

UTILICORP UNITED INC.

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

FILED²

OCT 19 1999

Missouri Public
Service Commission

In the matter of the Joint Application of)
UtiliCorp United Inc. and St. Joseph Light)
& Power Company for authority to merge)
St. Joseph Light & Power Company with)
and into UtiliCorp United Inc. and, in)
connection therewith, certain other related)
transactions)

Case No. EM-2000-292

UtiliCorp United Inc. and St. Joseph Light & Power Company Merger

Direct Testimony

October 19, 1999

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

Before the Public Service Commission
of the State of Missouri

Direct Testimony
of
John W. McKinney

October 19, 1999

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

CASE NO.

INTRODUCTION

1

2 Q. Please state your name.

3 A. My name is John W. McKinney.

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

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

7 Q. Please state your business address.

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

9 Q. Please describe your educational and employment history.

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

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

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

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

6 A. My direct testimony will,

- 7 • explain the planned operation of the St. Joseph Light & Power Company
- 8 ("SJLP") properties by UtiliCorp as a separate retail energy distribution unit;
- 9 • explain UtiliCorp's regulatory plan;
- 10 • explain the rate moratorium;
- 11 • discuss the merger synergies ;
- 12 • discuss why sharing of benefits is appropriate;
- 13 • discuss acquisition premiums;
- 14 • discuss misconceptions about premiums and merger savings;
- 15 • discuss regulatory treatment of premium recovery and merger savings;
- 16 • discuss appropriate capital structures;
- 17 • discuss synergy sharing
- 18 • discuss RTO's and Market Power;
- 19 • discuss the Commission's jurisdiction over the operations of the merged
- 20 company; and
- 21 • provide a brief summary.

22 OPERATION OF SJLP PROPERTIES

1 Q. How will UtiliCorp operate the SJLP properties?

2 A. UtiliCorp plans to operate the SJLP properties as a separate retail energy
3 distribution unit as described in more detail in the testimonies of UtiliCorp
4 witnesses Robert Green and Steve Pella. This includes separate rates for the
5 current SJLP customers.

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

7 A. Figure 1 below compares the electric rates of SJLP with the electric rates of
8 UtiliCorp's Missouri Public Service ("MPS") operating division.

Missouri LDC Rate Comparison (2)			
As of April 1999			
	SJLP (3)		UtiliCorp
Residential			
Summer @ 1000Kwh	\$ 70.63		\$ 77.51
Winter @ 750 Kwh	\$ 47.68		\$ 55.90
Annual Bills (1)	\$ 663.96		\$ 757.34
Annual Kwh	10,000		10,000
Annual avg \$/Kwh	0.0664		0.0757
Commercial			
Winter 50 KW / 12500 Kwh	\$ 602		\$ 651
Summer 50 KW / 12500 Kwh	\$ 852		\$ 945
Annual Bills (1)	\$ 8,227		\$ 8,988
Annual Kwh	150,000		150,000
Annual avg \$/Kwh	0.0548		0.0599
Industrial			
Winter 1000 KW / 400000 Kwh	\$ 14,566		\$ 14,411
Summer 1000 KW / 400000 Kwh	\$ 20,651		\$ 23,571
Annual Bills (1)	\$ 199,137		\$ 209,572
Annual Kwh	4,800,000		4,800,000
Annual avg \$/Kwh	0.0415		0.0437
(1) Annual bills are calculated by pricing the monthly usage by the base rate effective at the date of this schedule, and includes 12 months of customer charges.			
(2) Source Document: Typical Bills and Average Rates Report by Edison Electric Institute			
(3) Adjusted for SJLP 10/99 rate reduction of 1.33% for residential, and 4.23% for Commercial and Industrial.			
Figure 1			

9

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

1 A. Yes.

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

4 A. In the immediate future, UtiliCorp will continue to use the existing accounting
5 systems of SJLP until this accounting information can be transferred to
6 UtiliCorp's system.

7 Q. Is this important?

8 A. Yes. Since SJLP will be operated as a separate retail energy distribution unit, it is
9 imperative that the integrity of the accounting records be maintained to ensure
10 accurate accounting and reporting. After the transfer of information to
11 UtiliCorp's accounting system, the accounting information will be maintained in a
12 manner that will allow development of cost of service information necessary to
13 establish specific rates for the current SJLP operations and specific rates for the
14 current MPS operations.

