coal cost savings is Western's motivation to lower its coal costs and that the Applicant benefited from Western's efforts... Moreover, the Applicant failed to carry its burden of proof with respect to these claimed savings and failed to establish that the coal cost savings would not have been created but for the Centel acquisition.
>
> . . .
>
> 20. . . . The third source of claimed savings is a Power Plant Matrix Agreement, which resulted in staff reductions and increasing plant capacity factors . . . The evidence does not show that these savings would not have been realized but for the Centel acquisition or that the savings related to a sharing of personnel with West Plains . . . It appears that this type of employee reduction was in line with prudent utility management.
>
> 21. The fourth source of claimed merger savings is power plant savings from efficiency programs recently implemented by the Applicant in 1998. Similarly, the applicant claimed savings in a general workforce reduction implemented by the Applicant four years after the Centel assets were acquired. It appears from the evidence that these types of claimed savings are the result of good utility management and consistent with industry standards. The evidence does not establish that these recent corporate changes and restructuring efforts were related to the Centel acquisition.
>
> . . .
>
> 24. The final source of claimed cost savings is a general workforce reduction implemented by the Applicant starting in 1995. This reduction is said to involve 60 positions and is claimed to reduce costs by over $4.6 million . . . It appears that the workforce reductions were the result of general economic changes in the electric industry that were forcing all electric utilities to make such workforce reductions.

25. . . . In addition, the Commission notes that West Plains initially failed to provide adequate evidence and testimony to document their claimed savings and this failure unfortunately complicated and prolonged these proceedings.

(Emphasis added; Fischer Rebuttal, Ex. 703, p. 45-46, containing excerpts from KCC Order on Application, Docket No. 99-WPEE-818-RTS, pp. 18, 20, 21, 24-25)

Staff believes that the experience of the West Plains case relates to the present UtiliCorp/EDE case in that UtiliCorp will attempt to mix non-merger savings with merger savings in the present merger case, just as it did in the West Plains case. (Fischer Rebuttal, Ex. 703, p. 47).

In the "Acquisition Adjustment" section of this initial brief, information pertaining to an attempt by Kansas Power & Light Company (KPL) to track merger savings in Missouri in Case No. EM-91-213 is presented. In that proceeding, the Staff also argued conceptually against proposals to track merger savings, because such efforts would be very difficult and perhaps impossible to perform successfully. In a later rate proceeding, KPL abandoned any attempt to track merger savings in Missouri. What is interesting about the KPL case is that while the company was not seeking direct recovery of the acquisition premium, it developed and proposed a much more detailed tracking proposal than the Joint Applicants did in this case, and the Commission ultimately rejected KPL's proposal. (Featherstone Rebuttal, Ex. 702, pp. 85-87, 90, and 93-94). This history is set out in more detail in the "Acquisition Adjustment" section of this initial brief.

### F. No merger tracking system has ever been developed and successfully implemented

No merger tracking system has ever been successfully developed or implemented in this jurisdiction or in any other jurisdictions, to the Staff's knowledge. Further, the Staff is not aware

that a merger savings tracking system has ever been used anywhere to set rates. (Featherstone Rebuttal, Ex. 702, p. 76) In several past Missouri merger applications, the Staff has had the opportunity to interview utility consultant Thomas J. Flaherty, a partner in Deloitte & Touche, LLP., a specialist in utility mergers. On pp. 77-80 of Staff Witness Featherstone's rebuttal testimony, an excerpt of a transcribed interview of Mr. Flaherty by Staff in the Western/KCPL merger application (Case No.EM-97-515) is shown. In this excerpt, Mr. Flaherty discusses the reasons why a tracking system has never been successfully developed or implemented for rate purposes. Mr. Flaherty identified the key factor as being the inherent inability to measure the costs and savings associated with after-the-fact events and separate the events between merger and non-merger impacts.

The Commission should keep in mind that UtiliCorp's proposal to use a savings tracking mechanism to set rates and allegedly protect ratepayer interests is completely untested and untried both in Missouri and in other jurisdictions. The Commission should not rely upon a belief that a tracking system can later be successfully agreed to and implemented as a basis for granting approval to an otherwise objectionable regulatory plan.

## XIV. MPS SAVINGS ASSIGNMENT

If this merger is approved, one decision the Commission must make at some point is how any resulting merger savings should be assigned between the UtiliCorp Missouri divisions, MPS and EDE, for ratemaking purposes.

UtiliCorp's proposal as to the division of merger savings between EDE and MPS is a simple one: assign all merger savings to EDE (with one minor exception). The only exception to the Joint Applicants' proposed treatment is the relatively minor savings

estimated to occur in the generation capacity area, which are proposed by the Joint Applicants to be evenly split between MPS and EDE. The amount of the savings to be assigned to MPS is approximately $643,600 on an annual basis. (Holzwarth Direct, Ex. 26, p. 19).

The Staff strongly disagrees that, if this merger is approved, that all or nearly all of any resulting savings should be assigned solely to the EDE division of UtiliCorp. There are several reasons for this position.