15 **THE REGULATORY PLAN**

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

18 A. In preparing the regulatory plan, UtiliCorp concluded that the combination or
19 merger of the companies would definitely create benefits and that these benefits
20 should be shared between customers and UtiliCorp shareholders.

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

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

3 A. Anytime one company merges with or acquires another, sound economics require
4 that the transaction create sufficient synergies to allow for the recovery of the cost
5 of the transaction and to allow both customers and shareholders to benefit from
6 the transaction. If this cannot be accomplished, the financial profile of the
7 acquiring company will suffer and the transaction will not make any sense from
8 an economic standpoint.

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

11 A. Yes. Any combination of two utilities should result in the maintenance or
12 improvement of the efficiency and reliability of the surviving utility. Mr. Pella
13 will address UtiliCorp's customer care model and the new systems that are in
14 place to bring about these results.

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

17 A. Yes. The benefit or savings or synergies which result from the transaction must be
18 equal to or greater than the premium paid for the property, so that there will be
19 benefits for the customers after the cost of the premium is recovered. This is the
20 case with the merger of UtiliCorp and SJLP.

21 Q. Please explain.

22 A. The merger will clearly create savings which would not otherwise exist absent this
23 transaction. With the appropriate resolution of this case by this Commission, the

1 premium will be recovered by UtiliCorp and the customers will see benefits
2 including a lower cost of service. As I will explain later, it would be
3 inappropriate, however, for all of those savings to be passed on to either
4 shareholders or to customers exclusively without providing for the recovery of the
5 costs of the transaction.

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

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

- 10 1. UtiliCorp will not file any case with the Commission requesting a general
11 increase or decrease in electric, gas or steam rates for the SJLP operating unit
12 for a period of 5 years after the closing of the merger.
- 13 2. During the fifth year of the rate moratorium, UtiliCorp will prepare and file
14 general rate cases for the retail electric, gas and steam operations of the SJLP
15 unit. These rate cases will have operational law dates which coincide with
16 the conclusion of the 5 year rate moratorium;
- 17 3. These rate filings will include an accounting of the synergies realized during
18 the moratorium and the balance of the acquisition premium that is yet to be
19 recovered;
- 20 4. Included in these rate filings will be the complete flow-through of all test-year
21 O&M synergies, adjusted to the forward average level of saving for years 6
22 through 10 of the regulatory plan, net of the costs to achieve the synergies,
23 resulting from the merger;

- 1 5. Fifty percent (50%) of the unamortized balance of the acquisition premium
2 paid by UtiliCorp for SJLP will be included in the rate bases of the SJLP
3 unit's retail electric, gas and steam operations and the annual amortization of
4 this acquisition premium will be included in the expenses allowed for
5 recovery in cost of service in these cases. The return allowed on this
6 premium, for the recovery period, will be based on the capital structure of
7 60% debt and 40% equity as established by Mr. Siemek in his synergy study;
8 the net effect of item #4 and #5 is a guaranteed minimum reduction in the
9 SJLP revenue requirement of \$1.6 million.
- 10 6. The balance of the retail electric, gas and steam rate bases will be allowed a
11 return based upon a SJLP unit capital structure of 47% debt and 53% equity
12 for the period covered by the regulatory plan. This capital structure
13 approximates the capital structure recommended by the Staff in SJLP's last
14 rate case.
- 15 7. The allocation of corporate and intra-business unit costs to MPS shall exclude
16 the SJLP factors from the methodology for the period covered by the
17 regulatory plan.

18 **THE RATE MORATORIUM**

19 Q. Please explain the details of the rate moratorium.

20 A. During the 5 year rate moratorium, UtiliCorp will not file any case with the
21 Commission requesting a general increase or decrease in the rates, (electric, gas or
22 steam) for the SJLP operating unit unless there is the occurrence of a significant,
23 unusual event, such as: an act of God; a significant change in federal or state tax

1 law; a significant change in federal or state utility law or regulation; or an
2 extended outage or shutdown of a major generating unit(s), which has a major
3 effect on SJLP jurisdictional operations. The Staff of the Commission will not
4 encourage or assist in the filing of any case with the Commission requesting a
5 decrease in SJLP's (electric, gas or steam) retail rates or a rate credit or rate refund
6 during the moratorium. UtiliCorp may file for approval mutually agreed to
7 special contracts with its customers and other tariff items that would cause no
8 change in rates.

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

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

18 **MERGER SYNERGIES**
19

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

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

1 UtiliCorp witness Bob Browning will address the savings derived from the
2 combining of the employees into one employee benefit program; and UtiliCorp's
3 witness Bob Holzwarth will provide the details relating to the calculations of the
4 savings that will result from operational savings and the joint dispatch of the
5 generating plants.

6 Q. Please explain how UtiliCorp will be able to keep track of the synergies during
7 the rate moratorium and determine the level of synergies occurring during the test
8 year for the rate cases that are planned to be filed during year five of the
9 moratorium?

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

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

19 A. Synergies need only be proved to reach the proposed hurdle level in each
20 subsequent rate proceeding. Only if the synergies fall short is there an adjustment.
21 That adjustment would result in a lower percentage of premium being included in
22 the SJLP unit's rate base for recovery. Any synergies above that level are used to

1 reduce rates during the normal course of the rate proceeding and result in even
2 lower costs to the customers.

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

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

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

7 A. Yes. We believe customers should benefit if a utility finds a more efficient way
8 of providing service. As utilities cut costs, these savings ultimately should be
9 flowed through to the customers. By way of example, many efficiencies have
10 been gained through UtiliCorp's recent re-engineering efforts. These programs
11 were audited and discussed at length in UtiliCorp's most recent Missouri rate
12 case. The savings resulting from these efforts were flowed through to our
13 customers.

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

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

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

18 A. The Staff of the Commission recommended and the Commission allowed
19 UtiliCorp to recover these costs from customers through rates. It could be then
20 said that the "net savings" were passed on to the customers.

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

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

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

9 A. No, there is no difference. The merger involves costs, but the merger and related
10 costs create savings. The concept of netting the costs ties to a long-held regulatory
11 concept of matching that is a mainstay in all regulatory processes. We believe
12 that only net savings or benefits should be passed on to the customers and that the
13 costs should be deducted before the savings are distributed. Otherwise, there is no
14 incentive for the companies or shareholders to undertake the transaction.

15 Q. Is this approach detrimental to the customers?

16 A. No. The customers of SJLP will not be harmed and their rates will not be
17 increased as a result of this transaction.

18 **WHY SHARING OF BENEFITS IS APPROPRIATE**

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

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

21 Q. Please explain.

22 A. If a portion of the benefits are not used to recover the premium, it would
23 discourage further attempts to make beneficial business combinations between

1 Missouri utilities. In the long run, this would be to the detriment of utility
2 customers who would have otherwise benefited from better service and lower
3 rates as a result of such combinations.

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

6 A. It would be unreasonable.

7 Q. Why?

8 A. It is not fair or reasonable to assign all the costs to one party or stakeholder in a
9 transaction and give all of the benefits to another. The benefits should be shared
10 between the stakeholders by allowing the costs to provide those benefits to be
11 recovered.

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

14 A. It would be consistent.

15 Q. Please explain.

16 A. We are requesting that the Commission first examine our proposal and determine
17 that significant merger benefits are or will be created as a consequence of this
18 combination. Next, it is appropriate to determine the transaction (premium) and
19 transition costs associated with the benefits are reasonable. Finally, our filing
20 demonstrates that benefits will remain after the transaction (premium) and
21 transition costs have been covered. Any other outcome is unfair and
22 unreasonable.

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

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

6 ACQUISITION PREMIUM

7 Q. During your discussion of the proposed regulatory plan for the merged company,
8 you mentioned the concept of an acquisition premium and explained that the
9 merged company regulatory plan requested inclusion of the premium in rate base.
10 Is that correct?

11 A. Yes. UtiliCorp is requesting that in year 6 after the merger is closed, 50% of the
12 unamortized premium be included in the rate base of the SJLP unit and the
13 amortization of the premium be included in the cost of service of the SJLP unit
14 when rates are being established. In most cases, when reasonable, a premium
15 should receive cost of service recognition in utility rates.

16 Q. Why?

17 A. When a merger between two electric utilities creates quantifiable benefits through
18 cost savings, the premium and the costs to bring about those benefits should
19 receive rate recognition.