First, Mr. Myron McKinney in his direct testimony asserts that once benefit of this merger is that it allows for the creation of economy of scale benefits (Myron McKinney Direct, Ex. 1, p. 8). "Economies of scale" are per unit cost reductions that result from an increasing size of the unit. Due to UtiliCorp after the merger being a bigger company than either the pre-merger UCU or the stand-alone EDE, the Joint Applicants allege that some of the merger savings relate to the combined entities' increased size. (Oligschlaeger Rebuttal, Ex. 712, pp. 44-45). None of these alleged merger savings would be possible unless both pre-merger utilities are combine together through the merger transaction.

For this reason, simple fairness and equity argue that both entities deserve an apportionment of merger savings. Each utility's ratepayers have historically paid in rates the costs of the individual entities for which reductions are now possible, in theory, due to the merger. (Oligschlaeger Rebuttal, Ex. 712, pp. 45-46). It would be blatantly unfair and unreasonable to assign all merger savings to one entity, benefiting only one set of customers. A particularly clear example of this potential inequity is in the joint dispatch/generation savings estimated by the Joint Applicants in this case. Joint dispatch savings are caused by bringing two sets of formerly separate generating resources together. Should MPS customers, who have historically paid for the costs of MPS' generating stations through depreciation expense and a

rate base return on those facilities, be totally ignored when those same generating facilities allow, in part, the possibility of merger savings hen combines with EDE generating resources? The answer is clearly no.

The second reason the Staff is opposed to the assignment of a grossly disproportionate amount of savings to the EDE division is the relative rate levels of the two utilities. Staff witness Philip K. Williams submitted evidence in his rebuttal testimony from several sources that current MPS rates are, in general, considerably higher than current EDE customer rates. (Williams Rebuttal, Ex. 717, p. 6-16). The Staff fears that one consequence of the merger would be a long-term trend of EDE rates increasing towards MPS level. (Id. at 15). In respect to this issue, however, the Staff foes not believe it is appropriate to flow all or almost all merger savings to UtiliCorp's proposed EDE customers currently paying relatively low rates, while completely ignoring UtiliCorp's MPS customers currently paying relatively high utility rates. (Oligschlaeger Rebuttal, Ex. 712, p. 46). Again, this proposal fails the fundamental fair and reasonable test.

As previously mentioned, UCU attempts to justify this wholly inappropriate proposed assignment of merger savings by asserting that all of the merger costs, including the acquisition premium, are being assigned to EDE. Therefore, according to UCU, since the merger savings should follow the costs, all savings likewise should go to EDE. In response, the Staff notes that the assignment of all merger savings to EDE is a choice made by UCE; it is not mandatory. The fundamental unfairness and unreasonable of ignoring MPS almost entirely in assigning merger savings is a much more important matter than consistency with a UtiliCorp decision to assign all merger costs to EDE. The Staff is not opposed to a reasonable assignment of merger transition cots to MPS along with a fair and reasonable portion of merger savings.

The Joint Applicants have argued that not assigning any merger costs or savings to MPS leaves that division in a status quo situation in respect to the merger, therefore protecting MPS customers from detriment. However, it is not true that MPS customers will not pay for any portion of the acquisition adjustment in rates under the proposed regulatory plan. As dicussed elsewhere in this initial brief, UtiliCorp has conceded that its proposal to "freeze" MPS' corporate allocators from the impact of the EDE transaction will lead to indirect recovery of part of the acquisition adjustment. (Tr. 241, 462). That proposal would lead to the MPS division being taken off cost-based ratemaking in future rate cases for the express purpose of allowing UtiliCorp certain indirect recovery of the acquisition premium. The Staff would submit that the frozen allocators proposal of UtiliCorp will lead to recovery of a significant merger cost (part of the acquisition adjustment) through MPs customer rates, and that this treatment cannot reasonably and fairly be considered as leaving MPS customers unaffected by the merger. In this light, the proposal to assign all merger savings to EDE is even more unfair and unreasonable.

For the above reasons, the Staff urges the Commission to reject UtiliCorp's proposed arbitrary assignment of almost all merger savings to the EDE division. If the Commission approves this merger, it should direct that any future merger savings should be shared in a fair and reasonable manner between EDE and MPS.

## XV. TRANSACTION COSTS AND COSTS TO ACHIEVE

At issue in this case is the regulatory treatment of certain costs that the Staff labels "Transaction Costs." These are costs directly associated with the completion of the merger transaction, including, for example, "fees paid for legal, banking and consulting services necessary to close the transaction." (Russo Rebuttal, Ex. 715, p. 3, lines 1-5). The Joint

Applicants argue that these costs are no different than "Costs to Achieve"[23] because they are all necessarily incurred in order to achieve the synergies potentially available as a result of the merger; that unless these transaction costs are incurred, no synergies will be possible. (Siemek Surrebuttal, Ex. 7, p. 29, lines 6-7). Accordingly, the Joint Applications propose that transaction costs receive the same regulatory treatment as costs to achieve.