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

21 A. The inclusion of premiums in rate making is accomplished through the booking of
22 a premium in an acquisition adjustment account. The assets are required by the
23 FERC's Uniform System of Accounts to be recorded at original costs and the

1 premium in the acquisition adjustment account, which is amortized as an expense
2 over a period of years, as approved by the Commission. Generally, the premium
3 is treated as another part of the company's investment in serving customers which
4 it is entitled to recoup and earn a reasonable return on through the rates set by the
5 Commission.

6 Q. How is the premium determined?

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

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

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

18 Q. Is this transaction a pooling?

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

21 Q. What is the significance?

22 A. In a purchase transaction, the portion of the premium, commonly referred to as
23 "goodwill", recorded in the financial statements is the difference between the total

1 consideration, as described for the pooling-of-interests transaction, and the fair
2 value of the identifiable net assets acquired. In a purchase transaction, goodwill
3 does not necessarily equal the premium. That is, goodwill equals the premium
4 only when the book value of the acquired net assets equals the fair value of the net
5 assets.

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

9 Q. Does it really matter whether we use the term premium, goodwill, or acquisition
10 premium or acquisition adjustment?

11 A. No. These are just various accounting terms referring to the same value. For the
12 purpose of setting rates, the amount we are discussing is the amount paid over the
13 net book value of the assets of SJLP.

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

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

1 Q. Please continue.

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

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

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

16 **MISCONCEPTIONS ABOUT PREMIUMS AND MERGER SAVINGS**

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

19 A. I disagree with this argument because it does not consider the aggregate impact on
20 rates from a merger. Specifically, it does not take into consideration the cost
21 savings generated through synergies. When the premium and resulting cost
22 savings are analyzed together, the Commission will see that inclusion of the
23 premium in the cost of service will not increase SJLP's customer's rates. It will

1 even lower rates. Therefore, the transaction will be able to close. Consequently,
2 the suggestion represents an incorrect application of the public detriment standard.

3 Q. Please expand on this last statement.

4 A. When the impact on revenue requirements related to the premium is viewed
5 separately from other elements of a merger, it would naturally be perceived as a
6 detriment. However, a correct application of the public detriment standard should
7 be to ensure that the aggregate impact from the merger is not detrimental to
8 customers. In this merger of UtiliCorp and SJLP, the cost savings from synergies
9 should be considered and weighed against the cost of the premium.

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

12 A. Sometimes regulators believe that including a premium in utility rate
13 determinations provides incentives for the negotiating utilities to settle on a higher
14 purchase price. This misconception stems from an erroneous "all or nothing"
15 approach to premium recovery. When the ratemaking treatment of the premium is
16 judged for its reasonableness based on the value of aggregate merger benefits, the
17 purchasing utility has an incentive to minimize the premium paid for the acquired
18 utility because it may not receive full cost of service recognition for the premium.

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

21 A. No, of course not. When the utility realizes that the premium will be evaluated for
22 reasonableness, it accepts the risk of recovery of this element of cost in rates.

1 Actually, by arbitrarily choosing not to include a premium in rates, the regulators
2 create disincentives for mergers that may establish net benefits for customers.

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

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

10 A. This approach would be unreasonable.

11 Q. Why?

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

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

1 A. No. The Commission would determine the reasonableness of the premium just
2 like it determines the reasonableness of other investments and expenses incurred
3 by utilities. For example, it is common for regulators to evaluate the
4 reasonableness of electric plant investments based on capacity needs and other
5 economic and accounting criteria. Generally, the regulator performs this
6 evaluation of construction costs without participating in the utility management's
7 negotiations with contractors, equipment suppliers and board of directors.

8 Also, sometimes regulators believe that to establish a precedent of not allowing a
9 premium in the cost of service relieves the commission of the burden of testing
10 the purchase price for reasonableness. However, a commission is charged with
11 the responsibility of determining the reasonableness of utility rates generally.
12 Arbitrarily excluding a premium from rate determination may make the review
13 process simple for the regulators but would be contrary to the commission's
14 obligation to serve the public's interest and would undoubtedly discourage
15 beneficial mergers from occurring. That is, utility customers would be deprived of
16 merger benefits because shareholders are not permitted to recover reasonable
17 investments that include a premium and shareholders are not provided due process
18 in the review of their investment.

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

22 A. No. This assertion ignores the fact that the unregulated firm retains the cost
23 savings from synergies created through the merger. That is, in the case of the

1 unregulated firm, there is not a regulatory commission requiring merger savings
2 to be flowed to customers. Therefore, the unregulated firm recovers the premium
3 through the merger savings. Actually, when regulators do not allow recovery of a
4 premium and yet pass the all of the cost savings to the customers, it is the
5 regulated utility that is disadvantaged.

6 Q. Why?

7 A. This is because the regulated utility is not allowed to recover any part of the
8 investment in the premium on the one hand, while on the other it makes all the
9 merger savings available for its customers. The combined effect of this treatment
10 is to lower the utility's earnings below the level it would achieve without the
11 merger. Under these circumstances, a merger probably should not go forward.

12 REGULATORY TREATMENT OF PREMIUM RECOVERY

13 AND MERGER SAVINGS

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

16 A. The Commission has stated that it is not opposed to consideration of acquisition
17 adjustment for ratemaking purposes. Specifically, the Commission has indicated
18 that it is not opposed to the concept of a savings sharing plan (as part of an
19 acquisition adjustment request) provided that only merger-related savings are
20 shared. The Commission has said that it does not wish to prevent companies from
21 producing economies of scale and savings which can benefit ratepayers and
22 shareholders alike (Kansas Power & Light / Kansas Gas & Electric Case No.
23 EM-91-213). The Commission has evaluated each merger on its own merits and

1 has concluded that different circumstances have necessitated different approaches
2 and solutions. For example, in one case an earnings sharing grid was approved
3 with target returns set high enough to allow for full or partial recovery of the
4 premium or acquisition adjustment (Union Electric / Central Illinois Public
5 Service Co. Case No EM-96-149). In another case, rate freezes were established
6 for a period of time that allowed for a full or partial recovery of the acquisition
7 adjustment (Western Resources / Kansas City Power & Light Case No. EM-97-
8 515).

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

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

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

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

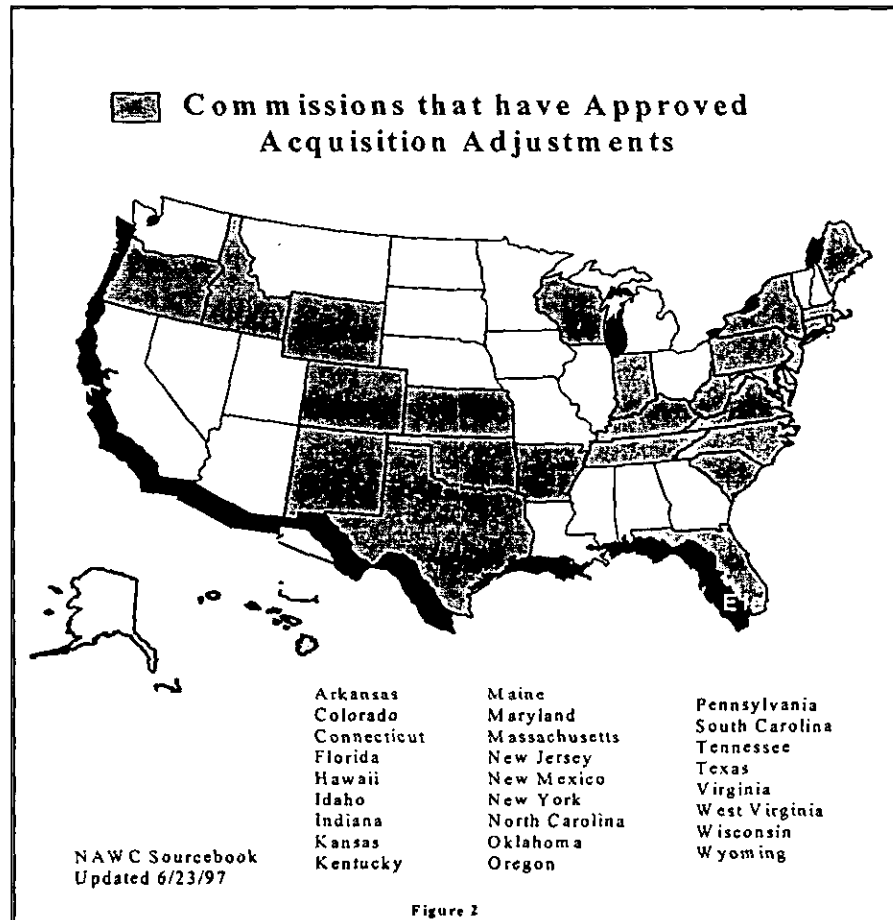
19 Q. Please summarize the results of your review.