The Staff takes the position that transaction costs are separate and distinct from costs to achieve and that, in part because of these distinctions, transaction costs should receive an altogether different regulatory treatment.

**A. Transaction costs are different from costs to achieve in that they are part of the overall cost of the transaction itself.**

Unlike costs to achieve, transaction costs are directly associated with a merger or acquisition transaction. Indeed, Accounting Principle Board Opinion No. 16 defines costs of a business combination accounted for by the method chosen by Joint Applicants (the "purchase method") as direct costs of the acquisition. (Russo Rebuttal, Ex. 715, p. 3, lines 8-12). "Under the 'purchase ' method of accounting for a business combination, direct out-of-pocket and incremental costs of the combination, including finders' fees and fees paid to outside consultants for accounting, legal, engineering investigations and appraisals, are considered direct costs of the acquisition." (Russo Rebuttal, Ex. 715, p. 3, lines 16-20).

The direct connection is easily appreciated when one considers that an acquisition can, in fact, occur irrespective of whether the acquisition partners incur any costs to achieve. On the other hand, an acquisition without the standard transaction costs is almost inconceivable. Costs of such items as legal, banking, and consulting services normally must be incurred in order to

[23] The Staff defines "Costs to Achieve" as "...costs that the Companies will incur in order to combine the systems and processes of EDE and UtiliCorp after a merger is approved." (Russo Rebuttal, Ex. 715, p. 9, lines 17-19).

complete the transaction. Transaction costs, then, are more standard in nature, and may be seen as "hoops" that the acquisition partners must "jump through" in order to consummate the deal itself. Indeed, when one refers to transaction costs, specific types of costs are quite likely to spring to mind. The same, however, cannot necessarily be said of costs to achieve, which are often unique to the particular business combination, and as such, are inherently more discretionary and thus often reflect a greater degree of creativity on the part of the merger partners regarding the types and amounts of expenditures. Lending further support to the argument that transaction costs are fundamentally different from costs to achieve is the fact that transaction costs are generally incurred during the time leading up to and including the execution of the transaction, while costs to achieve are normally incurred after (and sometimes long after) the transaction is completed. (Russo Rebuttal, Ex. 715, p. 12, lines 21-23, p. 13, lines 1-4).

**B. The regulatory treatment of transaction costs**

Given that transaction costs are a necessary and integral component of the transaction itself, it follows that the arguments advanced by the Staff as to why the acquisition premium---i.e., the amount by which the acquisition price exceeds the net book value of the acquired assets---should not be recoverable in rates are applicable also to the regulatory treatment of transaction costs. (Russo Rebuttal, Ex. 715, p. 7, lines 1-3). Like the acquisition premium, transaction costs are incurred primarily to further the interests of the shareholders and not the ratepayers. The shareholders, after all, are seeking to enter into the particular transaction as a way to increase the value of their investment. (Russo Rebuttal, Ex. 715, p. 7, lines 9-10). Any resultant benefit to the ratepayers is of secondary concern. Moreover, when a prospective business combination between regulated utilities also involves non-regulated operations, the companies have a real incentive to seek, to the extent possible, to have the combination financed out of the regulated

operations. Therefore, the shareholders, who are in the first instance the primary beneficiaries of any business combination, should bear the costs to consummate the transaction. Further, "the recovery of transaction costs, as stated in APB Opinion 16, is associated with the acquisition premium in purchase transactions and therefore should not be the responsibility of the ratepayers." (Russo Rebuttal, Ex. 715, p. 7, lines 6-8). Finally, like the acquisition premium but unlike costs to achieve or future savings, transaction costs represent up-front outlays of "hard" dollars that are rather easy to measure (Russo Rebuttal, Ex. 715, p. 7, lines 10-13). Again considering that these transactions are entered into primarily for the benefit of the shareholders, it is unreasonable to expect ratepayers to bear the burden of known transaction costs in exchange for the hope of being able to realize a portion of some potential future savings.

It should also be noted that a Commission decision in the instant case not to permit rate recovery of transaction costs is consistent with its recent rulings with respect to this issue. In April of this year, for example, in a case involving the acquisition by Atmos Energy Company of Arkansas Western Gas Company d/b/a Associated Natural Gas Company (Case No. GM-2000-312), the Commission approved a Unanimous Stipulation and Agreement, by the terms of which there will be no recovery of transaction costs. Likewise, in the merger case involving Kansas City Power & Light Company and Western Resources, Inc. (Case No. EM-97-515), the Stipulation and Agreement, approved by the Commission on September 2, 1999, called for no recovery of transaction costs.

Notwithstanding the Staff's position to the contrary, in the event that the Commission decides that recovery of transaction costs in rates should be permitted, Staff would recommend that they be amortized over a period of 40 years. (Russo Rebuttal, Ex. 715, p.76, lines 21-23). This is in contrast to the Joint Applicants' proposal that transaction costs be amortized along