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

1 Q. Are any of these cases noteworthy for purposes of the UtiliCorp-SJLP merger?

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

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



6

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

1 The Oklahoma Corporation Commission, (in an Oklahoma Gas and Electric
2 Company acquisition) established criteria which are pertinent to the UtiliCorp -
3 SJLP transaction. The Oklahoma Commission criteria are as follows:

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

9 Q. How do these points relate to this merger?

10 A. They describe this transaction.

11 Q. Please explain.

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

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

20 A. Yes, I have. In Accounting For Public Utilities, by Robert L Hahne, Gregory E.
21 Aliff, and Deloitte & Touche (1998 ed.), the issue of acquisition adjustments is
22 addressed. The general rule related to the acquisition of utility plant previously
23 used in the utility function is that the rate base component for the plant includes

1 only the original cost of the property to the first owner devoting the property to
2 public service. The excess amount paid is referred to as an acquisition adjustment
3 and is placed in a separate account to be treated for ratemaking purposes as so
4 authorized by the regulatory commission. The necessity of this separate
5 accounting treatment is largely a consequence of certain abuses in the utility
6 industry during the 1920s and 1930s. Commonly owned utilities were able to
7 inflate their rate bases by purchasing affiliated companies at inflated prices.
8 However, rate base treatment and/or cost of service treatment has been allowed by
9 various regulatory commissions under a variety of circumstances.

10 Q. Under what circumstances?

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

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

18 Q. Does the UtiliCorp/SJLP transaction meet these tests?

19 A. Yes.

20 Q. Have other commissions considered and employed these standards?

21 A. Yes. A number of cases exist where rate base and/or cost of service treatment has
22 been allowed as a result of satisfying the criteria listed above. For example:

1 The Tennessee Public Service Commission in 1969 allowed both rate base and
2 cost of service treatment for acquisition adjustments of a telephone company
3 where the acquisitions were found to be in the best interest of the public and not
4 for the purpose of inflating the rate base.

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

9 Q. Are there other such cases ?

10 A. Yes. For example, as far back as 1946, the Louisiana Public Service
11 Commission allowed rate base and cost of service treatment for an electric
12 company's acquisition adjustments stating that the criteria specified above had
13 been met. The Commission stated that:

14 "The owners of a public utility are entitled to earn and receive a fair rate of return
15 upon the money prudently invested in property used and useful in rendering
16 public service. Money is prudently invested, even though it is in excess of the
17 original cost of the property purchased, if the excess of purchase price over
18 original cost was paid as the result of arm's-length bargaining between
19 nonassociated buyer and seller, if the excess was necessary for the integration of
20 the property into a larger and more efficient system, and if the purchase
21 necessitating the excess did or reasonably should have resulted in public benefit
22 by improvement of service to customers or in lowered rates or both better service
23 and lowered rates. This integration cost or excess of purchase price over original

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

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

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

9 A. No. The Commission has in the past used the concept of Fair Value rate base
10 determination many times in the setting of rates for electric utilities. While the
11 majority of rate cases today are decided on an original cost basis, and Missouri is
12 normally regarded as an original cost state, the United States Supreme Court
13 (Southwestern Bell Telephone v. Public Service Commission of Missouri, 262
14 U.S.276; 43 S.Ct.544; 67 L.Ed. 981 [1923]) and the Missouri Supreme Court
15 (State ex rel, Missouri Water Co. v. Public Service Commission, 308S.W.2d 704,
16 718-19 [Mo. Banc 1957]) have stated in at least two opinions that the
17 Commission is to consider Fair Value information in the setting of rates when that
18 information is provided by the utility. Since I am not an attorney, I can only offer
19 a layman's view. From my reading of those decisions, I would say the
20 Commission has the right to use its judgment to set the value of property at the
21 level they believes is proper based upon the total evidence provided to them.

22 CAPITAL STRUCTURES

1 cost termed in prescribed system of accounts as 'Utility Plant Acquisition
2 Adjustments' should remain a part of the prudent investment during the life of the
3 physical property to which it was applied, and its extinguishment from the
4 investment when and if required by the Commission, should be accomplished by
5 amortization through annual charges to Operating Revenue Deductions during the
6 life of the property remaining after the date of the purchase which created the
7 excess."

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

16 In an interesting case that discusses what is meant by "Original Cost", the
17 Vermont Public Service Board in a gas rate proceeding in 1973 stated that:

18 "Original cost" relates to the cost incurred by the utility purchasing the facility,
19 not the original cost of a prior owner. Assuming prudent investment, the
20 stockholders should be allowed to earn a return on their actual 'out-of-pocket'
21 investment; the fact that the marketplace may place a higher or lower valuation on
22 the property does not affect the amount of the actual price paid by petitioner."

1 Q. The regulatory plan refers to the SJLP capital structure. Will you please explain
2 the significance of the SJLP capital structure?

3 A. In addition to the capital structure proposal that is to be used for the premium
4 recovery an additional part of the regulatory plan proposal in this case is a
5 determination by the Commission that the current capital structure (47% debt,
6 53% equity) of SJLP as a standalone operation be used as the capital structure in
7 setting future rates for the SJLP customers.

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

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

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

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

16 ALLOCATIONS

17 Q. The last item in the regulatory plan refers to the allocation of UtiliCorp's
18 corporate and intra-business unit costs and how the merger will impact those
19 allocations. Will you please explain why allocations are a part of the regulatory
20 plan?

21 A. Yes. The current allocation methodology has been used by UtiliCorp for some
22 time and allocates those costs through the use of various drivers (factors) to the
23 different business units.

1 Q. Does excluding the SJLP factors from the corporate allocations have an adverse
2 effect on the MPS operations?

3 A. No. The corporate and intra-business unit allocations to MPS will not increase if
4 the SJLP factors are excluded.

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

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

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

13 A. Yes. The total regulatory plan, while many items call for special regulatory
14 treatment, are provided as means that allow the economics of the transaction to
15 work and ensure, when done in total, that no customers will be harmed.

16 **RTOS AND MARKET POWER**

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

20 A. Yes. The Commission has requested other public utilities to address Regional
21 Transmission Organizations ("RTOS"). Consequently, the direct testimony of
22 UtiliCorp witness Mr. Richard C. Kreul will explain UtiliCorp's position in
23 regard to RTOS.

1 Q. Does the Commission have a rule that requires merging companies to file a Retail
2 Market Power Study?

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

6 Q. Will UtiliCorp and SJLP provide a retail market power study in connection with
7 this proceeding?

8 A. No. UtiliCorp and SJLP will include, as part of their merger filing with the
9 Federal Energy Regulatory Commission ("FERC"), a market power analysis as
10 required by the FERC. The Commission will be served with a copy of that
11 analysis. In this regard, there is considerable debate as to the form of the analysis
12 necessary to determine if merging companies will exert market power. At this
13 time the FERC only requires all merging companies to complete an "Appendix
14 A" analysis, which reviews the market power position of the merged company on
15 the wholesale market.

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

17 A. No. Retail competition does not exist in Missouri, and we are not sure when
18 choice will come for the retail customers. At this time, the only competitive
19 market is the wholesale market and, therefore, that is the only market that can be
20 meaningfully analyzed.

21 Q. When can such an analysis be accomplished?

22 A. Once the Missouri General Assembly and the Commission have decided when
23 competition will be allowed for the retail customer, and what form the market will

1 take, we will be able to perform a meaningful retail market power analysis. It is
2 premature to consider retail market power issues at this time since we have no
3 knowledge as to the form of the retail market. In any event, UtiliCorp, as the third
4 largest retail electric company in Missouri before and after the merger, does not
5 believe that the merged company will exercise any significant measure of retail
6 market power.

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

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

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

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

20 COMMISSION JURISDICTION

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

1 A. Minimal. It is my understanding that due to the merger, the Commission will lose
2 jurisdiction over the equity financing of SJLP. In all other respects, the
3 Commission's jurisdiction will remain intact including jurisdiction over
4 operations, customer service, revenues, rules and the retail rates. The corporate
5 offices for the combined company will remain in Missouri, and the Commission
6 will maintain complete access to the books and records of the merged company.

7 SUMMARY

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

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

12 Q. Does UtiliCorp and SJLP meet this requirement?

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

17 Q. Does this conclude your direct testimony?

18 A Yes.
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20
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22